

'Finally, a book that gives dozens of examples of innovative pricing. Even one idea that grabs your attention can create a fortune.'

*Philip Kotler, S.C. Johnson & Son  
Distinguished Professor of International  
Marketing at Kellogg School of Management,  
Northwestern University, USA*

ROUTLEDGE 

**SECOND EDITION**

# **INNOVATION IN PRICING**

**Contemporary Theories  
and Best Practices**

**Edited by Andreas Hinterhuber  
and Stephan M. Liozu**

# Innovation in Pricing

Pricing has a substantial and immediate impact on profitability. Most companies, however, still use costs or competition as their main basis for setting prices. Product or business model innovation has a high priority for many companies, yet innovation in pricing received scant attention until the first edition of this groundbreaking book.

This new edition of *Innovation in Pricing* builds on the success of the first, examining the ways in which pricing innovation can drive profits through cutting-edge academic research and best practice case studies from leading academics, business practitioners and consultants in pricing.

The second edition has been fully revised and updated according to the latest developments in pricing, with:

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- new chapters, including a chapter on business model and pricing model innovation
- a new introduction that makes explicit just what strategic pricing can do for your organization.

This book is the only book dedicated to innovation in pricing and is an essential read for business executives, innovation managers and pricing managers wishing to treat innovation in pricing as seriously as they treat product, service or business model innovation. It is also valuable supplementary reading for advanced students of marketing and sales.

**Andreas Hinterhuber** is a Partner of Hinterhuber & Partners ([www.hinterhuber.com](http://www.hinterhuber.com)). He is also a visiting professor at the University of Bolzano, Italy. He has led consulting projects in pricing in B2B and B2C companies worldwide, including Lufthansa, Tieto, International Paper, Continental, SPX, Fercam, Swarovski and many others.

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‘Getting a fair price for a superior offer should be value based. We at SKF believe that clearly demonstrated sustainable measured value is a cornerstone of gaining competitive advantage for the industry as a whole. We want our customers to be profitable and successful. This book is a must read for those who want to raise the level of performance of their enterprise to become a valuable contributor to the business sector they work in.’

*Vartan Vartanian, President, Industrial Market,  
Regional Sales and Service of SKF, Sweden*

‘An understanding of the mechanics of pricing is one of the key weak spots in the skill sets of those responsible for revenue generation – be they marketers or sales-people. I’ve waited a long time for a book that successfully opens up the mysteries of innovative pricing.’

*David Thorp, Director, The Chartered Institute of Marketing, UK*

‘The brilliance of *Innovation in Pricing* is the ease with which Hinterhuber and Liozu bridge the vexing scholar–practitioner chasm by stripping complex pricing ideas down to their pragmatic utility. By introducing innovative dimensions for thinking strategically about how components of the pricing mix can be optimized, their book is an essential read for executives and consultants in search of new combinations to revitalize the pricing function as a source of competitive advantage and value creation.’

*Nnaoke Ufere, CEO, iServiceX, Inc., USA*

‘Companies spend vast amounts of resources in R&D, engineering and marketing while, most of the time, neglecting their pricing and value strategies. This book shows that pricing is a critical dimension of marketing strategies and that pricing innovation can bring the best out of these strategies. It also emphasizes the multi-dimensional nature of pricing which requires innovation, creativity and breakthrough thinking.’

*Andreas Ising Schulze, CEO, Advanced Polymer  
Technology Corp., USA*

‘I really enjoyed reading this book as it is one of the very few books written from a true marketing angle and giving a real attractiveness to pricing theory. Consistent with the definition of an innovation, the authors suggest to CHANGE THE RULE of pricing and display a comprehensive list of pricing strategies to align price and value. Congratulations for this revolution in pricing!’

*Paul Millier, EM Lyon, France*

‘This book is full of the latest pricing strategies practicing executives and researchers on marketing have to know.’

*Atsuo Utaka, Kyoto University, Japan*

# **Innovation in Pricing**

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**Part I**

**Introduction**



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# 1 Innovation in pricing

## Introduction

*Andreas Hinterhuber and Stephan M. Liozu*

Few companies treat innovation in pricing as seriously as they treat product or business model innovation. One key objective of this edited volume is to raise the importance of innovation in pricing, both in academia as well as in the industry.

### **A historical perspective on innovation in pricing**

Five decades ago, in 1968, Elizabeth Marting edited the book *Creative Pricing*. This book is a collection of papers by 19 scholars and pricing practitioners on creative pricing approaches. The book covers the following topics: the role of pricing, pricing policy and objectives, nonfinancial aspects of pricing, pricing by distribution channel, pricing by product type, the use of computers in pricing and management of price changes. In the foreword, Elizabeth Marting comments (Marting, 1968: 5): “It is the thesis of this book that with sound planning, flexible techniques, and adequate support, pricing can be made to have a positive, productive impact on company profits; in short, that it can be creative.” We agree. Pricing can and should be a topic of innovation and creativity.

In the first chapter, Oxenfeldt suggests (Oxenfeldt, 1968: 9), “The notion that pricing can be creative is itself quite creative and new.” For decades, research in pricing has been dominated first by economic theory and later by cost accounting. We conjecture that price strategists and price setters have the opportunity to be creative, although “it runs counter to the writing and thinking of most economic theorists” (Oxenfeldt, 1968: 10).

The questions raised 50 years ago are still valid. The answers as to what constitutes an innovation in pricing have changed.

### **What is innovation in pricing?**

Innovation in pricing regards instances in which companies innovate their pricing strategies, tactics or organization, or where companies use an understanding of consumer psychology to change customer perceptions of value and price in order to jointly increase profits and customer satisfaction (Hinterhuber & Liozu, 2014). The premise of this book is that most managers spend a disproportionate amount of time and resources on product or business model innovation while essentially

neglecting innovation in pricing. This book aims to change this by offering a collection of best practices and relevant research on innovation in pricing.

## **Contents overview**

This book is the result of a rigorous selection process of the most insightful papers dealing with innovation in pricing. Our initial call for papers generated a high interest from both academia and pricing professionals. Ultimately, over 50 papers were submitted for review. After a review process we selected 25 papers. For this second edition, we added 3 and eliminated 5 chapters from the original first edition. They are organized in four sections: innovation in organizing the pricing function, innovation in pricing strategy, innovation in pricing tactics and, finally, psychological aspects of pricing.

*Andreas Hinterhuber* and *Stephan Liozu* provide a roadmap for innovation in pricing (Hinterhuber & Liozu, 2014). The authors identify a total of 21 alternative approaches of how companies can implement innovation in pricing strategies, in tactics and in the organization of pricing. Each of these approaches is illustrated with a short case study or example. This roadmap starts with a simple premise: about 95 percent of companies do not engage systematically in pricing innovation. Most companies invest heavily in product innovation and essentially neglect innovation in pricing. This is an error. The benefits of this roadmap are straightforward: by implementing two to three approaches of innovation in pricing strategy, tactics or organization companies can, this research suggests, substantially increase profits and customer satisfaction conjointly via pricing. This is the ultimate hallmark of an effective pricing strategy.

### ***Innovation in organizing the pricing function***

*Stephan Liozu* and *Kellie Ecker* examine options for the organizational design of the pricing function in firms. They conduct a literature review on centralization and decentralization. Four possible designs of the pricing function are proposed: centralized, decentralized, center-supported and center-led. The authors conjecture that center-led pricing, which combines elements of centralization with elements of decentralization, is superior to other organizational designs. The authors also present their own research on the effectiveness of center-led pricing. The authors hope that these research findings contribute to the ongoing debate on organizational design of pricing for performance.

*Niklas Hallberg* and *Linn Andersson* investigate the organizational barriers that prevent companies from implementing innovative pricing strategies, such as value-based pricing. This research, based on two case studies, identifies two main barriers: excessive decentralization and sales force incentive schemes. The authors also discuss how firms address these challenges: centralization of pricing authority and increased sales force control and training. The results of this study indicate that innovation in sales-force management and, more specifically, centralization of pricing authority are key success factors for the implementation of

value-based pricing through customer value map analysis, especially when sales force value-based pricing and value-based selling capabilities are not yet fully developed. Examining this interaction effect between decentralized pricing capabilities and the effectiveness of centralizing pricing authority is certainly worthy of future study.

*Stephan Liozu, Andreas Hinterhuber, Sheri Perelli and Toni Somers* explore the topic of the role of top executives in supporting and leading corporate pricing activities and programs. The authors report the results of a quantitative inquiry with 557 CEOs and business owners of firms from around the globe examining how CEO championing of pricing affects pricing capabilities and firm performance. The authors propose a structural model, which includes first- and second-order measurement models. The results suggest that the level of championing from CEO and business owners in pricing positively influences firms' decision-making rationality, pricing capabilities, level of collective mindfulness and pricing orientation, thereby leading to significantly higher firm performance. This study is thus a strong call to action for CEOs aiming to improve organizational performance. The main implication: champion the pricing function.

*Ronald Baker and Stephan Liozu* conjecture that the nature of senior management is changing. Firms face strong levels of competitiveness, and their business models are being challenged as a result. The authors suggest that value management at the organizational or corporate levels is becoming a number-one priority. Although chief marketing and chief commercial officers are highly qualified to manage value processes, they do so along with performing a multitude of other functions or processes that distract their attention from the core function of value management. The authors propose that chief value officers, whether functionally or process-oriented, offer CEOs an expert and an ally dedicated to leading value strategies and processes at the organizational level. With their expertise, drive and dedication, they manage business value centrally and make sure that all firm processes and functions are aligned to create, quantify and capture value. This focused attention on value leads to a transformation of the firm's DNA and the adoption of business value as the firm's *raison d'être*.

In an interview *Andreas Hinterhuber and Todd Snelgrove* explore how a Vice President of Value can drive profits in industrial markets. This emerging, fascinating and demanding position requires, of course, customer value quantification and documentation, creating case repositories of quantified value, capturing the voice of the customer for marketing and new product development and maintaining the organizational momentum in value-based pricing and selling. Value quantification is demanding; few companies excel at this capability. Among the not yet fully resolved questions is the issue of how to quantify the value of intangible elements in B2B, such as the value of relationships, brands or expertise. Quantifying intangibles, the authors suggest, essentially means translating intangible elements into tangible features that customers value.

*Mark Stiving* examines the difficult topic of measuring return on investment (ROI) for pricing systems investments (Liozu & Hinterhuber, 2014). The author clarifies the benefits of using IT-based pricing systems by explaining their three

biggest capabilities (execution, analytics and science) and the types of data typically used by these systems: customer master, transaction data, waterfall data and competitor pricing. The benefits of using IT-based pricing systems can be found in increased margin, increased win rates, more opportunities, lower costs and reduced liabilities. Finally, attention is paid to the set of steps to incorporate all these elements in an ROI study.

### ***Innovation in pricing strategy***

*Stephan Liozu* and *Katie Richardson* examine the role of business model innovation in the context of innovation in pricing. The authors highlight that innovation in pricing requires effective market segmentation, customer value quantification, change management, sales force training, management of distribution channels and an understanding of how to integrate new pricing models with legacy pricing structures. Finally, new pricing models should be tested before implementation.

*Rafael Farrés* further investigates the role of customer value-based pricing in industrial companies. The author makes it clear that even research-intensive, innovative companies should adopt a variety of alternative pricing strategies across their product and service portfolio. The author highlights firm and environmental conditions that make value-based pricing particularly suitable and illuminates under which conditions cost- and competition-based pricing approaches are appropriate for industrial firms. The author also presents a series of pricing tools that have enabled industrial companies to implement value-based pricing strategies: the price waterfall, the price-value map, turnover build-up, terms and conditions analyzer, the pricing explorer and the price-volume scatter plot. Especially for practicing executives at the beginning of the transformational journey towards value-based pricing, the discussion of these pricing tools and metrics will be useful.

*Linda Trevenen* proposes a grounded and practical essay on the art and science of customer segmentation, which she refers to as the heart of a profitable market strategy. In this chapter, she suggests that grouping customers based on what they value enables a firm to provide distinct offerings and prices to each of these customer groups. However, too often, many firms do not make the effort to segment their customer base or simply fall back along traditional segmentation lines – demographic or geographic – because these data are available and require minimal effort to distinguish between customer types. As a result of not applying a deeper needs-based segmentation, the firm is faced with price variability, lack of adherence to contracts and a culture of ‘giving in’. The author makes a few recommendations that smart firms can apply for better customer segmentation: set boundaries and fences, create pricing policies and have a deeper level of customer understanding that leads to profitable growth. This chapter explains the importance of segmentation and the strategies and practical activities for deploying it, and it describes how to implement segmentation best practices into the organization so that a segmentation strategy realizes greater profitability.

*Ralf Drews* conjectures that, in many companies, the ‘value-based pricing’ of a new product offering is applied only after the product has passed all design stages in R&D. In addition, often the pricing approach is focused only on the

offering itself. Although it seems to be common practice, the author argues that this approach has major disadvantages. First, the pricing is neither considered nor made in the context of a company's other important value contributors. Second, the value of the product's features is unclear because they are not seen in the context of application. Last but not least, the new product is not tailored to the needs of a specific customer profile or to cultural buying preferences. If companies seek to create a product with superior value, it must be defined and priced before R&D even knows what it will look like. Furthermore, it is critical that the buying psychology of a specific customer be taken into account. In this unique chapter, the author describes how companies can achieve this and which critical success factors are necessary for this uncommon but useful approach.

*Magnus Johansson* investigates the role of pricing capabilities and processes in fast-paced B2B firms. Extant theory treats the two processes of value creation and value capture (i.e. pricing) separately. This chapter suggests departing from this conceptual separation when dealing with pricing and value creation processes in fast-paced business environments, such as the semiconductor industry. In these environments value creation and value capture are iterative and intertwined, value is co-produced together with customers, and there is a high uncertainty around the total value jointly created between the supplier and the firm. This chapter suggests that, in these circumstances, pricing processes have to be iterative as well and that price-setting authority has to be more localized. The contribution of this chapter is thus a sketch of required pricing capabilities and processes in highly dynamic environments, which are markedly different from capabilities and processes described by extant research in static environments.

*David Dvorin, Jered Haedt and Vernon Lennon* address one of the critical elements of the mergers and acquisition process: improvements in pricing. The authors propose a robust framework for assessing opportunities of improving pricing during the mergers and acquisition process; they also highlight how to implement price increases during this process. The authors finally summarize the impact of price improvements on the enterprise value of merged or acquired businesses.

*Nelson Hyde* discusses four widely held pricing myths. Pricing managers seem to believe that lower prices lead to higher volumes, that customers are price-sensitive, that prices have to be set at prevailing market prices and that lower prices increase the likelihood of closing the sale. These assumptions are, as this chapter suggests, myths that prevent companies from creating and communicating customer value and from implementing value-based pricing. Overcoming these myths thus enables companies to adopt customer value-based pricing strategies.

*Todd Snelgrove* traces the past and present of total cost of ownership (TCO) approaches and highlights in which direction TCO could evolve. As the 'sum of purchase price plus all expenses incurred during the productive lifecycle of a product minus its salvage or resale price' (Anderson & Narus, 2004), this approach is exclusively concerned with the cost side of customer value and neglects the value of customer-specific benefits (Anderson & Narus, 2004). In this chapter the author shows how TCO approaches can be expanded to incorporate the value of customer-specific benefits. Through case studies, this chapter illustrates the

difference between lowest initial purchase price, lowest TCO and an expanded view of TCO that includes the sum of all customer-specific value created. This chapter also highlights the importance of communicating the price and value premium in industrial markets. The contribution of this chapter is thus to illuminate that TCO can be compatible with customer value-based pricing.

*Fernando Resende* discuss how to optimize profitability through pricing in an environment where prices are negotiated. This chapter illustrates how suppliers of complex projects can reduce their own costs through scope optimization and service-level adaptations. This chapter also suggests ways to avoid price leakage through discount optimization and through a shared understanding of future required volumes, service levels and price developments.

### ***Innovation in pricing tactics***

Customer value communication is an integral element of pricing tactics. *Christopher D. Provinces* analyzes a series of different value-communication tools in business markets. These tools differ by interactivity and complexity. Non-interactive tools are economic benefit claims that are developed based on observational studies or customer interviews. Interactive tools are decision-support analytical models such as ROI tools and value calculators. Complex interactive tools are workflow and business-model studies. This chapter then suggests using different value communication tools depending on the degree of outcome risk and the complexity of the product offering. In sum, this chapter offers an up-to-date summary of case studies and recent research on innovative ways to communicate customer value in B2B markets.

*Harry Macdivitt* reinforces the fact that understanding, using and communicating the value created for their customers is a challenge for many businesses. He claims that this results in an inability to respond assertively and confidently to customer demands for deep discounting. Margin erosion, premature commoditization and loss of market share follow. At the heart of the issue is the lack of a unifying framework for analyzing, quantifying and communicating value. In this chapter, the author introduces a framework for analyzing customer value. He illustrates the application using two contemporary case studies. The author claims that the proposed tool led to new insights and the creation of deeper, richer and more focused customer value propositions. This structured approach thus facilitates the implementation of customer value-based pricing.

*Neil Biehn* and *Craig Zawada* examine alternative approaches to measuring customer willingness to pay. The quantification of customer willingness to pay is clearly at the center of effective, profitable pricing strategies. The authors critically examine alternative approaches to measuring customer willingness to pay in industrial markets. The authors then illustrate the importance of measuring customer willingness to pay in five specific B2B pricing models: spot pricing, agreement or contract pricing, list or matrix pricing, subscription pricing and promotional pricing.

*Steven Forth* highlights the role of collaboration and conversations between stakeholders to implement innovative pricing approaches. Traditional pricing-management software is based on the analysis of transactions and its use has been limited to quantitatively oriented pricing experts. In this chapter, the author describes software for quantifying customer value. The software quantifies customer value to enable collaborative processes around the pricing of B2B goods and services in negotiated markets. Collaborative approaches facilitate customer value quantification. The author suggests that in the future, pricing will need to draw on and support a more diverse group than in the past.

The sales function has a fundamental role in the process of communicating and delivering value to customers. *Mike Moorman* proposes a sales-effectiveness framework composed of three parts to implement value-based selling. First, an analysis of competitors, customers and markets delivers customer insight. Then, the go-to-market-strategy is built on a segmentation strategy, a value-proposition strategy, a channel strategy and a robust sales process. Finally, operational excellence aligns sales resources, sales force capabilities, motivation, tools, marketing programs and sales support tools to implement value-based selling vis-à-vis customers. The key feature of this chapter is a structured approach blending customer, company and competitor insight (Hinterhuber, 2004) to implement value-based selling.

### ***Psychological aspects of pricing***

*Ben Lowe, Julian Lowe and David Lynch* provide a comprehensive overview of behavioral aspects of pricing. Behavioral economics has now definitely entered the mainstream research in management. In a recent special issue of the *Strategic Management Journal* (Powell et al., 2011), Levinthal (2011) asks the question, “A behavioural approach to strategy – what’s the alternative?” Research examining behavioral and psychological aspects of pricing seeks to understand how customer perceptions of value and price are formed. Consequentially, the chapter analyzes the following salient aspects of behavioral pricing: factors driving customer value perceptions, the role of internal and external reference prices, fairness perceptions in pricing, implications for price reductions (e.g. discounts, coupons, free gifts) and price increases, price endings, price quality perceptions, consumer price knowledge and, finally, price setting in nonmarket contexts. This chapter emphasizes that customer willingness to pay is driven by both utilitarian value (“economic utility”) and psychological value (“psychological utility”). As pricing and marketing managers gain an improved understanding of factors driving psychological value, their ability to set profitable prices also increases.

*Carmen Balan* specifically examines research on odd prices. Odd prices (e.g. 99 cents) have a long history. In 1965, the retailer Dave Gold discovered that charging 99 cents for all bottles of wine increased sales of all bottles, including those that previously had cost 89 cents or 79 cents. He exited the liquor business and became a highly successful entrepreneur after launching the 99 Cents Only

chain of stores (Porter, 2011). This chapter summarizes current research on odd prices, which points out that odd prices lead to increased demand due to both a level effect (i.e. customers underestimate prices) and an image effect (i.e. the product appears to be on sale). Odd prices still seem to work, although most of what we know stems from research in consumer-good markets. This chapter suggests both an increased use of odd prices in industrial markets as well as further research examining the effects of odd prices in B2B environments.

### ***The next frontier in pricing***

The final chapter in this collection is by *Kevin Mitchell*. This chapter highlights the evolution of the pricing profession over the past three decades. Pricing evolved from a clerical position to a tactical, commercial function to, finally, a C-level function deeply aligned with – and in many cases driving – company strategy. The author highlights the reflections of the Professional Pricing Society on critical elements for the future of the pricing function.

As the editors of this book, we have been honored to work with highly talented pricing practitioners and scholars from around the world. We feel blessed by the level of innovative and creative thinking that we have been able to bring to the surface by giving these experts an opportunity to share their thoughts, approaches and views. We thank all authors for their contributions to and participation in this exciting project.

It is our intention to contribute to the future evolution of the pricing profession. We are dedicated to making pricing gain the respect it deserves and to transforming the perceptions of pricing from a pure analytical and static science to a more strategic, innovative and impactful element of the marketing mix. Please join us in our journey to advance the pricing profession.

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## 2 **Is innovation in pricing your next source of competitive advantage?**<sup>1</sup>

*Andreas Hinterhuber and Stephan M. Liozu*

Is product innovation a top priority for you? You certainly are not alone. Have you tinkered with your company's business model and considered business-model innovation? Great, but your competitors have done this already, and your customers may even expect it. But what about another area that is less recognized but yet a crucial factor in product innovation: innovation in pricing? Could it be your next source of competitive advantage? As a result of a series of interviews with CEOs and top management and after researching pricing practices at leading companies in the U.S., Europe and Asia (see "About the Research"), we estimate that less than 5 percent of companies have applied innovation to their pricing strategy, tactics or organization. Our research also shows that companies that implement innovation to their pricing activities significantly outperform their competitors. Thus, chances are good that innovation in pricing is your next and most powerful source of competitive advantage.

Based on our research, we develop a framework for action to kick-start innovation in pricing. This roadmap is a unique overview for both understanding current global best practices of innovation in pricing and for guiding organizations to successfully implement innovation in pricing. The roadmap, which lays out more than 20 possible avenues for innovation in pricing, will offer any organization, regardless of size, industry or nationality, a few key ideas on innovation in pricing. Our research suggests that this is enough. Many highly successful companies – Zipcar and Salesforce.com to name a few – have built their competitive advantage essentially around one, and only one, pricing innovation.

In this chapter, we first define innovation in pricing and discuss why it is too often neglected. Then, we develop our roadmap for action. Following that, we delve into the essence of the framework by showing how using innovation in pricing strategy, pricing tactics and pricing organization can lead to superior profits and increased customer satisfaction.

### **What is innovation in pricing?**

Most companies, unfortunately, view pricing as antagonistic, a win-lose relationship with customers. What one party gains the other loses, or so goes the weakly held assumption. Our research shows innovation in pricing helps to break this

vicious cycle. Such innovation brings new-to-the-industry approaches to pricing strategy, pricing tactics and pricing organization with the objective of increasing customer satisfaction and company profits. As we show throughout our examples, the joint increase of company profitability and customer satisfaction constitutes the hallmark of innovation in pricing.

The experience of General Electric illuminates the importance of innovation in pricing. In the past the company was selling aircraft engines to airlines at or below cost in the attempt to recover profits through non-transparent maintenance contracts. Customer satisfaction was low-service contracts were expensive and capital outlays were high. GE struggled to bridge the gap between its own capital outlays and cash inflows. Innovation in pricing enabled the company to overcome both problems. Instead of selling jet engines, GE now sells “power by the hour,” that is, usage rights to jet engines that include maintenance and spare parts. Customers pay only when the aircraft is flying and thus earn money. In contrast to maintenance contracts, GE now has every incentive to ensure that the jet engines perform. As a result, profits, as well as customer satisfaction, increase dramatically. In a very similar vein, the success of companies, such as Salesforce.com or Zipcar, is not based on product innovation but rests solidly on innovative approaches to pricing. Salesforce.com does not sell software but licenses usage rights to customers who appreciate the advantage of tying payments to usage intensity. Contrast this with traditional software pricing where customers pay a fixed fee regardless of the benefits experienced. Similarly, Zipcar’s success in the car rental industry is not due to better vehicles or improved customer service, but lies predominantly with the company’s pricing schemes, which give customers the option to pay for rental cars on a much more flexible basis – by the minute.

Innovation in pricing is thus already a source of competitive advantage for a small number of leading companies. It is less about numbers and much more about the appropriate model that will enable a company to grow profitably while at the same time providing superior customer satisfaction. If innovation in pricing is such a powerful tool to drive profitability, why are so few companies embracing it?

### **Why innovation in pricing is not a priority**

Our research suggests that product or service innovation is a top-management priority for close to 100 percent of companies. But only 5 percent of companies introduce new-to-the industry pricing innovations. During our interviews, we find only one case of a company that has implemented an innovative pricing strategy. This company, a B2B equipment company, has, like GE and its “power-by-the-hour” approach, shifted from selling products to charging customers a given fee that reflects the enhanced productivity realized and which includes service, maintenance and performance guarantees. This new approach propels the company from an also-ran to an industry leader in terms of customer satisfaction, growth and profitability.

As interesting as this single case may be, it is an exception. The typical answer to our question of whether the company has engaged in any form of innovation in pricing is “No, we have not introduced any innovation in pricing.” Many executives, who are frequently true pioneers in other fields, such as product innovation, marketing, finance or talent development, seem to hold the following weakly held conviction: “Pricing did not change that much over the past decade. Why should it change now?” This conviction may have been nurtured in part by the fact that, with the exception of a few pioneering studies (e.g. Hewitt & Patterson, 1961; Hinterhuber & Liozu, 2013; Nagle, 1983), academic research in this area is still scarce.

We contend that it is a mistake to underrate the position of pricing as enabler of innovation. Powerful advances in information technology as well as emerging dynamics in customer behavior are dramatically changing what is possible in pricing. Our research suggests that the following roadmap can provide a strong framework to guide innovation in pricing.

## **Roadmap for innovation in pricing**

This framework (Figure. 2.1) starts with a simple premise: About 95 percent of companies have not systematically engaged in innovation in pricing. For these companies, pricing strategy is largely based on competition- or cost-based pricing, and pricing tactics are limited to discounting. Furthermore, these organizations do not have a dedicated function – for example, a chief pricing officer responsible for improving price setting or price-getting capabilities. The essence of the framework is the three key areas that our research suggests are critical in approaching any pricing innovation – strategy, tactics and organization. This framework should be used as a canvas for executives to facilitate the plotting of their current pricing practices. More importantly, by mapping out the universe of best-practice innovations in pricing, this canvas encourages executives to consider alternative approaches to pricing. Next, we break down the essential elements of the framework and look at innovation in pricing strategy, tactics and organization.

## **Innovation in pricing strategy**

### ***Good-better-best market segmentation***

One way to implement innovation in pricing strategy is to move from a one-size-fits-all pricing policy to a policy with multiple price and value configurations, reflecting differences in value creation for different market segments. Good-better-best market segmentation offers customers a large number of products at different price points in order to address a broad array of customers having large variations in willingness to pay. Allstate, one of the most profitable auto insurance companies, is able to successfully compete against no-frills Internet competitors through a policy of price and value segmentation. Depending on the customer’s brand/

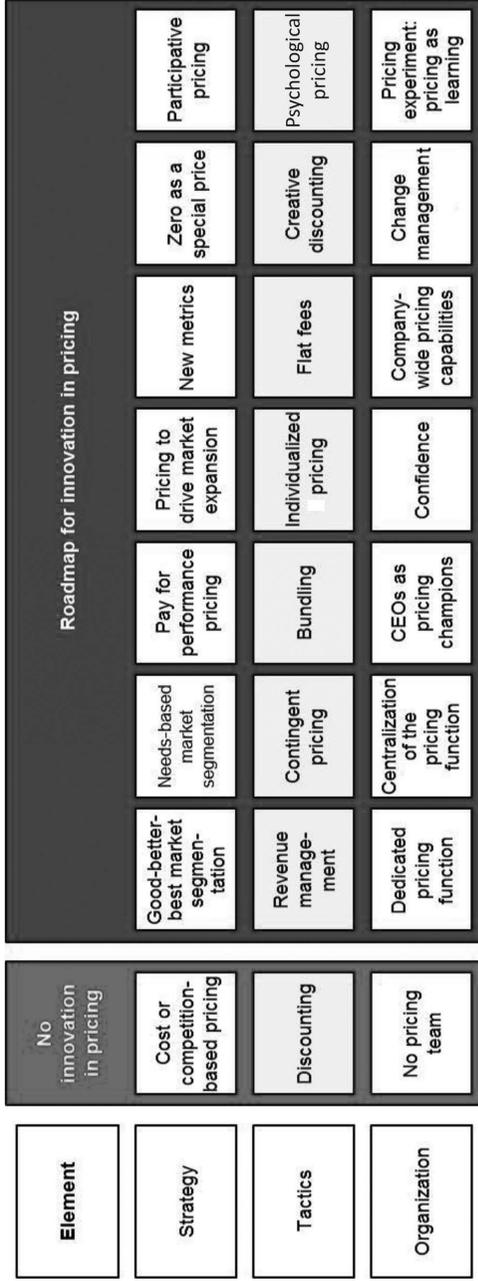


Figure 2.1 A roadmap for innovation in pricing

price sensitivity and her need for customer support, Allstate divides customers into four distinct clusters (high/low brand sensitivity and high-low self-service) and competes in these different market segments through four distinct brands, offering a substantially different customer experience at different price points.

### ***Needs-based market segmentation***

Although a good-better-best market segmentation is an innovation for many companies, this approach has an important limitation: Customers typically struggle to understand to which degree these different products meet their needs. In other words, customers have very specific and complex needs rather than just the desire to purchase a low price, mid-price or premium price product. Recent academic research suggests that needs-based market segmentation is the current gold standard in market segmentation (Best, 2012; Kotler & Keller, 2011). Practitioners agree: Hans Strasberg, CEO of Electrolux, the Swedish household appliance manufacturer, says, “Given the differences in what customers value, we have abandoned the traditional industry segmentation based on price and a ‘good-better-best’ hierarchy. Now our segmentation has as many as 20 product positions that relate directly to different lifestyle and purchasing patterns of consumers” (Knudsen, 2006: 76). A needs-based market segmentation allows the company to simultaneously offer a multitude of products in the premium as well as in the entry-level category with close to zero cannibalization, since these products are squarely targeted at clearly distinct needs of well-defined customers. Since the global rollout of its needs-based market segmentation approach, Electrolux has by far outpaced its competitors in terms of growth and profitability.

### ***Pay-for-performance pricing***

Here the seller is paid depending on performance outcomes determined conjointly with the customer. Consider the following example: The U.K., Sweden, Australia and Canada are among the few places where the reimbursement of new pharmaceutical products is closely tied to criteria reflecting the new product’s incremental value over existing therapies. For new pharmaceuticals, the U.K. has a threshold range of £20,000 to £30,000 per QUALY (quality-adjusted life year). In this environment, Velcade (bortezomib) by Johnson & Johnson (J&J), a product for treating multiple myeloma, is considered not cost effective since treatment costs are approximately £3,200 per treatment cycle, or £40,000 per QUALY. Traditional pricing approaches would have suggested either to drop the price to reach the threshold (implying a price drop by up to 50 percent) or to exit the U.K. market. J&J, however, proposed an alternative pricing approach to regulatory authorities. Under the new pricing scheme, J&J links reimbursement to effectiveness. Only when patients respond fully to the new drug do they remain on therapy and the National Health System funds it. When patients show a minimal or no response the treatment ceases, and J&J bears the full cost. This new approach (full reimbursement in case of no response) reduces the costs for patients on therapy to

approximately £22,000 per QUALY. As a result, Velcade is today the market share leader in the U.K. while also being the most expensive therapy in this segment.

Advertising, industrial services (e.g. software, consulting, logistics and transportation) and complex engineering projects are other areas where pay-for-performance pricing is currently widespread. Performance-based pricing is costly in large part because monitoring is intensive. Nevertheless, we expect to see a substantial increase in these arrangements in other areas in the future, very likely in consumer-goods markets.

### ***Pricing to drive market expansion***

Rather than compete for market share, innovative pricing approaches expand the overall market. The pricing of Ford's Model T is an example: In the years between 1910 and 1925, Ford reduced prices by approximately 80 percent, thus expanding sales volume more than 50-fold. In his autobiography, published in 1922, Henry Ford states:

Our policy is to reduce the price, extend the operations, and improve the article. You will notice that the reduction of price comes first. We have never considered any costs as fixed. Therefore we first reduce the price to a point where we believe more sales will result. Then we go ahead and try to make the price. We do not bother about the costs. The new price forces the costs down. The more usual way is to take the costs and then determine the price, and although that method may be scientific in the narrow sense, it is not scientific in the broad sense, because what earthly use is it to know the cost if it tells you that you cannot manufacture at a price at which the article can be sold? But more to the point is the fact that, although one may calculate what a cost is, and of course all of our costs are carefully calculated, no one knows what a cost ought to be.

(Ford, 1922: 146)

In a very similar vein, IKEA does not allow costs to dictate prices. IKEA starts with determining prices based on what key customer segments are willing to pay. The company then works backwards to determine allowable costs. This focus on prices as drivers of cost allows IKEA to continuously expand the overall market for home furniture.

### ***New metrics***

Innovative pricing strategies align pricing with customer goals. This frequently leads to new pricing metrics. Theodore Levitt, a marketing professor at Harvard Business School, famously quotes Leo McGinneva about why people buy quarter-inch drill bits: "They don't want quarter-inch bits. They want quarter-inch holes" (Levitt, 1986: 128). Figure 2.2 shows how some companies benefit from implementing innovative pricing metrics. In all these cases, companies align the

<i>Company</i>	<i>Traditional pricing strategy</i>	<i>New pricing metric</i>	<i>Result</i>
<b>BASF</b>	Paint sold on a per kg basis to car manufacturers.	Outcome-based pricing. Price is set per painted car.	High customer satisfaction. Joint collaboration with customers to reduce environmental impact and paint consumption.
<b>Michelin</b>	Truck tires sold at largely fixed prices.	Michelin Fleet Solutions sells mobility. Pricing is based on performance (per km) and includes maintenance.	Initial difficulties (new business model), expansion across Europe at above-average margins.
<b>Schindler</b>	Elevators sold at cost-plus prices.	Sale of usage rights. Variable pricing based on distance and number of passengers transported.	Market share growth in competitive market; access to new customer segments.

*Figure 2.2* Innovation in pricing – new metrics

basis of their own pricing policies with clearly defined customer outcomes. This interest alignment enables high customer satisfaction, thus overcoming customer resistance to a change in pricing approach.

***Zero as a special price***

Zero is a special price that uniquely captures customer attention (Shampanier et al., 2007). A number of companies seem to have mastered the art of profitable growth while essentially giving away the main product. Ryanair, with average flight revenues of 40€ per customer, barely breaks even on its flight operations. Yet it is Europe’s most profitable airline, largely as a result of the profitability of its ancillary revenues from third parties, early boarding fees, baggage fees or onboard sales. Skype (Internet calls are free, fixed-line calls are sold at regular prices), Google (search is free, advertisement is sold), fast-consumption newspapers (given away for free, advertisement is sold) and open-source software (standard models are free, customized versions are sold) compete very successfully by using similar pricing strategies.

***Participative pricing***

Recent advances in information technology enable the customer to take an active part in pricing. Participative pricing comes in two forms: Name your own price

and pay what you want. Name your own price (NYOP) mechanisms ask customers to submit a bid price for a product. The customer receives the product only if this bid price is larger than an unknown threshold price. Priceline, of course, is a prime example in this respect. NYOP enables a large degree of price discrimination among customers. NYOP is more profitable than fixed prices if the seller is a monopolist; with competition, NYOP increases profitability if it allows a company to expand its current customer base with price-sensitive customers who would otherwise not purchase (Shapiro, 2011). NYOP also contributes toward mitigating competition, since customers differ in their bidding costs. NYOP firms thus target customers with low bidding costs while fixed-price sellers target customers with high bidding costs (Fay, 2009). Based on these considerations we thus expect that NYOP mechanisms will gain in popularity, quite likely in industrial markets.

Pay What You Want (PWYW) allows the customer full discretion in price setting. In contrast to NYOP mechanisms, sellers have to accept any price, including zero. Examples of PWYW pricing can be found in information services (e.g. Wikipedia), in museums (voluntary contributions), in the music industry (e.g. Radiohead) and in the hotel and restaurant industry. Fairness considerations, social norms and credible threats by the seller to switch back to fixed prices (Mak et al., 2010) seem to motivate customers to pay non-zero prices. In three experimental studies involving restaurants and cinemas, PWYW pricing leads to lower average prices than previously posted fixed prices but higher revenues due to new demand. Thus, participative pricing can be beneficial for sellers as well as for customers (Kim et al., 2009).

## **Innovation in pricing tactics**

### ***Revenue management***

Revenue management is probably the most successful tactical pricing innovation in service industries. Successful implementation increases company revenues by 3 percent to 7 percent and profits by 30 percent to 50 percent (Skugge, 2004). Revenue management varies price levels and bookable capacities conjointly to optimize profitability. This tactic has evolved from the travel industry (airlines, then hotels, then rental cars and finally cruise lines), to leisure services (golf courses, sport clubs, restaurants), to industrial services (freight transportation, advertising time) and finally to consumer services (equipment rental, home repair). It can be applied in industries characterized by the following features: fluctuating demand, existence of different customer segments, fixed and perishable capacity, high fixed costs, low variable costs and predictable demand. We anticipate that in the future, capital-intensive industrial manufacturers will consider applying revenue management to at least part of their supply. As a testimony, Infineon, a leading chip manufacturer, is currently experimenting with dynamic pricing (Ehm, 2010).

### ***Contingent pricing***

As an alternative to a fixed high- or low-price strategy, contingent pricing is an arrangement to sell a product at a low price if the seller does not succeed in obtaining a higher price offer during a specified period (Biyalogorsky & Gerstner, 2004). As an example, Caterpillar sells its spare parts to dealers with the option to repurchase the product at a 10 percent price premium in case another dealer or customer runs out of stock and has an urgent need for the product in question (Sheffi, 2005).

### ***Bundling***

Bundling – selling two or more products or services as a package – increases profits since it allows companies to appropriate a larger share of customer surplus if customers differ in their relative valuation of single components. Vacation packages, car accessories, software and subscriptions (e.g. Internet and print editions) are prime examples of bundling. Also here, innovative pricing tactics allow an increase in both customer satisfaction and firm profits.

### ***Individualized pricing***

Information technology enables service companies (e.g. insurers) to charge substantially different prices for identical products or services based on individual customer data. SunTrust, one of the largest U.S. banks, is implementing individualized pricing for car loans and home mortgages. The company uses software to search for instances where it undercharged customers willing to pay more for a home mortgage; the software also detects cases where the company lost business due to excessively high prices. The software finally produces an optimized, individualized price for different customers (Kadet, 2008).

### ***Flat fees***

Flat fees are gaining popularity. Telephone companies, train companies, health clubs, amusement parks, restaurants, Internet retailers (e.g. Amazon and its unlimited free shipping option of its Prime program) and even executive airline companies (e.g. California-based Surf Air) allow customers unlimited consumption for a fixed fee. Academic researchers document that pure economic interests do not motivate customer preferences for flat fees. Customers typically end up paying more with a flat fee than with a conventional pay-per-use plan, yet customer satisfaction is higher. Thus customers pay more and are, nevertheless, happier.

### ***Creative discounting***

Robust processes for defining and monitoring discounting practices are a prerequisite to drive profitability via pricing. Even if these processes are in place,

aggressive customers or aggressive competitors can exercise pressure on sales personnel to relax these rules and grant price concessions. Our own research shows that leading-edge companies apply creativity to their discounting practices rather than slashing their prices across the board. One example of creative discounting is *non-linear pricing* where prices develop non-linearly with product volume. This tactic can be found in air travel (special offers for spouses paying less than the full price in business class), banking services (monthly account fees drop with the number of products held by account holders) and in all instances where paid-for membership cards (e.g. Costco) entail purchases at discounted prices. Another example is in *steadily decreasing discounting* (Tsiros & Hardesty, 2010) where discounts are gradually phased out (e.g. in week 1 by 40 percent, in week 2 by 30 percent, in week 3 by 20 percent discount, etc.) as opposed to an immediate reduction in discounts under high-low pricing. Current research shows that steadily decreasing discounts lead to higher future price expectations of customers (prices increase over time as discounts are gradually phased out), which in turn leads to higher quantities purchased in the current period. *Bonus packs*: Current academic research (Chen et al., 2012) demonstrates the following counterintuitive finding: although customers should be indifferent between a 33 percent price reduction and a 50 percent bonus pack (both lead to the same per unit price), customers prefer the bonus pack, even in circumstances where the bonus pack leads to higher average prices than the discount (e.g. 35 percent bonus pack versus 30 percent discount). Customers thus associate higher numbers (e.g. 35 percent free product) with higher savings, although actual prices paid are higher. *Discount presentation*: common sense would suggest that presenting an offer as “pay only 60 percent” is equal to “get 40 percent off the regular price.” Recent academic research (Kim & Kramer, 2006) suggests otherwise: the former discount presentation format results in higher perceived savings and higher purchase likelihood than the latter. The novelty and uniqueness of the discount presentation format appears as more persuasive to customers than traditional and known presentation formats. *Cross-market discounts*: When companies are active in more than one market, they can use discounts in one market to stimulate sales in the other market. Giant Eagle, a dominant retailer in Pittsburgh, also owns GetGo, a chain of gasoline stations. In 2008, the company started its highly successful campaign “Fuelperks!” where customers earn a 10 cent discount on each gallon of fuel upon a \$50 purchase of groceries at Giant Eagle. For Giant Eagle this campaign has been tremendously successful, so much that its competitors filed (and lost) a lawsuit claiming unfair sales practices. Recent empirical research (Goić et al., 2011) shows that these cross-market discounts increase both firm profits and customer welfare as consumers pay lower prices. Also, creativity in discounting avoids blanket price reductions and improves both customer satisfaction and firm profitability. *Participative discounts* link reduced prices to specific actions of customers that support the company’s strategy. These actions could be referrals or simply minimum purchase requirements. Recent research suggests that minimum purchase requirements can lead customers to feel happier when paying more (Yoon & Vargas, 2010). Customers who qualify for the minimum purchase requirement (e.g. \$500)

and are offered a lower discount (e.g. 20 percent) end up being happier than customers who are offered a larger discount (e.g. 30 percent) without the minimum purchase requirement. Also here, higher customer satisfaction and higher profits coexist as a result of creativity in discounting. *Creative free*: Instead of fully charging for supplementary services (which customers could perceive as greedy) or giving them away for free (which hurts profits), leading companies apply creativity to select free supplementary services. For instance, Hilton Hotels in California allows free parking at its hotel facilities for all guests under one circumstance: It applies to electric vehicles only. In this way, the company actually improves its ability to charge for parking. In addition, through this policy customers perceive Hilton as environmentally friendly, even if they have to pay for parking.

### ***Psychological pricing***

Customer preferences in B2C and B2B markets are not stable; they are constructed. Research examining psychological aspects of pricing seeks to understand how customer perceptions of value and price are formed and how companies can favorably influence customer perceptions of value and price. Here are some examples of psychological pricing. *Advertised reference prices* (e.g. manufacturer-suggested retail price \$299, now only \$99) influence customer behavior, even if customers themselves know that these reference prices are inflated (Suter & Burton, 1996). A judicious use of advertised reference prices can thus influence customer choice towards higher margin products. In this respect, master salesman Steve Jobs provides an illuminating example. Before the launch of the iPad in 2010, the non-trivial question was, “How on earth will Apple convince its customers to pay about double the price of an existing tablet (the price of Archos, a competing product, was \$250 at that time) and still leave an Apple store with the feeling of having obtained a bargain?” Enter Steve Jobs. At the launch event, he announced (Jobs, 2010): “Well, if you listen to the pundits, we’re going to price it under \$1,000, which is code for \$999.” Behind him the number \$999 appears on the screen. He goes on: “And just as we were able to meet and exceed our technical goals, we have met our cost goals . . . And I am thrilled to announce to you that the iPad pricing starts not at \$999, but at just \$499.” The number \$499 replaces \$999 on the screen. The audience roared. *9-endings*: More than 50 percent of posted retail prices end in the number 9. Customers perceive prices ending in 9 as lower than they actually are; they also associate 9 endings with special offers. Thus, 9 endings have both level and image effects (Stiving & Winer, 1997). Despite their widespread use and possible wear-off effects, 9 endings still seem to lead to higher sales (Anderson & Simester, 2003). The *compromise effect* is in effect when brands gain market share when they become intermediate, rather than extreme, options in a choice set. Customers are averse to extreme options. Pricing managers thus have the option to increase the likelihood that customers buy a premium product by adding a super-premium product to their product lines. It is well documented that companies such as Starbucks, Dell, FedEx and Amazon make heavy use of compromise effects to profitably influence customer choice.

## **Innovation in pricing for the organization**

Few companies are organized for pricing. Less than an estimated 5 percent of all companies have a dedicated pricing team in place responsible for analyzing, developing and monitoring pricing capabilities. Innovation in organizing the pricing function is thus predominantly concerned with establishing novel approaches to increase the effectiveness of pricing itself. The following are potential starting points.

### ***Dedicated pricing function***

At its most basic level, innovation in pricing requires, for close to 95 percent of companies, the establishment of a dedicated pricing team. Typical responsibilities include the establishment of a price list that reflects customer value; the establishment of a performance-oriented discounting policy; the development of guidelines to communicate value and price to customers; the gathering of information on customers, products and sales personnel to analyze key performance indicators related to pricing (e.g. price deviations from target prices, discounting behavior by sales personnel, actual profitability versus target at customer level, etc.); the development of pricing tools; the capability assessment and development of sales personnel; and the chairmanship of pricing council.

### ***Centralization of the pricing function***

Recent research suggests that a center-led pricing design, which combines elements of centralization with elements of decentralization, increases firm performance (Liozu et al., 2012). Center-led pricing teams thus rely on a pricing office at the headquarters level to ensure consistency of a company's pricing strategy with overall firm strategic guidelines, to harmonize and to balance pricing policies across countries and business units and to build localized pricing capabilities and pricing teams in key countries and business units.

### ***CEOs as pricing champions***

Current academic research strongly suggests that active CEO championing of pricing positively and significantly influences pricing capabilities and firm performance (Liozu & Hinterhuber, 2013a). CEO championing of pricing poses high demands on CEOs. They need to recognize the importance of pricing, enthusiastically support the pricing function and provide resources – including CEO and top-management attention – to the pricing team, show tenacity when faced with obstacles when changes in pricing are needed, identify the key actors responsible to solve pricing problems when they arise and publicly show confidence in what pricing can do for customer satisfaction and for company profitability.

### ***Confidence***

Confidence may be the single most important intangible differentiator between high performing and low performing companies (Hinterhuber & Liozu, 2012).

Innovation in pricing requires confidence – the belief in own abilities to take on any challenge, a sense of purpose, a vision for the future, the confidence in the future, the conviction that own products/services deliver value, the courage to withstand customer price objections, the courage to implement price changes in the market and, lastly, the ability to say “no” to customer requests for price reductions. Our research suggests that giving confidence to sales personnel is a leadership responsibility. High performing companies have CEOs who instill confidence in their sales organization by encouraging them to set high standards for excellence, by enabling them to build an emotional reservoir gained through valuable experiences and by encouraging them to trust their own judgment.

### ***Companywide pricing capabilities***

Pricing capabilities are a complex bundle of routines that cover the three critical dimensions of pricing: the customer perspective (measuring and quantifying maximum willingness to pay, price elasticity and value-in-use), the competitor perspective (knowledge about price levels of competing products and ability to respond to market changes) and the company perspective (availability of pricing tools, existence of price-management processes, availability of trainings to develop employee skills in pricing). Current research shows that companywide pricing capabilities are positively related to firm performance (Liozu & Hinterhuber, 2013b). An increasing number of leading companies recognize the strategic role of pricing capabilities. Jeff Immelt, CEO of General Electric, states: “A good example is what we’re doing to create discipline around pricing. . . . When it comes to the prices we pay, we study them, we map them, we work them. But with the prices we charge, we’re too sloppy” (Stewart, 2006: 65). As a result of this insight, Jeff Immelt has appointed a chief pricing officer responsible, among other tasks, for analyzing and developing pricing capabilities across business units and countries.

A periodic assessment of pricing capabilities allows companies to (1) analyze an organization’s pricing capabilities over time and across geographical boundaries, (2) compare pricing capabilities both within and across firms and (3) plan and implement measures to develop pricing capabilities further. This benchmarking and improvement of pricing capabilities leads to increased organizational performance (Dutta et al., 2002).

### ***Change management***

Innovation in pricing fundamentally engages the organization in a change-management process. A new pricing approach is not “just a change of marketing signals” but “a new way of life” (Forbis & Mehta, 1981: 42). Engaging the organization to experiment with and implement new pricing approaches is thus fundamentally a change-management process that significantly exceeds the complexity of activities, such as changing list prices. New pricing approaches frequently require new capabilities, a new organizational structure, different goal and incentive systems, new processes and tools and new organizational

priorities. From an organizational perspective, innovation in pricing thus has to be treated like an ongoing change management process as opposed to a project with a finite life.

### ***Pricing experiments: pricing as organizational learning***

For some leading-edge companies, innovation in organizing the pricing function finally implies treating pricing as organizational learning. Amazon is an excellent case in point. The company changes the prices of its products several times a day and measures customer satisfaction, purchase patterns, profits and revenues after each price change in an ongoing attempt to identify the specific price point that delivers both high customer satisfaction and profits on any given time segment. For newly launched books, for example, the frequency and magnitude of price changes are larger than for those of established book titles, suggesting that Amazon places a strong emphasis on experimentation in the period shortly after new titles come to market (Pollono, 2011).

Counterintuitively, frequent price changes can be beneficial for consumers. In one of our recent studies for a diversified energy company that attempted to switch its customers from heating with fuel to heating with environmentally friendly wood pellets, the CEO struggled with the following paradox. Customers never complained about fuel prices but complained strongly about occasional price increases of the newly launched, innovative wood pellets. After conducting face-to-face interviews and a conjoint analysis with customers, the rationale becomes clear. Since prices for fuel vary constantly, price memory is impossible. In an attempt to be customer-oriented, the company had kept prices for wood pellets largely constant in the past, despite rising input costs. Paradoxically, this policy ends up hurting both customers and the company. Customers become obsessed with price and are very reluctant to switch to innovative products, even if doing so would be in their best interest: Although they are more expensive on a per unit basis, these innovative wood pellets actually lower total energy costs. Also, the company is worse off since some of these innovations have higher margins. After our analysis, this company now varies prices for wood pellets randomly around a predefined corridor. The ability of customers to remember price drops substantially if prices change frequently, significantly increases sales of innovative products. We emphasize that, in this case, stopping customers from fixating on price translates into higher firm profits as well as lower total costs to customers. Both parties are now better off.

### **Innovation in pricing increases value**

As the examples of Ryanair, Zipcar, General Electric and our own research suggest, innovation in pricing is indeed possible even in the absence of product innovation. Figure 2.3 illustrates this point.

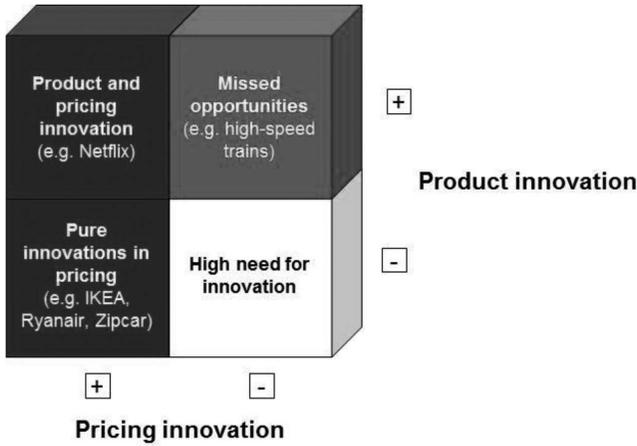


Figure 2.3 Innovation in pricing versus product innovation

Companies placing a high emphasis on product innovation without a similar emphasis on pricing innovation are missing important opportunities for value capture. For example, instead of pricing high-speed train tickets in Europe in line with airline tickets, many formerly state-owned railway companies have set prices at only moderate premiums over conventional train services. Pure cases of innovation in pricing are related to the majority of examples discussed so far. The underlying driver of superior profitability and customer satisfaction of GE, Zipcar and others have been the ability of these companies to apply innovation in pricing to a well-established product or service. The final category in the matrix contains cases of joint product and pricing innovation. Netflix is a prime example. The company’s founders, annoyed with late fees, pioneered a new pricing structure and a new delivery format (streaming video).

This contraposition of product and pricing innovation also helps to spot potential discrepancies. Many companies attempt to launch tomorrow’s products with yesterday’s pricing strategies. Companies can and should develop unique pricing concepts to respond to the unique features of their new products and business models.

Our research certainly does not imply that companies should attempt to implement all innovative pricing approaches discussed here. Our joint experience in academia, in industry and in advising companies from around the world, however, strongly suggests that all companies, regardless of size, industry or geographic location, will be able to adapt two or three key ideas of our roadmap to design innovative pricing approaches that will increase profits and customer satisfaction.

### About the research

Our research on innovation in pricing has two objectives. We first want to document to which degree an average U.S. firm practices innovation in pricing. Second, we want to provide a state-of-the-art summary of what constitutes innovation in pricing in academic research and managerial practice. To meet our first goal, we conducted 50 interviews in 20 firms in the U.S. and Europe. Our respondents were CEOs, board members, business-unit managers and operating managers in sales, marketing, pricing and finance. We interviewed participants in these firms with open-ended interview questions and asked them to describe, in detail, pricing decisions and processes at their respective firms. In particular, we probed for instances of innovation in pricing. Consistent with a grounded theory approach, data analysis took place simultaneously with data collection. We listened to the audio recordings of each interview several times, and we read the transcripts of each interview repeatedly. To meet our second goal, we examined pricing practices in 70 large firms in the U.S., Europe and Asia by analyzing publicly available information and by interviewing managers at pricing workshops that we conducted in Europe and the U.S. We complemented this analysis with a rigorous literature review on cutting-edge academic research on innovation in pricing and marketing.

### Note

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## **Part II**

# **Innovation in organizing the pricing function**



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# 3 The organizational design of the pricing function in firms

## A center-led management approach

*Stephan M. Liozu and Kellie Ecker*

### Introduction

“Organizing is one of the central and inescapable tasks of top management. And the experienced executive is painfully aware of how little is known as to what constitutes effective organization” (Simon et al., 1954: iii). From 1954’s classic management book by Simon *et al.* on centralization versus decentralization to the most recent *McKinsey Quarterly* issue on the same topic (Campbell et al., 2011), the debate on how to organize functional teams in firms rages on. This debate, however, has never been holistically extended to the organization of the pricing function. Traditionally, the pricing function receives limited attention in firms and in marketing literature. Data from the Professional Pricing Society, the world’s largest organization dedicated to pricing, reveal that fewer than 5 percent of Fortune 500 companies have a full-time function exclusively dedicated to pricing (Mitchell, 2011) and, according to McKinsey & Company, fewer than 15 percent conduct systematic pricing research (Hinterhuber, 2004). Historically, pricing has received little attention from either practitioners or marketing scholars (Hinterhuber, 2004, 2008; Malhotra, 1996; Noble & Gruca, 1999). A review of 53 empirical pricing studies concluded that pricing literature is highly descriptive and fragmented and that theoretical understanding of firm pricing decisions is limited (Ingenbleek, 2007). Pricing academic literature is silent about how organizational and behavioral characteristics of firms may affect pricing processes and how firms organize for pricing (Ingenbleek, 2007). The question of centralized versus decentralized pricing organization has been debated in the pricing profession and has rarely been academically explored. To address this deficit, we conducted a literature review on the concepts of centralization and the various forms it could take in firms. Then we used the findings from a qualitative inquiry that included interviews with 44 managers in 15 companies in ten U.S. states. The goal of this study was to explore similarities and differences in experiences related to pricing management and orientation. Results documented stark differences in how firms organize for pricing, manage the pricing process and develop internal capabilities to face uncertain and ambiguous pricing decisions. Five organizational elements associated with advanced pricing orientation and pricing maturity emerged: championing behaviors, organizational confidence, pricing capabilities,

change capacity and center-led pricing management. We also used the result of a quantitative inquiry conducted among 748 marketing, pricing, commercial and management professionals and leaders involved in managing pricing activities for their firms to measure the effect of these five characteristics on perceived firm performance.

Armed with our theoretical exploration and the findings from both our qualitative and quantitative studies, we conjecture that center-led pricing is a critical element of the organizational design for pricing. We propose a different definition of pricing centralization that is not related to power and pricing compliance but associated with the diffusion of pricing knowledge, the support of pricing decisions and the creation of pricing intelligence and intellectual capital in firms. Our conclusions also indicate that firms using value-based pricing have adopted the center-led management design to pursue an organizational transformation of their pricing orientation. We also conjecture that a pricing organizational design evolves over time based on pricing maturity, external conditions and organizational structure. No design can stay static for too long.

## **Theoretical foundation**

Our work was informed by organization theory (March & Simon, 1958; March, 1994) and by the literature linking pricing and firm performance. We take organization theory to include the internal structure of the firm and the relationships between its units and departments (Grant, 1996) as well as the flow of information within organizations supporting and influencing decision-making processes (March, 1994, 1999; Simon, 1961). A critical question is how and where pricing decisions occur in organizations and what organizational factors influence processes and managerial judgment when decisions are made. For this paper, we focus on the constructs of organizational structure (Aiken et al., 1980; Hall, 1977; Hall et al., 1967; Miller et al., 1988), centralization versus decentralization (Argyres & Silverman, 2004; Fayol, 1949; Simon et al., 1954) and the contemporary concept of center-led functional management.

### ***Organizational structure***

Organizational structure, which can be variously defined and take myriad forms, relates to dimensions that “cannot be reduced to or deduced from properties of the organization’s members” (Aiken et al., 1980). Several reviews (Hall, 1977; John & Martin, 1984; Miller et al., 1988) have suggested that complexity (structural differentiation), formalization and centralization are the most common and consistent characteristics of structure. We focused on the characteristics of centralization of the pricing function in the hands of specialized experts. Structural differentiation “includes differences in attitudes and behaviours on the part of the members of the differentiated departments” (Lawrence & Lorsh, 1967) and is defined as the differences in occupational specialties present in the organization and their degrees of professionalism (Hage & Aiken, 1967, 1970). Centralization,

which reflects the hierarchical nature of the organization, is one of its most critical structural dimensions (John & Martin, 1984). Van de Ven and Ferry (1980) define centralization as the “locus of decision making authority within an organization.” However, for complex decision-making that requires professional competencies, decisions are often left to experts. The notion of expertise is important in our definition of centralization. Locus of authority is highly dependent on locus of expertise. Because central positions are non-routine and highly specialized, they are likely to reflect power and influence (Pfeffer, 1978) but not decision-making authority.

### ***Centralization versus decentralization***

Management literature is rich in papers and studies illuminating the historical roots and drivers of the centralization debate and dates from the 1920s when large multinational corporations evaluated organizational design options (Cummings, 1995). Cummings defined the term *centralized* as indicating that “authority to make important decisions lies towards the ‘head’ . . . while conversely decentralization implies more autonomy” (1995: 103). Simon et al. (1954: 1) proposed a similar meaning on both centralization and decentralization constructs:

an administrative organization is centralized to the extent that decisions are made at relatively high levels in the organization; decentralized to the extent that discretion and authority to make important decisions are delegated by top management to lower levels of executive authority.

Most definitions proposed by other scholars centered around the characteristics of decision-making delegation (Kruisinga, 1954), of levels of authority (Simon et al., 1954) and of hierarchical designs (Simon, 1965). However, earlier in the centralization versus decentralization debate some scholars addressed the question of balance between both approaches and started to move away from the polarized approach to centralization. Fayol (1949: 33) stated that “the question of centralization or decentralization is simply a matter of proportion, it is a matter of finding the optimum degree for the particular concern.” Simon et al. (1954) concurred with this conclusion and guided their case studies towards the question of examining the degree of centralization and decentralization of the different decision-making functions. Other scholars conjectured that hybrid organizations and behaviors might be an appropriate intermediate design between polar forms of centralization (Argyres & Silverman, 2004). Additionally, in case of required organizational change and difficult adoption and implementation of technology, several organizational configurations in the same firm might be required depending on the transformational stages they sit in (Hall, 1977: 215). A more centralized approach might be more appropriate for the initial implementation stage to ensure organizational buy-in while a more decentralized approach might be better once the changes are internalized and the organization experiences high adoption levels.

More recently, authors have characterized the centralized versus decentralized phenomenon as a “pendulum swing” in which speed is dictated by the external environment (Evaristo et al., 2005: 67) or as “fashion that is inherently temporary” and created by management gurus (Cummings, 1995: 116). The focus has now moved to the question of operating effectiveness raised at the time by Simon et al. (1954: 21), of gain versus pain analysis (Campbell et al., 2011) and of the creation of unique competitive advantage through unique organization design (Dutta et al., 2002).

### ***Hybrid organizational design: center-led pricing management***

While the centralization versus decentralization dilemma continues to occupy the management agenda, we conjecture that there is a need to elevate the debate to a new form of organizational design. Recently center-led management design emerged in the business world led by the procurement and supply chain management functions. The concept of center-led management embraces the notion of hybrid organizational design by offering a centralized approach related to skills specialization, knowledge diffusion and process efficiency while encouraging a decentralization approach to decision-making. This approach proposes a balance between the two centralization poles and allows firms to focus in parallel on decision-making efficiency and organizational capability building. When applied to the pricing function, the presence of a centralized, highly specialized team of pricing experts supporting decentralized pricing activities (Deaker & Zang, 2006) can positively influence business leaders’ capabilities to make better pricing decisions. These experts allow for decisions based on scientific analysis and facts rather than intuition or gut feeling. A central team of experts acts as internal consultants who can not only increase decision-making rationality but also boost organizational confidence in executing pricing activities (John & Martin, 1984). Central marketing and pricing teams focus on the diffusion of pricing expertise and skills across the organization. These capabilities are therefore concentrated within a few positions, resulting in a “led from the center” pricing strategy (Ecker, 2010: 13). Because these central positions are non-routine and highly specialized, their expert incumbents are likely to gain power and influence (Pfeffer, 1978) while not having pricing decision-making authority. The specialization of centrally grouped pricing experts in the organization is needed to perform specialized tasks supporting a broad array of pricing-related activities in marketing, sales, R&D and management.

### ***Centralization options from a practical perspective***

Pricing practitioners experience three principal variations of centralized pricing in addition to the decentralized model (Figure 3.1): centralized, center-supported and center-led. We examined these constructs and found that while center-led appears to be the most effective for a company employing a value-based pricing approach, the other models also have benefits in some situations.

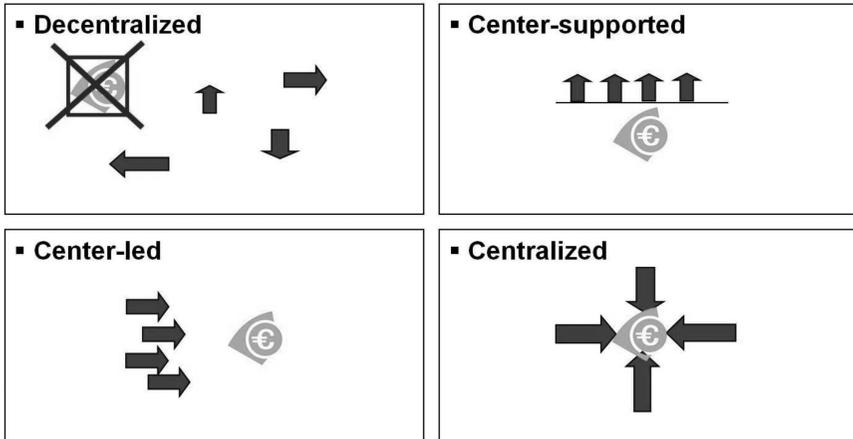


Figure 3.1 Types of pricing organizations

Decentralized pricing is the de facto organizational design for most companies. It is the status quo where pricing direction is given by a headquarters function and then executed in the field based on the local conditions and situation. The key measurement of success in this environment is revenue. In other words, if customers are buying, then it must be the right price. This structure has the least control and transparency. There is also a lack of direct ownership, and so when something goes wrong there is no one responsible to fix it. It does, however, give the most flexibility to the sales force who, when given the directive to increase revenue, can usually do so simply by dropping the price. Since the success of the strategy is sales driven, it is highly dependent on sales people and their relationships with clients. This produces the danger that when a sales person leaves the company, their knowledge of the customer and prices is lost. Companies can be surprised to learn that the best sales people in terms of revenue are rarely the best sales people in terms of profit.

Center-supported pricing is the next level up from decentralized pricing. It is mainly used by companies that recognize they have a need for pricing, but they are not ready to give up any control or decision-making authority. The key measurement of success is process improvement. The pricing function is established to support the organization in functional ways. This would include creating sales tools for evaluating business, managing SAP/Oracle pricing systems, organizing price increases, ensuring list prices are printed and enumerating pricing processes. Sometimes a company will invest in a specialized pricing system that would also be under the responsibility of the pricing team. The role of pricing is limited to supporting the decisions and direction of the management. This creates a department that is responsible officially for pricing but with no authority to influence profit management. It will lead to process improvements and still allows for

flexibility of the sales force. However, it only gives the company the illusion that it has control of pricing and will not have significant impact on the bottom line. Some organizations will see this as a failure and go back to decentralized pricing rather than maintain the headcount.

Centre-led pricing establishes a pricing expertise at the strategic level of the company and then diffuses the knowledge and selects responsibilities to other parts of the organization. Key measurements of success are profit and process improvement. To successfully implement center-led pricing, change management will need to be employed to ensure that all levels are aligned to the goals of pricing and will make decisions on the local level to support those goals. The pricing experts are responsible for not only tools and processes, but also for establishing guidelines and skills development programs throughout the company. It does take away some of the flexibility for the sales force, as they have to adhere to guidelines established by the experts. However, the trade off is that they will have new skills to help them sell on value and understand the impact of the pricing offers they make. This brings more consistency and predictability to the business.

Similar to center-supported pricing, center-led design improves pricing processes and takes functional ownership of pricing systems. In addition, the experts will establish new processes that aid in the goal of profit improvement. By collaborating with all levels of the organization, it will also institute a pricing intelligence community. This brings information from many areas to a central point where trends, opportunities and threats can be identified, evaluated and considered for strategic direction. It also helps the company better assess and respond to any competitor moves in the market, such as whether a price change is a local phenomenon or a concerted action.

Centralized pricing brings the maximum level of control to pricing. A central team of experts and analysts are responsible for all pricing in the organization. This is usually focused on control and is autocratic in nature. Key measurements are profit and compliance to the standards. In a large organization, a strongly centralized pricing can ensure that price erosion is kept under control and that clients are treated consistently. The pricing function is responsible for all processes, systems, analysis and, ultimately, for the content of all offers made to clients. Due to the nature of the analysis and approval process, it is seen as being restrictive to the sales force and discourages initiative taking. The response time to clients is increased and can result in loss of sales from the lack of flexibility. Companies will sometimes deploy this model in times of a crisis and then move to a center-led design once control is established and they understand better the amount of flexibility that might be needed.

The practical exposé on the four types of organizational design for pricing does not give any clear answer on which design works best for an organization. Each design offers advantages and disadvantages that practitioners and leaders in the firm need to consider in detail. As discussed, depending on the situation the firm faces in the market and the level of pricing maturity, a firm might start with one design and transition to another once the pricing skills and processes are in

place. There is no silver bullet solution to organizing for pricing. Leaders need to establish their pricing goals and strategies and then design the best architecture to increase their pricing power. In the process they will have to consider trade-offs between various variables related to pricing: delegation, speed of response to customers and the sales force, approach to price decisions, etc.

## **Research design and methods**

Following our in-depth literature search and practical exploration on the centralization construct, we conducted qualitative and quantitative research projects to investigate the elements impacting the organization of the pricing function in firms and the impact of these elements on relative firm performance. In both studies, the organization of the pricing function emerged as an important theme. More details on our empirical studies and their findings follow in the next sections of the chapter.

### *Qualitative survey*

#### *Methodological approach*

We conducted a qualitative study using semi-structured interviews to develop a grounded theory (Corbin & Strauss, 2008) about how organizational factors affect the adoption of a pricing approach in industrial firms. We aimed to get a better understanding of how managers in these firms make pricing decisions and what roles they play in the firm's pricing process.

#### *Sample*

Our sample consisted of 44 managers in 15 small and medium U.S. industrial firms. Relying on the principal researcher's professional network and advice by the Professional Pricing Society, over 36 small and medium U.S. firms were identified in three industries: building materials, transportation products and plastics products. Seven firms were small as defined by the Small Business Administration 2007 size standards by industry ([www.sba.com/size](http://www.sba.com/size)) as having between 50 and 380 employees and eight were medium-sized with between 900 and 2,200 employees. More information of sample characteristics is available in the Appendix.

#### *Data collection*

The primary method of data collection was semi-structured interviews conducted over a three-month period from April to June 2010. Thirty-seven interviews were conducted in person at the respondents' place of employment and 7 were conducted by telephone. The interviews, averaging 60 minutes or more, were digitally recorded and subsequently transcribed by a professional service.

*Data analysis*

Consistent with a grounded theory approach, data analysis commenced simultaneously with data collection. The audio recordings of each interview were listened to several times and the transcripts of each interview read repeatedly. Three stages of rigorous coding (open, axial and selective) then ensued. The process resulted in a reduction in the number of categories from 92 to 40, yielding seven major themes and capturing 781 of the total “codable moments” out of the 2,554 ones originally identified.

*Quantitative survey**Methodological approach*

To test our hypotheses, we designed a cross-sectional, self-administered survey to measure the latent variables associated with our conceptual model. Marketing, pricing, commercial and management professionals and leaders involved in managing pricing activities for their firms constituted our population. The Professional Pricing Society (PPS), a professional organization dedicated to the education and networking of pricing professionals around the world, supported our research. The survey was emailed to 18,300 PPS members in April 2011. Responses were returned over an eight-week period. About 300 “bounced back” and were assumed not to have reached the intended recipients. Of the remaining 18,000, 1,148 surveys were returned partially or fully completed for a response rate of 6.4 percent. We determined 748 were usable for further analysis. Our response rate is consistent with surveys targeted at large professional organizations not typically asked to participate in academic research. Sample characteristics are provided in the Appendix.

*Measure development and assessment*

Since there was little empirical precedent to measure the degree to which a center-led pricing team supports an organization with specific pricing activities, a multiple-item scale was also developed by the team in accordance with an operational definition as suggested by Kerlinger and Lee (2000: Chapter 3) and by relying on our fieldwork and on extant research. We used seven items ranging from 1 (“rarely done”) to 7 (“frequently done”) to operationalize this scale as shown in Table 3.1.

This scale was refined through pretests and pilot testing using established item development procedures and guidelines (Churchill, 1979). Content validity was determined through comprehensive review of the literature, pilot tests and assessment by a panel of practitioners and academics to ensure that measurement items covered the domain of the constructs (Nunnally, 1978; Churchill, 1979). To assess the survey’s quality, face-to-face interviews with pricing practitioners were conducted using Bolton’s pretesting methodology (Bolton, 1993). We pretested our scale items with a small panel of academics and pricing and business practitioners.

Table 3.1 Center-led survey items

<i>Items</i>	<i>Centre-led pricing management (CLED)</i>
CLED1	Conducts pricing training with divisional decision makers and top executives
CLED2	Manages specific pricing projects or programs to support divisional marketing programs
CLED3	Assists in the design and/or implementation of pricing tools
CLED4	Conducts pricing research activities to support pricing decision making process
CLED5	Assists decision makers with price setting process as part of the formal product development process
CLED6	Provides top management with pricing reports and trends
CLED7	Provides knowledge with overall pricing process (for example, pricing increases, pricing reviews)

Next, a pilot test involving 150 professionals representing pricing, business and general manager functions from companies in both manufacturing and service industries provided 70 complete and usable responses.

## Findings

### *Qualitative study*

We discovered stark differences in the locus of the pricing function, the nature of the pricing process, the organizational structure, the diffusion of pricing capabilities and in leaders' behaviors in firms with a value-based pricing orientation versus those with cost- or competition-based orientations.

*Finding 1: Firms using value-based pricing (VBP) support pricing decisions by reliance on formal market research, scientific pricing methods and 'expert' recommendations while those using other orientations (cost or competition) rely on experience, prior knowledge, gut and intuition*

Three out of four firms in our sample that had adopted VBP conducted formal quantitative market research to calculate customers' value and to derive final pricing points. These firms used scientific methods, such as conjoint analysis, KANO and customer acceptance testing, to define a range for the price point. Respondents claimed these methods reduced the level of uncertainty when managers made the final price point definition, thus increasing the level of rationality in the decision-making process. Figure 3.2 illustrates the VBP price point definition process highlighting the role of internal experts and consultants from "central" or center-led pricing teams as critical to support, test and validate pricing decisions.

As illustrated in Figure 3.4, of the six firms that used cost-based pricing (CBP), most developed advanced cost models – all used margin targets – to inform pricing

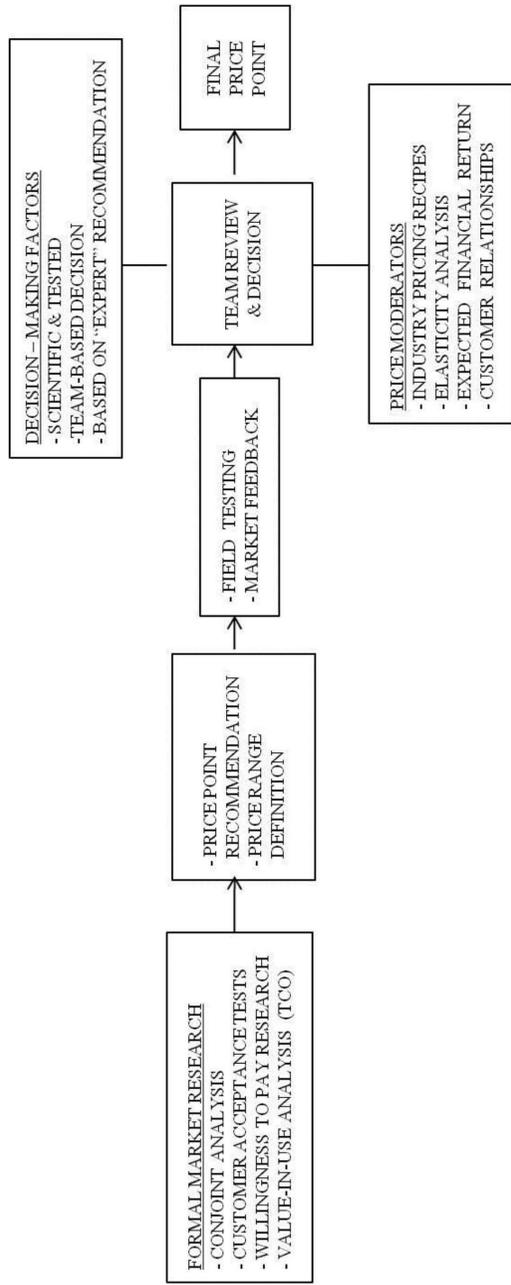


Figure 3.2 Price point definition process for value-based pricing (VBP)

<i>Scientific decision-making process</i>	
VB1 – SM	“Basically, we give one recommendation . . . and we try to make this recommendation with a proof, with an evidence that this is right. And this is done in this Phase 4 (of Stage Gate), for example, within the second customer contact phase, which can be a conjoint analysis because then you have facts and data that support your recommendation.”
VB1 – EL	“The large decision-making is up to the product manager, of course. He will follow the recommendation of the (functional) guy based on the controlled research.”
VB4 – SM	“We try and get feedback from our testing. So whenever you have tests done and you can quantify the performance of the new product versus the other alternatives that customers have access to (and) then we try and see if we can quantify the benefit that this product will deliver based on all the benefits we think it brings. We will survey as many customers as we have access to, or as much test data as we have generated and have access to. . . . We ask them to test it, test the hypothesis. Instead of saying every analysis you come up with is wrong and therefore cannot be implemented, you create an implementation plan that allows you to test.”
VB2 – FA	“We do an analysis of the investment, definitely. . . For something like that, because it would be like a new product and we would be investing, we have a process internally where, before we finalize anything, it goes before the executive team, and we review the pricing. We review our returns on the project.”
<i>Unscientific decision-making process</i>	
CB5 – EL	“I would love to say it’s scientific, but it ain’t, I mean, it ain’t . . . it’s a gut check that’s made that.”
CB3 – EL	“Yeah, it’s not a highly scientific, there’s not an algorithm I could give you.”
COB1 – SM	“Now what that premium is, is highly, in my mind, unscientific. That’s almost (as much) art as it is science . . . A quantification of the value of the system is the Holy Grail for me.”
COB3 – EL	“We had information coming in from Japan. We had information coming in from China. So we knew we were in a favorable position, which I think gave us the confidence to go a little bit higher, but I can’t say at the end of the day I did a spreadsheet and put in all the factors and came out with a number and said, ‘That’s the number we’re going to.’”
COB2 – EL	“As far as having some working formula that enables us to say that this marketplace enables us to mark up 50% of what we would normally do, it’s probably not as sophisticated as that. It is more a sense of understanding the marketplace and the pricing associated with the applications, and then the value add that we bring to the table to ensure that we achieve maximum pricing.”

Figure 3.3 Differences in the decision-making process between firms using value-based pricing and those that did not

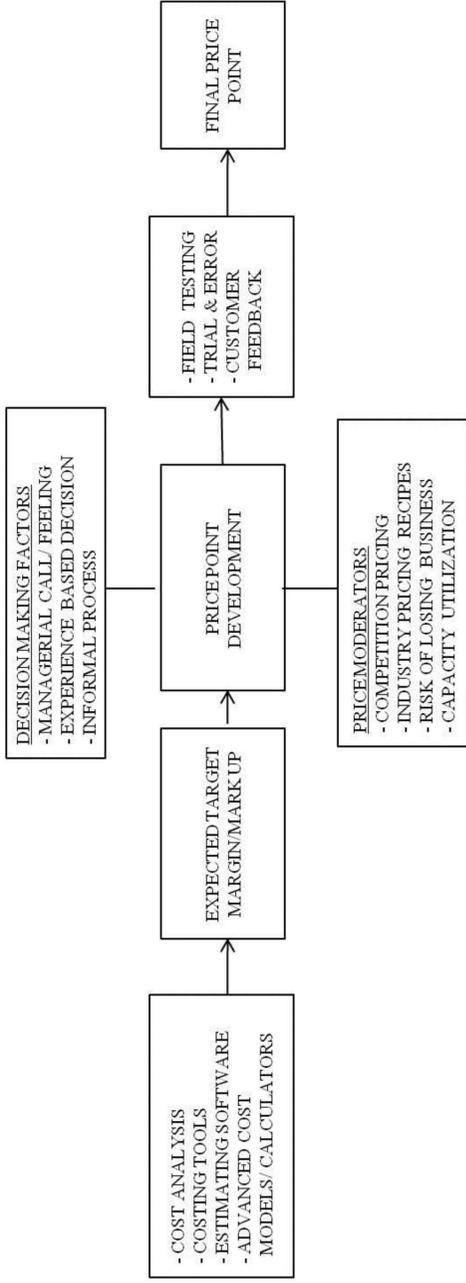


Figure 3.4 Price point definition process for cost-based pricing (CBP)

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VB1 – EL	“We have dedicated (functional) managers. They don’t do anything else, and then just (customer research), and this is observation of the customer. It’s videotaping of the customer. It’s understanding what is the unarticulated needs of the customer, and of course, also the articulated needs.”
VB3 – EL	“The way (company) works is we have the business units in (country) which are in charge of development. So they bring the products and then they bring overall pricing guidelines worldwide.”
VB3 – SM	“You’ve got the senior manager of pricing, which is responsible for the pricing processes; continuous improvement for (Corporation) overall . . . and then within that group you have a few analysts who help manage the pricing within the system: one technical person, one person who helps on the reporting . . . one individual who helps out with projects like agreement review process (and) strategic business pricing. And we also have a group that focuses in on day-to-day maintenance of making sure price points in the system don’t go below a certain threshold.”
VB4 – EL	“In a development group . . . there’s three people like (name) who are development managers. We’ve got hundreds of development people in the world. . . . That’s all they do. They don’t sell a thing. . . . So they’re doing the advanced design, advanced development.”
VB2 – SM	“We have engineering services, our project managers . . . (who) can put together is a cost justification analysis. . . . The department is called Engineering Services . . . they’ll bring in all the formulas/cost justifications from our customer’s end.”
VB2 – EL	“We have a pricing department. It’s four people that are split by market segment, and they’re responsible for doing quotes for new business or large – anything that’s not under contract should come to them for pricing, to do a quote.”

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*Figure 3.5* Evidence of role specialization in firms that use value-based pricing

decisions. When faced with uncertainty, managers of all firms reported using prior knowledge and experience and half admitted to relying on intuition and guessing to define the final price point (see Figure 3.5). Most of these managers (5 out of 6 firms) characterized their pricing process as ‘unscientific’ despite the fact that it was based on financial data and was formulaic in nature. Figure 3.3 provides evidence of the scientific versus unscientific nature of decision-making processes in these firms.

*Finding 2: Pricing is an orphan in industrial firms using cost or competition pricing orientation*

No dedicated pricing function existed in the 11 firms in our sample using cost or competition pricing orientation. In these firms, pricing activities were highly fragmented, followed informal pricing review processes and focused only on margins versus prices (7 out of 11 firms). By contrast, all firms using VBP had dedicated pricing functions (involving 3 to 15 members), tracked specific pricing key performance indicators (KPIs) and led specific monthly pricing reviews.

*Finding 3: The locus of pricing responsibility varies based on pricing orientation*

In the 11 firms using CBP and competition-based pricing (COBP), the locus of both tactical and strategic pricing responsibility was situated in the sales function. In all firms using VBP, the pricing function reported into the marketing organization. In these industrial firms, marketing was responsible for strategic pricing resulting in greater integration of pricing programs in the overall marketing planning process.

*Finding 4: Firms using VBP designed formalized processes and established centralized or center-led pricing expertise*

All firms using VBP created specialized units composed of highly skilled professionals whose mission was to support the pricing decision-making process. These units included, as illustrated in Figure 3.5, a packaging engineering group, a dedicated pricing team acting as internal consultants or a specialized market research team. The role of these units was to provide project-related support to managers who made business unit-specific pricing decisions.

In these firms, pricing responsibility was center-led and the department provided pricing support to the entire organization. Our findings (see Figure 3.6) suggest a definition of centralization in which knowledge and capabilities were

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VB1 – EL	“. . . we have three full-time equivalents for voice of the customer studies. We have that centrally. So whenever we develop a product for this market, we get them here and they set the whole system because it’s a very formal thing.”
VB3 – SM	“The overall team supports all of the (Company) North America . . . the profit desk underneath the pricing team can look to see whether or not the price points are too low.”
VB3 – FA	“Pricing is actually at the corporate level here, it’s marketing that has that pricing team underneath. So marketing is responsible for defining the price points.”
VB4 – SM	“I am a corporate function; I go from business to business.”
VB4 – EL	“When we wanna do something different and new, we hooked up with them (Central Team) (and) when we said, ‘You know, on our mature business, we got too many price points. We need to simplify this thing. How do you help us simplify?’ . . . there’s this group out there that knows (and) consults on this all the time. Why don’t we tap into them, and let’s start a project. (That) group is kinda looking for the best of the best in (Company) and in cross-training.”
VB4 – SM	“We tap into our corporate sales and marketing (team) (and) say, ‘Hey, they’ve got professionals that know the terminology, the theory, and the strategy associated with pricing in general.’ And you do a little bit of negotiation role-playing and that sort of thing. So that’s probably once a year or once every year and a half.”

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*Figure 3.6* Evidence of expertise centralization in firms that use value-based pricing

concentrated to create the concept of a center of excellence for pricing. Five out of six sales and marketing respondents in firms using VBP indicated that this central pricing function acted as a strong resource to improve managerial pricing management. None of the firms using CBP (0 out of 6 firms) reported the existence of a centralized pricing function.

**Quantitative study**

An exploratory factor analysis (EFA) was conducted on the dataset of 748 pricing and business professionals using principal axis factoring with Promax rotation. The EFA resulted in 6 factors, consistent with our conceptual model. The summary statistics for the center-led pricing management construct are shown in Table 3.2, and construct correlations are shown in Table 3.3. Each item loaded on its respective factor with a value greater than 0.40 and no cross-loadings of more than 0.20 (Hair et al., 2010; Igbaria et al., 1995). Two items did not load properly and were removed from the model.

We conducted a confirmatory factor analysis (CFA) to validate the factor structure. The measurement model was constructed incorporating each construct and associated items. The model was further trimmed and appropriate covariance relationships were added when theoretically justified (Byrne, 2009). The composite

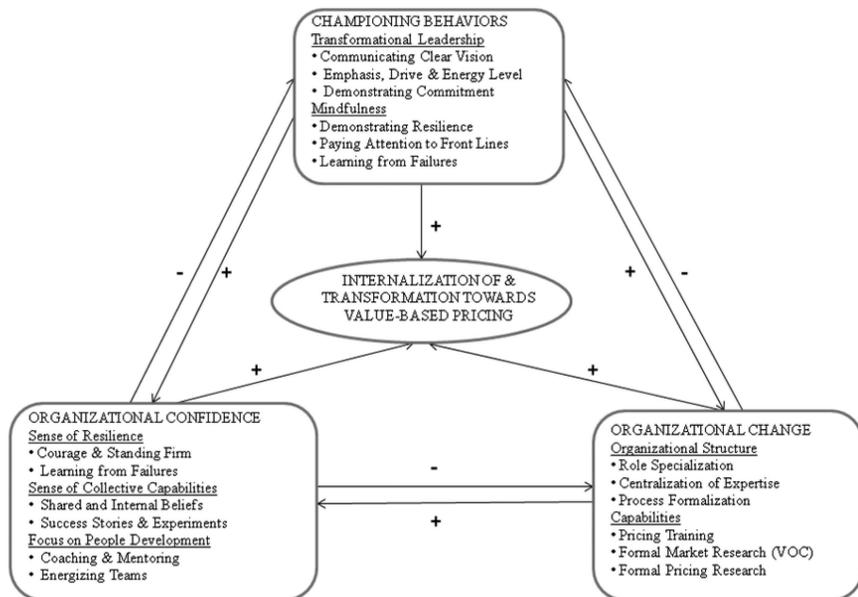


Figure 3.7 Conceptual model for the internalization of and transformation towards value-based pricing

Table 3.2 EFA summary statistics

<i>Construct</i>	<i>No. of Items</i>	<i>Loadings</i>	<i>Cronbach alpha</i>
Center-led pricing management	5	0.667; 0.589; 0.613; 0.669; 0.688	0.784

Table 3.3 Construct correlation scores

<i>Constructs</i>	<i>Mean</i>	<i>Standard deviation</i>	<i>Cronbach alpha</i>	<i>Centre-led pricing management</i>
Centre-led pricing management	5.20	1.48	0.784	<b>0.43</b>
Pricing capabilities	4.31	1.50	0.906	0.445
Relative performance	4.82	1.31	0.915	0.328
Organizational confidence	5.07	1.41	0.851	0.317
Championing behaviors	4.94	1.59	0.959	0.449
Organizational change capacity	4.93	1.46	0.919	0.363

reliability (CR) for the center-led management construct is provided in Table 3.4. The CR value exceeds the acceptable threshold level ( $>0.70$ ) and the average variance extracted (AVE) value confirming the reliability of the indicators and demonstrating convergent validity. For discriminate validity we show that, for this construct, the maximum shared variance (MSV) and average shared variance (ASV) are less than the AVE (Fornell & Larcker, 1981).

Supported by our theoretical review and the results of our qualitative inquiry, we hypothesized that center-led pricing management was one critical organizational element associated with pricing that influenced pricing capabilities and organizational confidence in pricing as shown below and in the hypothesized model displayed in Figure 3.8.

**HYPOTHESIS 2a:** *Center-led pricing management has a positive effect on pricing capabilities.*

**HYPOTHESIS 2b:** *Center-led pricing management has a positive effect on organizational confidence.*

Our results indicate that center-led pricing management has a positive effect on pricing capabilities but not on organizational confidence as shown in Table 3.5.

Furthermore, the decomposition of the R square for pricing capabilities as shown in Table 3.6 revealed the strong contribution of championing behaviors (36 percent) and center-led pricing management (29 percent) in explaining its total variance. Finally, organizational change capacity was the stronger contributor to the R square of organizational confidence with 38 percent of explained variance.

Table 3.4 Results of the measurement model

<i>Constructs and corresponding items</i>	<i>Cronbach alpha</i>	<i>Mean</i>	<i>Standard deviation</i>	<i>Standardized regression weights</i>	<i>Standard error</i>	<i>Critical ratio</i>	<i>Composites reliability</i>	<i>Average variance extracted</i>	<i>Maximum shared variance</i>	<i>Average shared variance</i>
<b>Center-led pricing management (CLEd)</b>	<b>0.784</b>						<b>0.79</b>	<b>0.43</b>	<b>0.26</b>	<b>0.20</b>
CLEd2		5.01	1.598	0.617	0.078	14.436				
CLEd3		5.56	1.389	0.584	0.069	13.504				
CLEd4		4.70	1.603	0.645	0.078	15.252				
CLEd5		5.15	1.509	0.692	0.072	16.67				
CLEd7		5.58	1.292	0.729	0.06	17.792				

*Table 3.5* Results of the structural model

<i>Hypothesis</i>	<i>Beta</i>	<i>Supported</i>
H2a: <i>Center-led pricing management has a positive effect on pricing capabilities</i>	0.354***	Yes
H2b: <i>Center-led pricing management has a positive effect on organizational confidence</i>	0.013	No

*Table 3.6* Pricing capabilities R square decomposition

<i>Independent variables</i>	<i>Dependent variables</i>	<i>Correlations</i>	<i>Standardized estimates</i>	<i>Portion of variance explained by IV</i>
Championing behaviors	Pricing capabilities	0.551	0.351	36%
Centre-led pricing management	Pricing capabilities	0.445	0.359	29%
Organizational change capacity	Pricing capabilities	0.477	0.135	12%
Controls	Pricing capabilities			23%
<i>Total</i>				<i>100%</i>
<i>Pricing capabilities</i>		0.543		
<i>R square decomposition</i>				

## **Discussion and implications for innovation in pricing**

The goal of this chapter was to propose a thorough review of the potential organizational designs for pricing management and to summarize the findings of our empirical research projects. We believe that the content of this chapter makes strong contributions to the fields of pricing management and organizational design.

First, we have reviewed literature related to the centralization construct and proposed the four types of potential design of the pricing function in firms from a practical perspective. Leaders in firms wishing to design for pricing can review these options and consider the implications for their pricing function. Then, we have proposed that firms comprised in our sample using value-based pricing all adopted a center-led management design leading to the successful adoption of this modern and advanced pricing orientation.

Second, we demonstrated that organizational design for pricing needs to be dynamic based on the internal situation of each firm and based on external market forces. This is even more relevant today in a very turbulent economic environment. The recent changes in currency dynamics, the recent forces of regionalization (Brexit and others) and the collapse of emerging markets since 2015 demonstrate

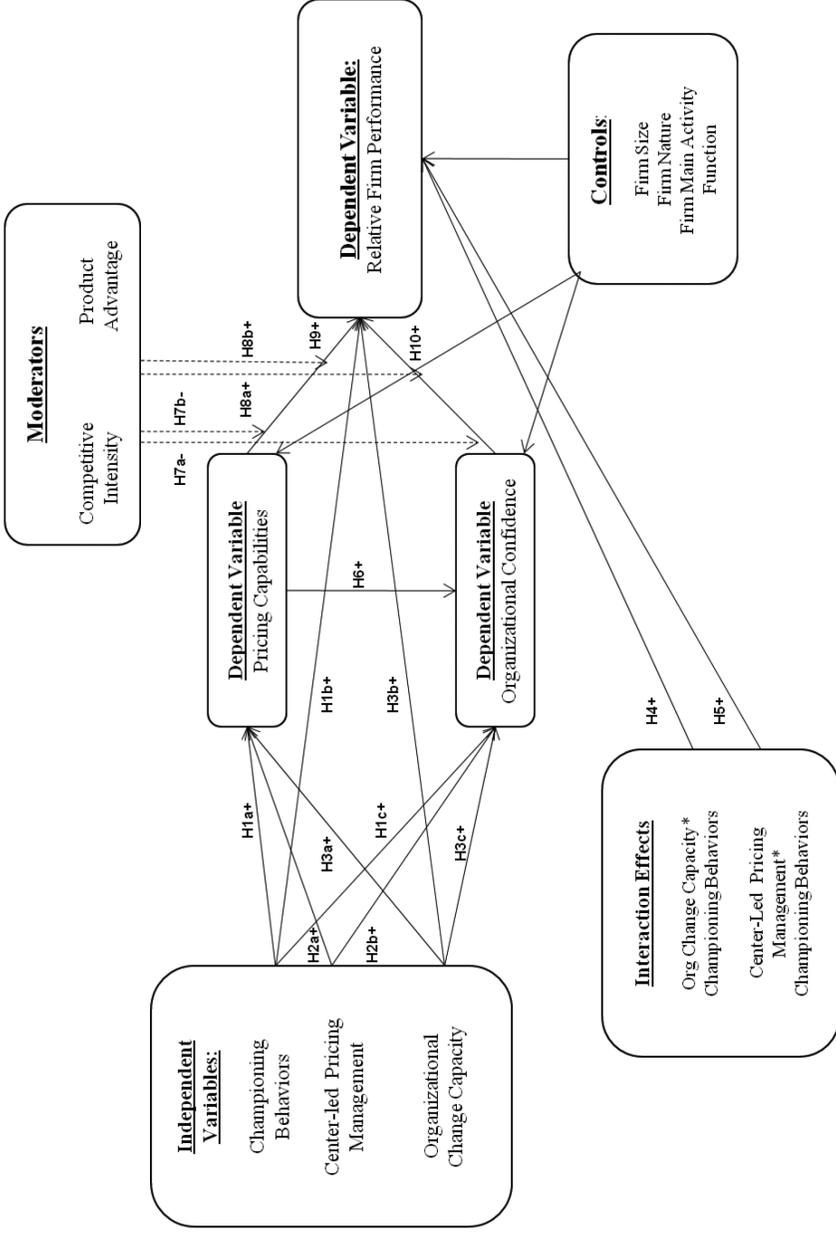


Figure 3.8 Hypothesized quantitative model

that no structure can be static. Some of the most progressive companies using center-led and centralized pricing organizational designs have recently changed their models to account for the environmental changes. Jeff Immelt, CEO of GE, recently justified further decentralization to their business units in a LinkedIn post. Other companies, like 3M, Philips Health Care and Eastman Chemicals, have also started a process of decentralization of their pricing teams in order to be much more reactive to the dynamic conditions. This paper demonstrated the need to be agile and to adjust to external forces. Businesses need faster pricing decisions and real time pricing adjustments when currencies fluctuate and when regional competitors are taking quick and local pricing actions. Since 2015, the trend of decentralization is real. It might change in the future but this might be the optimal pricing organizational design at this time.

Third, this chapter shows that when firms embark on an organizational transformation towards pricing excellence, they might evolve and change their organizational design along the way. Thales recently embarked on such a journey and adopted the center-supported model considering the current level of pricing maturity and the complexity of their divisional structure. This model might evolve two or three years from now when Thales' culture and divisional integration get to the next level. With this, we imply that there is no perfect organizational design for pricing. There is an optimal design at the time of the decision that considers maturity, culture and external forces.

Finally, we have designed a unique quantitative scale to measure the activities of center-led pricing teams. This scale can be used in future research projects related to pricing. Our findings suggest that center-led pricing management is one of the five organizational factors related to pricing leading to firm performance. We therefore show that organizing for pricing using the center-led model can benefit firms and can increase the level of capabilities and confidence related to pricing. Pricing teams play a strong role in boosting expertise, skills and confidence. As a result, they receive a high level of credibility and acceptance from commercial teams located in business units and divisions. Center-led management of pricing is therefore a unique design where compliance is obtained because the central team of experts is dedicated to the pricing success of their counterparts in business units. Center-led pricing teams act as internal consultants dedicated to the pricing success of their divisions and their entire corporations.

Much more needs to be studied and written on the topic of organizational design for pricing. The debate about centralized versus decentralized pricing is still ongoing. We contribute to this discussion by adding an innovative design for the pricing function called the center-led management of pricing. We also propose that this design leads to superior performance in firms. Many firms (DSM, DuPont, ITT, Parker Hannifin, etc.) have adopted this design and have created central marketing or commercial excellence teams in charge of pricing management. These companies have pioneered the center-led design for pricing excellence.

# Appendix: Sample characteristics from qualitative and quantitative studies

Table 3.7 Qualitative survey sample characteristics

<i>Criteria</i>	<i>Characteristics</i>	<i>Firms</i>
Firm size	Small	8
	Medium	7
Industry	Building products	4
	Transportation products	5
	Resins and plastics products	6
Pricing orientation	Cost-based pricing	6
	Competition-based pricing	5
	Value-based pricing	4
	<i>Total firms</i>	15

<i>Criteria</i>	<i>Characteristics</i>	<i>Respondents</i>
Functions	Executive leadership	15
	Sales and marketing	18
	Finance and accounting	11
Nature	Face-to-face interviews	37
	Phone interviews	7
	<i>Total interviews</i>	44
States	Pennsylvania, North Carolina, South Carolina, Oklahoma, Michigan, Massachusetts, Georgia, Wisconsin, Delaware and Kentucky	

Table 3.8 Quantitative survey sample characteristics

	<i>Count</i>	<i>%</i>		<i>Count</i>	<i>%</i>
<i>Main activity</i>			<i>Function of respondents</i>		
Manufacturing firm	415	55	General management	65	9
Service organization	206	28	Marketing and sales	177	24
Distribution/retail company	107	14	Finance and accounting	29	4
Missing data	20	3	Pricing and revenue management	427	57
			Administrative and operations	27	4
<i>Nature of firm</i>			Missing	23	3
Publicly traded	437	58			
Privately owned	257	34	<i>Geography of firm HQ</i>		
Both	25	3	North America	508	68
Do not know	9	1	Latin America	10	1
Missing	20	3	Europe	180	24
			Asia Pacific	21	3
<i>Firm size – employee numbers</i>			Middle East/Africa	2	0
Less than 250	78	10	Missing	27	4
251 to 500	43	6			
501 to 1,000	45	6			
1,001 to 10,000	233	31			

	Count	%		Count	%
<i>Firm size – employee numbers</i>			<i>Geography of respondents' location</i>		
More than 10,000	329	44	North America	532	71
Missing	20	3	Latin America	22	3
<b>Total respondents</b>	<b>748</b>		Europe	140	19
			Asia Pacific	25	3
			Middle East/Africa	2	0
			Missing	27	4

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# 4 Organizational barriers and the implementation of customer value map analysis

A case study of a global manufacturing firm in the polymer technology industry

*Niklas Hallberg and Linn Andersson*

## Introduction

Value-based pricing is often recommended as superior pricing strategy (e.g. Dolan & Simon, 1996; Hinterhuber, 2008; Liozu et al., 2012; Marn et al., 2004; Monroe, 2003). However, while many studies provide detailed analytical recommendations on how to identify customer value and competitor prices (Forbis & Mehta, 1981; Kortge & Okonkwo, 1993; Marn et al., 2004; Monroe, 2003; Shapiro & Jackson, 1978; Smith & Nagle, 2005), the internal coordination and control mechanisms that determine firms' ability to implement value-based pricing are often more vaguely described.<sup>1</sup> For example, coordination and cooperation between different business departments (Dolan, 1995; Dutta et al., 2002; Lancioni, 2005b; Lancioni et al., 2005; Monroe, 2003; Nagle & Holden, 2002; Vogel et al., 2002) is identified as a key success factor for a more effective pricing but seldom elaborated. This is troubling since prior studies have found that firms often find it difficult to replace less effective pricing strategies, such as cost-based pricing and competition-based pricing, with value-based pricing (Hinterhuber, 2008). One reason for this may be that firms lack clearly specified authority levels for granting list price discounts to customers and systems for monitoring the sales force (Hallberg, 2017a; Johansson et al., 2012; Stephenson et al., 1979).

One important element of sales force management is the development of guidelines on how sales representatives should handle customer discounts (Hinterhuber, 2008; Marn et al., 2004; Monroe, 2003; Simon et al., 2003). However, the accumulated empirical evidence on whether pricing authority should be delegated to sales representatives is inconclusive. Some studies recommend that pricing authority under certain conditions (e.g. high commercial uncertainty) should be delegated to the sales representatives because of their superior information about the demands and willingness-to-pay of individual customers (e.g. Frenzen et al., 2010; Hallberg, 2017b; Lal, 1986; Weinberg, 1975). Other studies are more critical of delegating pricing authority to sales representatives because of the trade-off firms face between utilizing sales representatives' better information and the control-related problems that delegation can cause (Andersson, 2013; Hallberg,

2008; Mishra & Prasad, 2004; Stephenson et al., 1979), such as managing differences between the firm's objectives and the goals of the sales representatives (Joseph, 2001; Mishra & Prasad, 2005).

Since the purpose of value-based pricing is to set prices that match customer value and to position products relative to competing products, it requires that the firm accurately estimates the value of its products to each of its customer segments and is able to coordinate its prices across different customer segments. Hence, even if a decentralized pricing authority is suitable for estimating customers' willingness to pay (e.g. Frenzen et al., 2010; Lal, 1986; Weinberg, 1975), it might also prevent the firm from setting coordinated and competitively well-positioned prices. Thus, sales force price delegation might create an organizational barrier to the implementation of value-based pricing, which could limit firms' ability to reap the benefits from this strategy (Johansson et al., 2015). Organizational barriers may take the form of structural impediments, strategy obstacles and systems barriers (Harris, 2000). In this longitudinal case study of a firm implementing value-based pricing, we examine the nature of these organizational barriers by studying the mechanisms by which different levels of sales force price delegation affects the effectiveness with which value-based pricing is implemented. In other words, we address the question of *how sales force price delegation affects the implementation of value-based pricing*.

## **Theoretical foundation**

Publications on price management include a variety of recommendations on how firms should price their products. For example, firms are recommended to base their pricing on customer value (Anderson & Narus, 1998; Forbis & Mehta, 1981; Kortge & Okonkwo, 1993; Liozu & Hinterhuber, 2013; Marn et al., 2004; Monroe, 2003; Shapiro & Jackson, 1978; Smith & Nagle, 2005), competitor prices (Akintoye & Skitmore, 1992; Duke, 1994), customer price sensitivity (Dolan & Jeuland, 1981; Monroe, 2003; Nagle, 1984; Vogel et al., 2002) and opportunities for price discrimination across customer segments (Cannon & Morgan, 1990; Monroe & Lee, 1999; Tellis, 1986). However, despite the large body of research on different pricing strategies and analytical pricing techniques, empirical research on organizational barriers and control-related problems associated with the implementation of value-based pricing is sparse. To the extent that these issues are examined, it is mainly in terms of the different monetary incentives that can be provided to decision-makers at different levels in the organization to increase the likelihood of decisions with a positive effect on profit margin (Hinterhuber, 2004, 2008; Marn et al., 2004; Nagle & Hogan, 2006; Vogel et al., 2002). Hence, differential internal control mechanisms and organizational forms have traditionally been given little attention. Naturally there are exceptions; for example, research stressing top-management involvement (Liozu et al., 2014; Richards et al., 2005; Simon et al., 2003; Urbany, 2001; Vogel et al., 2002), coordination and cooperation between departments (Dolan, 1995; Dutta et al., 2002, 2003; Lancioni, 2005b; Lancioni et al., 2005; Nagle & Holden, 2002; Vogel et al., 2002) and organizational conflicts (Dutta et al., 2003; Zbaracki & Bergen, 2010).

***Value-based pricing strategy***

Value-based pricing strategy, which is claimed to be the most profitable pricing strategy (Anderson & Narus, 1998; Cannon & Morgan, 1990; Hinterhuber, 2008; Ingenbleek et al., 2003), is defined by Hinterhuber (2008: 42) as “the value a product or service delivers to a predefined segment of customers as the main factor for setting prices.” (See also Dolan, 1995; Monroe, 2003; Morris & Calantone, 1990; Thompson & Coe, 1997) We define customer value as “a customer’s perceived preference for and evaluation of those product attributes, attribute performance, and consequences arising from use that facilitate (or block) achieving the customer’s goals and purposes in use situations” (Woodruff, 1997: 142).

Contrary to our definition, customer value is sometimes defined as the difference between the benefits received and the sacrifices made by the customer (see Lapierre, 2000; Marn et al., 2004; Menon et al., 2005; Shapiro & Jackson, 1978; Teas & Agarwal, 2000). In these definitions, sacrifices refer to what the customer gives up when acquiring the product, such as price and time, whereas customer benefits are linked to the customer’s perception of the received value of acquiring and using the product.

***Estimating customer value***

The estimation of customer value plays an important role in the implementation of value-based pricing that firms often experience as difficult (Anderson & Narus, 1998; Johansson et al., 2016). Value-based pricing builds on plotting a firm’s products against competing products based on the products’ differential customer value and price. This allows the analyst to visualize the attractiveness of different competitive positions from the perspective of a potential customer.

The first step in applying value-based pricing is thus to quantify the *customer value* of the product in question. Forbis and Mehta (1981) suggest a method for accomplishing this. According to this method, the maximum price the customer is willing to pay is equivalent to the price of a reference product plus or minus the aggregated difference in value provided by the differentiating features of the focal product (e.g. difference in productivity, cost for maintenance, product life-time, payback time or return on investment) (see Marn et al., 2004; Monroe, 2003).

Once the customer value of the focal product is quantified, the same analysis is performed for competing products. As exemplified in Figure 4.1, the result of the analysis may then be plotted in a two-dimensional chart with the product’s customer value on the *y*-axis and the product’s price on the *x*-axis. Products plotted on the dotted line are consequently those products for which price equals customer value. Product P illustrates the focal product whereas Product C1 and C2 represent competitive products.

While the above procedure might be a useful technique for analyzing the competitive consequences of different prices, firms often encounter organizational challenges when implementing the result from this analysis since the relevant commercial information and pricing authority is distributed across different levels of the organization (see Mookherjee, 2006). These difficulties might ultimately

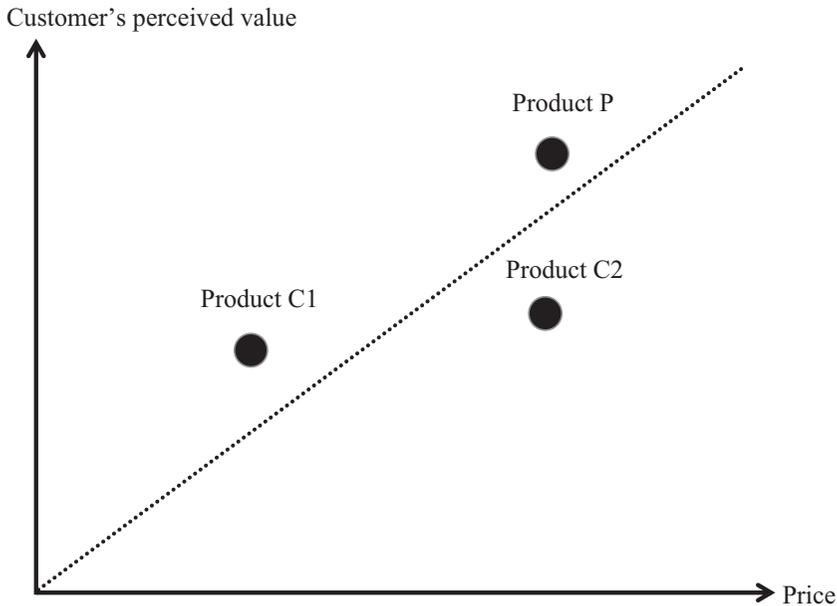
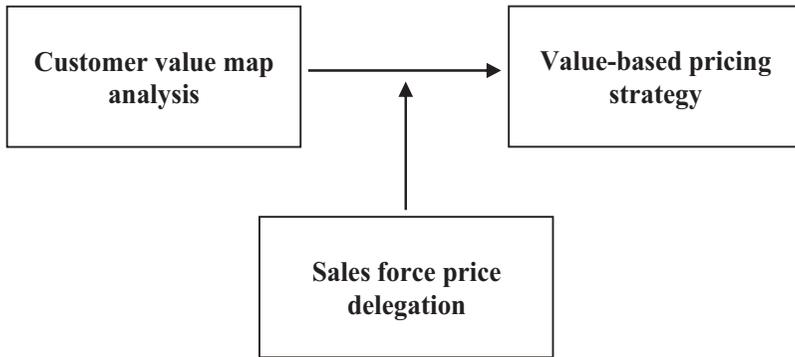


Figure 4.1 Graphical illustration of different value-price positions

lead firms to implement more traditional cost-based or competition-based strategies (Hinterhuber, 2008). This indicates that there are important organizational barriers that might prevent firms from implementing value-based pricing that should be taken into account. Among other factors, prior studies have shown that sales force delegation and control are important factors to consider when implementing new pricing strategies (Hallberg, 2017a; Hinterhuber, 2008; Marn et al., 2004; Monroe, 2003; Simon et al., 2003).

Coordination and cooperation between business departments is often stressed as an important factor for managing price since pricing requires information held by different departments (Dolan, 1995; Dutta et al., 2002; Lancioni, 2005b; Lancioni et al., 2005; Monroe, 2003; Nagle & Holden, 2002; Vogel et al., 2002). For example, the sales department might hold important information about customers, the marketing department might be responsible for developing the pricing strategy while the finance department is responsible for financial control (Dolan, 1995). However, even though there is a consensus that firms often encounter internal coordination problems when implementing new pricing strategies (Lancioni, 2005a), it is not yet fully understood what the sources of these problems are (Lancioni et al., 2005). It has been suggested that organizational barriers are created due to a lack of support from management (Richards et al., 2005; Simon et al., 2003; Urbany, 2001; Vogel et al., 2002), internal conflicts (Dutta et al., 2003; Lancioni et al., 2005) and an unclear delegation of the pricing authority (Hinterhuber, 2008).

Among other questions, there is an ongoing debate over whether pricing authority should be delegated to the individual sales representatives or not. Studies



*Figure 4.2* The moderating effect of sales force price delegation on the relationship between customer value map analysis and value-based pricing strategy

pointing to the benefits of delegation emphasize the impact of information asymmetries between the sales force and higher-level managers that puts the individual sales representative in a better position to set prices that match the individual customer's willingness to pay (Frenzen et al., 2010; Lal, 1986; Weinberg, 1975). Those in favor of price delegation also argue that the sales representative is motivated by the responsibility that follows with a full authority to set prices (Dolan & Simon, 1996). A centralized pricing authority is, on the other hand, advocated in cases where there is no information asymmetry between the sales representatives and managers (Lal, 1986; Mishra & Prasad, 2004). This indicates that an important determinant of whether firms should delegate pricing authority is the level of information asymmetry between sales representatives and managers (see Figure 4.2).

Empirical studies on the subject show that full delegation of pricing authority has a negative impact on profit margins because sales representatives tend to seek to increase volume rather than profit margin (Stephenson et al., 1979), a tendency that, for example, might cause sales representatives to give too large discounts (Joseph, 2001; Mishra & Prasad, 2005). The main recommendation that can be derived from this literature is that firms should delegate pricing authority to the individual sales representative and provide incentives that secure that the sales representatives' goals are aligned with business goals. In the following, we examine this implication in detail based on an empirical case study.

## **Methods**

We studied a global manufacturing company (ManComp) in the polymer technology industry. ManComp sells standardized product for the agriculture industry. ManComp was selected because between 2006 and 2010 it significantly changed its pricing organization and successfully implemented a value-based pricing strategy. ManComp's main markets are Western Europe and North America.

### **Data collection**

The data was collected through interviews and internal documents (e.g. reports related to the pricing project, presentation material for internal use, annual reports, internal training material, and pricing self-assessments). Eight respondents were interviewed at the head office of ManComp. Each interview lasted up to three hours. The respondents held positions such as marketing manager, pricing manager, sales manager, sales representative, finance manager and CEO. The respondents were selected based on a request to interview employees involved in the pricing process. The interview questions covered the project aimed at changing the pricing practice, the past and current practice for setting prices, pricing techniques, pricing authority, customer relationship management and the competitive market situation (see Appendix). Each interview was recorded and transcribed. In order to control the validity of our findings, a report was sent to the pricing project manager who was given the opportunity to comment on the results in a phone interview.

### **Data analysis**

The transcribed interviews and relevant data from internal documents were first structured chronologically to give a full account of the events that had transpired from the initiation of the pricing project at ManComp to its completion. This allowed us to sort and describe events at ManComp according to the sequence in which the new pricing project had developed. The case description was then structured according to *a priori* specified constructs such as *pricing strategy* (i.e. cost-based and value-based pricing), *pricing techniques* (e.g. value-based pricing) and *sales force price delegation* (e.g. the sales representatives authority to grant discounts) (Eisenhardt, 1989: 536). This allowed us to empirically examine the effects of different levels of sales force price delegation and pricing techniques on ManComp's ability to effectively implement a value-based pricing strategy. The empirical pattern that emerged from this analysis was then matched against the recommendations that had been identified in the literature review (Yin, 2009).

### **ManComp's implementation of value-based pricing**

In 2001, a large corporate group in the polymer technology industry acquired ManComp from a competitor. ManComp was, as a part of the agreement, given the permission to license the competitor's brand until the end of 2010. In 2006, ManComp launched a project with the purpose of rebranding its products. Since the competitor from whom ManComp was acquired was recognized as a premium brand and the acquiring group was more or less unknown within this particular industry, management at ManComp feared that the customers would request lower prices and change to competing products. Thus, the purpose of the rebranding project was to protect market share and to maintain price levels. Hence, in order to maintain profit margin and sales volume, management initiated a pricing project with the purpose of changing the pricing practice at ManComp. The

following four sections present the project of changing the pricing practice at ManComp. This includes pricing practices prior to the change, the actions that were taken in order to accomplish a change of the pricing practices, the pricing practice after the change and the perceived performance outcomes of the project. Table 4.1 summarizes the changed pricing practice at ManComp in terms of the pricing strategy, sales force price delegation and pricing techniques.

### ***Pricing at ManComp prior to the pricing project***

At the time when the pricing project was initiated, ManComp was using two different sales channels: original equipment manufacturers (OEMs) and dealers. Roughly 55 percent of the products were sold to OEMs, whereas the remaining 45 percent were spare parts sold to dealers. The OEMs are generally larger, global players that are handled centrally at the head office. The prices to the OEMs are negotiated for each customer and agreement. Due to the limited number of OEMs, their large turnover and the long-term customer relationships, specific sales representatives were assigned for each OEM and pricing authority was delegated to these sales representatives.

The sales representatives responsible for the OEMs used his or her experience and gut feeling when setting prices. As a result, the prices were largely based on customer history. The dealers, on the other hand, which are generally smaller, local firms that sell within a limited geographical area, were given price lists (with standardized rebates). The price lists were issued by the regional market offices, which autonomously set prices and handled customer negotiations. The pricing strategy used at this stage was, for both OEMs and dealers, cost-plus profit pricing. The pricing techniques that were used were profitability analysis for the different product categories (for the dealers) and individual OEM profitability. A pricing manager at the head office performed all these activities on a monthly basis. Prices across different regional markets were not monitored, neither was the sales representatives' performance in terms of gross profit margin achievement.

### ***Actions taken***

When initiated in 2006, the project team, consisting of the pricing manager, marketing manager, sales managers and the CEO, started by analyzing the pricing organization and formalizing an action plan in order to prevent possible negative consequences from the acquisition and the change in brand. The project team identified two main problems with the current pricing practice: inconsistent price level throughout sales regions that hindered the company from practicing competitive price positioning and the sales representatives were lacking the ability to set prices that matched customer value. According to the marketing director at ManComp, the problem was that the individual sales representatives placed too much focus on revenue and competitors' prices rather than profit margin and customer value. He explained:

The sales people always think of a market price, but the problem is that they cannot define the market price and they cannot determine the willingness of

Table 4.1 ManComp's pricing prior to the pricing project, actions taken and pricing after the project

	<i>Prior to the pricing project</i>	<i>Actions taken</i>	<i>After the pricing project</i>
<b>Pricing strategy</b>	<ul style="list-style-type: none"> <li>• Cost-plus pricing</li> <li>• Pricing authority regarding the dealers delegated to the regional market offices</li> </ul>	<ul style="list-style-type: none"> <li>• A project team consisting of managers and internal pricing experts was given the task of analyzing the pricing organization and providing recommendations for improvement</li> </ul>	<ul style="list-style-type: none"> <li>• Value-based pricing</li> <li>• A centralized pricing authority for all customers</li> </ul>
<b>Sales force price delegation</b>	<ul style="list-style-type: none"> <li>• Pricing authority regarding the OEMs delegated to the individual sales representatives at the head office</li> <li>• A pricing manager working dedicated with pricing</li> </ul>	<ul style="list-style-type: none"> <li>• A communication campaign addressing both employees and customers was conducted</li> <li>• Approximately 10% of the sales force was laid off</li> <li>• Top management had a high focus on pricing</li> <li>• A new IT tool was constructed and implemented in order to allow for better information management</li> </ul>	<ul style="list-style-type: none"> <li>• Strict guidelines regarding the sales representatives' authority to give discounts</li> <li>• Sales representatives rewarded on gross profit margin</li> <li>• Pricing lists issued by head office instead of the regional market offices</li> <li>• A pricing manager working dedicated with pricing</li> </ul>
<b>Pricing techniques</b>	<ul style="list-style-type: none"> <li>• Prices were set based on the individual sales representatives' experience/gut-feeling and customer history</li> <li>• Customer-profitability was analyzed for the OEMs</li> <li>• Product profitability was analyzed on an aggregated level for the different product categories</li> </ul>	<ul style="list-style-type: none"> <li>• Sales representatives were provided with training in value-based pricing techniques</li> <li>• Employees were hired based on their pricing skills</li> </ul>	<ul style="list-style-type: none"> <li>• Mapping customer value <ul style="list-style-type: none"> <li>○ Price elasticity of demand analysis</li> <li>○ Inter-country price coherent reports</li> <li>○ Quantification of customer's buying criteria <ul style="list-style-type: none"> <li>○ Identification and analysis of competitors' prices and products</li> <li>○ Customer-profitability analysis</li> <li>○ Product-profitability analysis</li> <li>○ Customer segmentation</li> <li>○ Revenue leakage analysis</li> </ul> </li> </ul> </li> </ul>

the customer to pay for that. They are not capable of doing that. It is not easy and probably they are much more short term driven. They want the product to be sold right now.

In order to address the two identified problems, a decision was made by management to implement value-based pricing and increase the consistency of prices across different sales regions. According to the project members, the pricing project was highly prioritized by management from the very beginning. The marketing director, one of the project team members, explained the high level of management support:

There was a focus from the top, no doubt about that. That was the only way because pricing need time and resource so if it is not coming, the commitment from top-management, you cannot have resources. The time that you dedicate to prices means that you cannot dedicate to something else. So if it is not in the priority of the company it cannot be in the priority of the employee. I think it is quite easy to understand.

Before any changes were implemented, an information campaign addressed to both employees and customers was launched. The part of the campaign that was directed toward employees was initiated one year before any actual changes were implemented. Its purpose was to convince the employees of the benefits of the new pricing practice. Approximately 10 percent of the employees within sales did not accept the new pricing practice. These employees were laid-off as a result of their refusal to accept the new pricing practice. The part of the campaign that was directed toward the customers was designed to convince them that ManComp's products, and the quality of products, would remain the same after the change in brand.

### ***Implementing competitive price positioning***

According to the CEO, the competitive positioning of ManComp's products were perceived as essential both in order to signal the value of the product to the customer and to prevent internal predatory pricing, which, in the long run, might lower the average price level. Hence, the next step in the pricing project was to centralize the pricing authority for all customers in order to secure that the products were sold at a premium price. Thus the decision was made to issue the price lists to the dealers from the head office rather than from the regional market offices. Further, the sales representatives' authority to grant discounts was restricted. According to the marketing manager, the decision to centralize the pricing authority and restrict the sales representatives' authority to grant customer discounts allowed management to limit the sales representatives' tendency to prioritize revenue over profit margin. The CEO explained:

Pricing is about positioning. I consider pricing to be the most important thing to influence the customer's perception of the value. So that is why we have decided since the beginning to position ourselves on the top and be a price

leader in the market. This is mandatory in this company. Then of course you need to be consistent. You cannot have countries where your position is low because this is a global market. Your premium price position needs to be coherent with the rest of the world.

### ***Matching prices according to customer value***

Next, the sales representatives were provided with training on how to identify and quantify the customer value of products and to communicate how ManComp's product created value for different customer segments. Further, the sales representatives were trained in how to analyze price elasticity and perform competitive price positioning. This new employee skill set was particularly valued when hiring new sales representatives. The training material was published on the intranet for easy access.

Additionally, in order to facilitate the implementation of value-based pricing and the handling of required data (e.g. competitors' prices and customer history), a new IT system allowing better information management and price analysis were constructed. This includes a toolbox of pricing techniques that enable the pricing manager to perform price elasticity of demand analysis, revenue leakage analysis, customer value map analysis, and inter-country price coherency reports.

### ***Pricing at ManComp after the pricing project***

The pricing project at ManComp was completed in 2010. The results of the project exceeded targets. Major changes had been made in several key areas as a result of ManComp's implementation of value-based pricing. As listed in Table 4.1, changes were made regarding the level of sales force price delegation and the use of different pricing techniques. These changes regarding sales force price delegation and the implemented pricing techniques are presented in the following sections.

### ***Sales force price delegation***

As a result of the new centralized pricing authority, the sales representatives' authority to allow discounts was restricted to 2 percent per year. In other words, the individual sales representatives could give the full 2 percent discount to one single customer or freely distribute it across several customers. Hence, discounting decisions were almost fully centralized, leaving only a small range for the sales representatives to negotiate. The limited possibility of sales representatives to offer discounts led to a decreased pressure to reduce the prices in customer negotiations. One of the sales representatives explained:

In the discussion with the customer, it is always about the price, that's always what the customer wants to talk about. The challenge is to convince the customer that the added value that [ManComp] sells is worth paying extra for. The restricted discounts makes it easier because we simply cannot go lower in price, even if the customer asks us to.

Thus, the restricted pricing authority resulted in a decreased focus on price in customer negotiations. When asked by the customer to lower the prices, the sales representatives either referred to the value provided by the product or offered a product with a lower quality and price. As indicated above, in some cases, if the sales representative judged that the customer had great future potential, the sales representative was able to offer a discount within their limited discount authority. Generally, the sales representatives did not experience that they were losing customers because of the new restricted discount policy. This was due to the greater precision in the competitive price positioning analysis. In other words, the customers were usually not able to buy similar products from a competitor at a lower price.

### ***Training the employees in value-based pricing***

As a substitute for using discounts as a tool in customer negotiations, each year the sales representatives were provided with training sessions on value-based pricing and how to communicate product value to the customers. The sales representatives responsible for the OEMs were obligated to perform customer value analysis for their respective customers, whereas the pricing manager, responsible for producing the price lists for the spare parts sold through the dealers, performed this analysis for a selection of these products. Analyzing customer value for all of the spare parts would be too time consuming. Thus, rather than quantifying the customer value according to the logic used for the OEMs, the pricing manager relied on price elasticity of demand analysis when adjusting the price levels for the standardized products.

### ***Price elasticity of demand analysis***

As a result of the centralized pricing authority, the pricing manager at the head office now issued the price lists to the dealers. The pricing manager monitored the prices charged to each customer and conducted revenue leakage analysis for each product category. By dividing the change in the average price level with the change in sales volume, the pricing manager was able to perform price elasticity analysis for each product category within the different sales regions. Based on these analyses, the pricing manager quickly detected changes in volume due to price changes and responded accordingly. The CEO explained the importance of price elasticity of demand analysis:

We do a lot of studies in price-volume-elasticity in order to understand exactly what impact we can expect on volume from a price increase. We are actually at the moment doing a study because we need to raise the price and we might lose some volume, we might lose a lot. But again, the gross contribution that we are going to get from the price increase is much higher than the additional volume we may get if we don't increase the prices at the level we would like to increase it.

### ***Value-based pricing of new products***

ManComp conducted a detailed analysis of customer value each time they launched a new product. This involved testing customers' buying criteria and

benchmarking competing products according to these parameters. For new product launches, an external organization, a university for example, was often hired to perform certified tests. These tests, in combination with the cost for maintenance and product life time, were benchmarked with competing products and analyzed.

### ***Competitive price positioning***

In order to perform competitive price positioning, new procedures for monitoring price levels between different sales regions were introduced. When conducting the monthly inter-country price comparison analysis, the pricing manager compared the average price level for each product category within each sales region with the average price of the competitors' products sold in the same region. The competitors' prices were obtained from product catalogues and the information the sales representatives received from customers. The sales representatives were responsible for reporting this information to the regional marketing office, which in turn reported it to the pricing manager.

The monthly inter-country prices comparison analyses enabled the pricing manager to both detect price differences between sales regions and provide him with the actual price position of each product category relative to competing products. According to the pricing manager, his analysis revealed that the competitor's prices differed between different sales segments, implying that many competitors lacked the capability to effectively perform price positioning. According to the sales representatives, knowing the prices of the competitors gave them better self-esteem when going into the customer meeting because they were confident that the prices were correct.

The CEO explained the advantages with the competitive price positioning:

I can see our prices compared to our competitors' and break it down in detail country by country. In order to position yourself, you need to know exactly where you are, market by market, so that is why we have people in all the markets that are doing this job daily, just collecting information on prices. They produce a lot of information that tells me exactly in any segment and product category where we stand. We are quite centralized when you talk about pricing because we know that inconsistent prices will reduce the average price level instantly. We give freedom in any thinking to the subsidiary but when we talk about pricing, we would like to keep everything under control because we need to coordinate, because we need to make sure that we are coherent in our image all over the world and that is the basis of our pricing strategy today.

### ***Pricing culture***

The internal awareness of the strategic importance of pricing was facilitated by the marketing meetings being held two or three times each year, during which there was always a session dedicated to pricing. Additionally, during the monthly meetings with the highest management level, where all of the departments, such as sales, marketing, manufacturing and finance, were represented, the first hour of the meeting was always dedicated to pricing. The pricing review for the last

month was discussed, including raw material trends, competitive scenario and performance on the key performance indicators for pricing, such as inter-country price consistency, profitability and gross profit margin. In order to facilitate a focus among the sales representatives on profit margin, they were measured and rewarded on the gross profit margin that they achieved.

### ***Perceived performance outcomes from the pricing project according to self-assessment***

Once the pricing project was completed in 2010, the result exceeded targets. The market share in Europe had more than doubled and the average price level had increased to the same level as the leading competitor. This made ManComp one of two actors in the highest European price segment. But perhaps most importantly, the profit margin (earnings before interest, taxes, depreciation and amortization, EBITDA) had doubled.

The marketing director explained the outcome as resulting from the decision to centralize the pricing authority. He believed that the sales representatives would have been unable to maintain a premium price level if they had maintained authority to grant customer discounts. Hence, the results from the pricing projects showed that the sales representatives, once they were provided with training in value-based pricing, were able to better explain the value of the products to the customers and thus get the customers to accept premium prices.

When commenting on the results from the pricing project, the marketing director said that maintaining a competitive positioning in the highest price segment was the key success factor in order to ensure that the customers would understand the value of the products:

I wouldn't believe it and I also think that they [top-management] didn't even consider the possibility to increase the market share and to reduce the price gap [between ManComp and the competitor in the highest price segment]. Probably they just wanted to keep the gap and keep the position but the results were exceeding the expectations. There is a lot of reasons why, we have been analyzing why it was good. For sure, one of the reasons, one part of the success is because of the price, because of what we've been doing. So I think it's been really a pillar in the brand switch project and I will take that with me in the future in the sense that when one wants to run a brand switch it is really risky not prioritizing pricing first. It is extremely important because pricing has an enormous effect on the perception of the value, enormous.

## **Conclusion**

The results of our study indicate that innovation in sales force management, or more specifically, sales force price delegation (such as ManComp's radical centralization of pricing authority), is a key success factor for the implementation of value-based pricing. While some prior studies recommend that pricing authority

is delegated to the individual sales representatives, because they supposedly hold better information about the customers' willingness to pay, our study indicates that there are important benefits of a centralized pricing authority. Hence, instead of being given guidelines for how to deduct discounts and incentives that reward profit margin achievement, we argue that the sales representatives should be provided with training on how to explain the centrally decided prices to the customers in terms of the value provided by the firm's products.

The decision of whether to delegate pricing authority to the individual sales representative should not primarily be seen as a question of information asymmetry (cf. Frenzen et al., 2010; Lal, 1986; Mishra & Prasad, 2004; Weinberg, 1975) and the alignment of sales representatives' and management's goals (cf. Joseph, 2001; Marn et al., 2004; Mishra & Prasad, 2005; Vogel et al., 2002). Rather, the key question is whether the firm has adequate knowledge and skills at the organizational level where pricing decisions are made and enough control over decision-makers at this level to guarantee that prices are consistent and coordinated (see Hallberg, 2015).

Prior studies have found that firms often find it difficult to implement innovative pricing strategies, such as value-based pricing, due to the organizational challenges they face in the implementation process (Hinterhuber, 2008). We identify three organizational barriers related to sales force price delegation that prevent an effective use of value-based pricing.

First, allowing individual sales representatives, or even regional sales offices, to independently issue prices causes inconsistency. This is highly problematic when doing value-based pricing since it undermines the competitive price positioning of products, a central aspect that requires consistent prices within and across sales regions. In other words, an effective use of value-based pricing requires that pricing authority is centralized and not spread across different decision-makers. Naturally, there are benefits of a decentralized pricing authority in terms of local and fast responsiveness to customer demand. However, our study indicates that, despite these benefits, decentralization is a deceitful path to customer satisfaction. Ultimately, value-based pricing builds on knowing what the products are really worth to the customer and consistently communicating this value to the customer. Local responsiveness in terms of asking individual customers to estimate their perceived value of the product is not the solution.

Second, sales representatives operating in cost-based business environments do not normally have the training or techniques for identifying and quantifying customer value. Naturally, this presents a challenge to firms attempting to change from cost- to value-based pricing. Managers are thus left with the choice of either centralizing pricing authority to a level where sufficient knowledge and control can be achieved (e.g. a pricing manager) or spending substantial resources on retraining its sales force. Given the cost of retraining the sales force and the limited benefits of having a sales force that is itself capable of delivering value-based prices (due to the coordination problems discussed above), this speaks in favor of centralizing pricing decisions. The managerial implications of this is that the implementation of pricing innovations in traditional organizations (such as

ManComp) should be accomplished with a strict top-down, rather than bottom-up, focus in order to avoid organizational coordination problems that might otherwise offset the benefits of these innovations.

Third, our study shows that granting sales representatives authority to give discounts makes the sales representatives more inclined to offer substantial discounts to customers and less inclined to spend time and effort on communicating the rationale behind the price in terms of customer value. In other words, granting sales representatives authority to give discounts leads to prices that correspond to what the customers claim to be their willingness to pay rather than the actual customer value provided by the firm. Presumably, this is simply the effect of sales representatives' wish to please their customers and make the interaction more pleasant, thus requiring less effort on behalf of the sales representative.

### **Implications for innovation in pricing**

We offer the following three recommendations to managers that, like the managers at ManComp, are dedicated to innovation in pricing and are about to begin the process of replacing their traditional cost-based pricing strategy with a value-based pricing strategy:

- Local responsiveness in terms of asking individual customers to estimate their perceived value of the product is not a solution to the challenges faced by firms in the implementation of value-based pricing; it is part of the problem. The solution is to identify the organizational level within your firm where decision-makers possess the right mix of product- and market-specific knowledge that may enable them to make pricing decisions that are both consistent (i.e. meet the requirement of competitive price positioning) and accurately reflect the value provided to customers.
- The implementation of pricing innovations, such as value-based pricing strategy, in more traditional industries (where firms normally rely on cost-based pricing) should be accomplished with a strict top-down, rather than bottom-up, focus in order to avoid organizational coordination problems that might otherwise offset the benefits of these pricing innovations.
- Granting sales representatives authority to give significant discounts leads to prices that correspond to what the customers claim to be their willingness to pay rather than the actual customer value provided by the firm. All negotiation games are structured by the parties' prior commitments. Make sure that the negotiation games your sales representatives play are structured so that they stand a chance of capturing a fair share of the money that is on the table.

### **Note**

- 1 This is not specific to studies of value-based pricing but applies more broadly to management and marketing research where there is a tendency to focus on the analytical problem and abstract from questions related to implementation, process and organization (see Foss & Hallberg 2014).

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# 5 CEO championing of pricing and the impact on firm performance

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## Introduction

Pricing – “the only marketing mix variable that generates revenue” (Rao, 1984: 39) – is a complex management challenge with indisputable impact on firm performance. As observed by Warren Buffet:

The single most important decision in evaluating a business is pricing power. If you’ve got the power to raise prices without losing business to a competitor, you’ve got a very good business. And if you have to have a prayer session before raising the price by 10 per cent, then you’ve got a terrible business.

(Frye & Campbell, 2011)

Yet, while pricing and firm profitability are inextricably linked (Lancioni, 2005), pricing has commanded scant attention by many scholars and practitioners (Avlonitis & Indounas, 2006). In particular, the role and influence of top management in the pricing process has been under-researched and under-appreciated.

Several studies have examined how firms make pricing decisions and how pricing decisions influence profitability (Ingenbleek et al., 2003; Smith, 1995). Others have demonstrated that CEOs, as architects of corporate strategy (Andrews, 1971), impact firm performance (Mackey, 2008) by committing organizations to specific courses of action (Harrison & Pelletier, 1997).

With respect to pricing, C-level involvement means setting the right objectives and incentives, driving organizational and cultural changes to support better pricing and taking responsibility for pricing strategy as a whole. Curiously, how and to what extent CEOs actually do this has not been directly studied.

To address this phenomenological gap, we surveyed 557 business owners, presidents and CEOs in firms from around the world to measure the effect of championing of pricing on firms’ organizational design and relative performance. Our inquiry contributes to the fields of pricing and organizational behavior by linking championing behaviors on pricing to three organizational factors – pricing capabilities, collective mindfulness and decision making rationality – and

subsequently to relative firm performance. Most importantly, our data highlight the role of organizational champions in support of the pricing function and imply that purposeful championing of pricing influences organizational design for pricing and may impact perceived firm performance.

**Theoretical background and hypotheses**

The development of our theoretical research model (shown in Figure 5.1) draws from related streams on pricing literature, firm capabilities and a resource-based view of the firm and from critical dimensions of organization theory from a decision-making perspective, such as bounded rationality, organizational champions and collective mindfulness.

*Pricing literature from an organizational perspective*

Several studies have examined pricing practices from the perspective of organizational decision processes but only a handful have linked the bodies of knowledge on pricing and organizational behaviors. Cyert and March (1992), who studied pricing behaviors in a retail environment, suggest that, over time, simplifying “rules of thumb” emerge within the firm. They argue that prices are “negotiated” between various departments of the firm as a way to reach consensus and achieve negotiated objectives. Finally, they propose that cost-based pricing

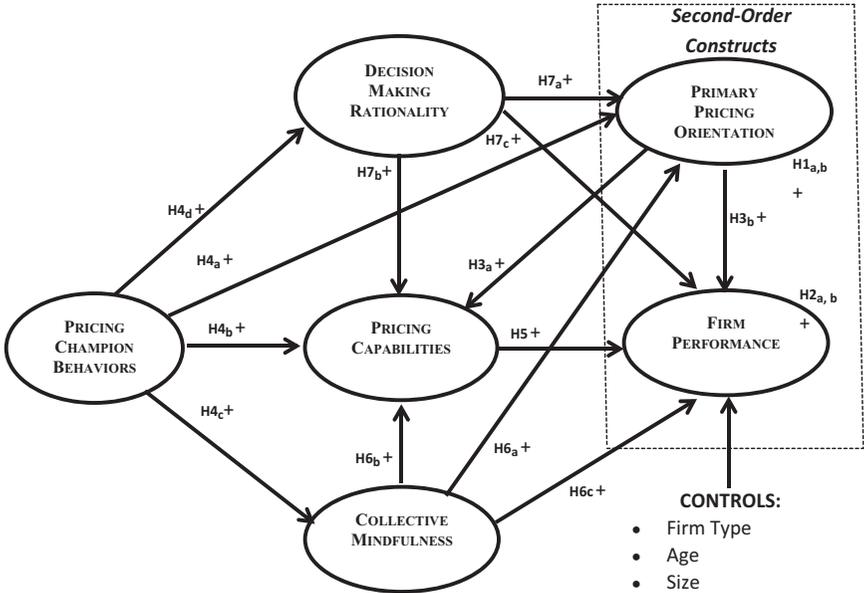


Figure 5.1 Research model and proposed hypotheses

practices are included among these rules of thumb or routines. Lancioni et al. (2005) researched the intra-organizational influence on business-to-business pricing strategies and, more specifically, the importance of interdepartmental rivalry and conflicting interests on the pricing process. The findings show that resistance to progressive pricing strategies emanates from many groups in firms, each of them “having parochial interests and agendas.” The finance department that was ranked as the most difficult to work with in developing a comprehensive pricing policy created the most dominant resistance and roadblocks. Senior management was also ranked high because of its desire to control the pricing process. Finally, Ingenbleek (2007) conducted a meta-analysis of 53 pricing studies drawn from cost-principle theory, decision-making theory and marketing strategy. Although no empirical research was conducted, Ingenbleek proposed a conceptual framework and several directions for future research in the field of value-informed pricing. His review of the literature suggests that information sources represent a key resource to be acquired, developed and deployed within the firm. However, the availability of information does not guarantee success in value-informed pricing. The degree to which information is processed, interpreted, communicated and used can influence the implementation of it. Thus the pricing process within the firm can influence the management of information related to customer value perceptions. Ingenbleek (2007) made the following critical conclusions with regard to pricing literature: (1) it is highly descriptive and lacks statistical significance; (2) research insights on pricing practices are often not cumulative; and (3) theory about how price decisions are made in firms is limited. We build on the scholarly work of Cyert and March, Lancioni and Ingenbleek by bridging the fields of pricing and organizational behavior. Logically, there is not a unique way for defining prices. Before setting a price, the company must decide what is going to be the strategy for the product in addition to what will be the proposed objectives, since the clearer these decisions are, the easier it will be to establish prices (Hinterhuber & Liozu, 2013, 2014).

### ***Pricing orientation and firm performance***

The notion of pricing orientation in firms has not been appropriately defined and explored. A handful of academic papers reviewed pricing approaches in business markets (Hinterhuber, 2008b) while others discussed pricing practices and their relationship to new product market performance (Ingenbleek et al., 2003, 2010). Managerial pricing orientation “deals with decisions relating to setting or changing prices. It also includes price positioning and product decisions introducing new pricing points to the business unit’s product or service mix” (Smith, 1995). Smith defined it as consisting of four dimensions (information getting and processing, pricing objectives, policies and beliefs, organizational decision processing and organizational responsiveness) and proposed four distinct managerial pricing orientations – cost, sales, competition and strategy.

We define pricing orientation by adapting the dimensions developed by Ingenbleek et al. (2001) – value-based pricing, competition-based pricing and cost-based

pricing. We consider pricing orientation from a firm's strategic perspective and define it as all pricing practices, methods, behaviors and processes leading to pricing decisions with the goal of maintaining and sustaining firm competitive advantage. Moreover, our methodological emphasis is placed on conceptualizing pricing orientation as a second-order factor and defining the three dimensions as first-order factors.

**HYPOTHESIS 1a:** *There are three distinct dimensions of a firm's pricing orientation.*

**HYPOTHESIS 1b:** *Each dimension contributes to a second-order construct of a firm's pricing orientation.*

Most pricing practitioners agree that pricing orientation and the lack of scientific and systematic return on investment (ROI) calculations for pricing strategies constrain visibility of pricing in the C-suite and restrain firm adoption of modern pricing approaches. In addition, marketing and pricing literature is silent about both the consequences of pricing orientations on overall company performance (Ingenbleek, 2007; Hinterhuber, 2008b) and, more specifically, on how value-based pricing might lead to superior firm performance. Perceived value-based pricing is a pricing practice whereby managers make decisions based on customer perceptions of product benefits and how these benefits are weighted by the customers relative to the price they pay (Ingenbleek et al., 2010). Ingenbleek et al. (2003) demonstrated that value-based pricing is a key pricing practice for obtaining larger returns and for creating a comparative advantage for the company's products. This was demonstrated in a study conducted by Füreder et al. (2014) on medium-sized companies in Austria that showed higher contribution margins when accompanied by the perceived value-based pricing strategy.

Competition-based pricing uses competitors' price levels and behavior expectations as key sources of information to determine pricing (Liozu & Hinterhuber, 2012). The main advantage of this approach is considering the actual pricing situation of the competitors. Its main disadvantage is that demand related aspects are not considered. Furthermore, a strong competitive focus among competitors can increase the risk of starting a price war in the market (Heil & Helsen, 2001).

Cost-based pricing is the simplest and most popular method for setting prices because it carries a sense of financial judgment, which involves adding a profit margin on costs, such as adding a standard percentage contribution margin to the products and services. First, sales revenue is determined; then the unit and total costs are calculated; followed by a check of the company's profit objectives; and, finally, establishing the prices. Thus, from a pricing professional perspective, it is necessary for customers to perceive enough value in products and commercialized services to justify the prices charged by the company.

Pricing strategies may be seen as a process that requires a good understanding of the internal structure of the company, a good knowledge of the market and a good knowledge of the diverse variables that comprise it and their interfaces. The price is considered one of the most impacting elements in companies' performance.

Ingenbleek et al. (2003) tested the relationship between pricing approach and new product success and found value-informed pricing had the overall strongest positive effect on product performance. A subsequent study (Ingenbleek et al., 2010) showed value-informed pricing positively influenced new product market (but not new product financial) performance, noting the latter link may require a more complex model including data on sales, costs and other information (Ingenbleek et al., 2010).

We believe firm performance may be better represented as a higher-order construct. Consequently, firms' relative performance is operationalized as a second-order factor measured by sales, profit and pricing. Conceptualizing firm performance in this manner recognizes that the construct's interpretation is derived from the content of the items used in its operationalization. Thus we posit:

**HYPOTHESIS 2a:** *There are three distinct dimensions of a firm's relative performance.*

**HYPOTHESIS 2b:** *Each dimension contributes to a second-order construct of a firm's relative performance.*

**HYPOTHESIS 3a:** *The firm's pricing orientation will be related positively to its pricing capabilities.*

**HYPOTHESIS 3b:** *The firm's pricing orientation will be related positively to its relative performance.*

### ***Organizational champions***

We define championing as "the persistent and persuasive communication of proposals that either provide the firm with new capabilities or allow the firm to use existing capabilities differently" (e.g. Floyd & Wooldridge, 1996: 55). Champions are valuable to organizations in that they are often able to mobilize company resources, generate momentum for a strategy (Noble & Mokwa, 1999) and spur on organizational innovation (Howell & Higgins, 1990). As a result, top managers have begun to recognize the importance of champions in the organization. Past research readily acknowledges the importance of champions and, more recently, the importance of fostering championing. Without champions, organizations may have a lot of ideas but few tangible innovations. The challenge facing management is to identify and effectively manage existing champions and to nurture potential champions (Howell & Higgins, 1990: 55)

Leaders can influence both functional management commitment and the adoption of innovative technology and practices in firms (March & Simon, 1958: 219). Top management support strongly impacts functional management commitment. This type of top management support is needed for initiatives, such as total cost of ownership (TCO) (Wouters et al., 2005) or value-based pricing (Hinterhuber, 2008a), that require inter-functional cooperation. Hinterhuber (2008a), for example, reported lack of support from senior management was an obstacle for 50 percent of respondents involved in value-based pricing implementation. Senior management support for customer-value management processes is a requirement

when firms try to implement a “philosophy” of doing business based on demonstrated value to customers (Anderson et al., 2007: 13). Senior management must “take a broader view of persuasively conveying this value merchant mind-set and culture to everyone working in the business and to the customers” (Anderson et al., 2007: 123). Hinterhuber (2008a: 49) argued that “senior management (support) can be obtained through various means, including lobbying, networking and bargaining. If such support is gained, middle-ranking executives can then implement value-based pricing strategies.”

Top management plays a key role in defining and promoting corporate-wide priorities and new strategic programs but also in identifying, allocating and deploying strategic resources to support these programs (Chandler, 1973: 4). Executive experience, overall personality and risk aversion behaviors help determine the course and rate of structural adaptation and innovation (Chandler, 1973: 283; Jaworski & Kohli, 1993). The influence, skills and drive of upper management are a resource leading to better strategy and greater economic rents by firms (Barney & Clark, 2007). Leadership styles (authoritative versus participative) and backgrounds (legal, finance or marketing) also impact the organization (Chandler, 1973: 317; Simon, 1961: 159).

Scholars and practitioners have focused on the role of champions from a leadership perspective. Organizational champions have been defined as charismatic leaders (Nadler & Tushman, 1990), transformational leaders (Bass, 1985: 22; Wang & Huang, 2009) and champions of change (Nadler & Nadler, 1997: 98). Champions may exhibit a “constellation of behaviors” (Howell et al., 2005) that can be nurtured and learned, including “communicating a clear vision of what innovation could be or do, displaying enthusiasm and demonstrating commitment to it, and involving others in supporting it” (Howell & Higgins, 1990). They may increase “effort-accomplishment expectancies” by reinforcing collective efficacy, increase self-efficacy and collective efficacy by expressing positive evaluations (Tasa et al., 2007) and showing confidence in people to perform effectively and meet challenges (Nadler & Tushman, 1990).

**HYPOTHESIS 4a, b, c, d:** *The more the involvement of the “champion on pricing,” the stronger the firm’s pricing orientation, (b) pricing capabilities, (c) collective mindfulness and (d) decision making rationality.*

### ***Capabilities and resource-based view of the firm***

According to the RBV, achieving a competitive advantage (Bamey, 1991) requires heterogeneous resources that are valuable, scarce, difficult to imitate and non-substitutable (Dierickx & Cool, 1989). Dutta et al. (2003) show that these conditions apply to pricing by describing pricing’s two main activities as price setting within the firm and in regard to customers. Dutta et al. found that the pricing process is inimitable and imperfectly mobile (nontransferable) because a firm cannot simply buy the pricing systems and skills required for effective pricing but must

design, develop and enhance a proprietary pricing system to ensure it is suitable for both the firm's requirements and those of its customers. In addition, as an extension of the RBV, the capabilities perspective argues that value creation by firms is driven not only by resources but also by capabilities (Grant, 1996), which are the multifaceted collections of skills and expertise that are embedded in a company's processes (Peteraf, 1993).

Our research follows Dutta et al. (2003) in considering pricing as a specialized operational marketing capability that is grounded in the RBV. In their case study of a large manufacturing firm, Dutta et al. go beyond the external determinants of pricing to focus on the internal processes and routines that enable a company to set its prices successfully. According to Dutta et al., pricing is a capability that is "based on the combination of routines, coordination mechanisms, systems, skills and other complementary resources that are difficult to imitate" (p. 619); it takes a firm approximately five years to develop a pricing system, and the pricing capability cannot be learned through a training program but must evolve over time and from experience. Moreover, Dutta et al. show that a strong pricing capability enables firms to generate higher rents through such means as improving the match between prices charged and customer value.

Pricing capabilities are found to be positively related to company performance (Berggren & Eek, 2007; Dutta et al., 2002, 2003; Hallberg, 2008). In these studies, pricing capabilities are complex, difficult-to-imitate processes that span organizational boundaries. Thus we link pricing capabilities theoretically to firm performance based on the RBV and propose:

**HYPOTHESIS 5:** *The firm's pricing capabilities will be related positively to its relative performance.*

### ***Organizational mindfulness***

Mindfulness, originally characterized by Langer (1989) as a state of alertness that is manifest in active information processing, includes creating new categories rather than relying on categories present in our memory; welcoming new information by being open and attending to changed signals; and welcoming more than one view and being aware of multiple interpretations. Fiol and O'Connor (2003: 60) observed, "The greater the level of mindfulness of decision makers, the more likely it is they will use decision making mechanisms to expand their search for information." Weick et al. (1999) extended the concept of individual mindfulness (Langer, 1989, 1997) to the collective, describing it as the widespread adoption and diffusion of mindfulness by the organization's members. Mindfulness helps organizations notice more issues, process them with care and detect and respond to early signs of trouble (Weick & Sutcliffe, 2007). Weick and Sutcliffe (2007) and Weick et al. (1999) describe five cognitive processes that constitute organizational mindfulness: (1) preoccupation with failure; (2) reluctance to simplify interpretations; (3) sensitivity to operations; (4) commitment to resilience; and (5) deference to expertise. We contend that these characteristics of high reliability

organizations can also be applied to the adoption and implementation of pricing strategies in firms.

Firms engaged in the development of modern pricing practices invest in developing pricing capabilities of their front-line personnel through pricing training for sales employees in order to equip them with tools and capabilities to achieve the firm's pricing goals. Sensitivity to operations also entails adjusting pricing programs by taking into account the knowledge of people who actually do the work (Weick & Sutcliffe, 2007). Commitment to resilience is strongly influenced by executive champions' internal development of shared beliefs, courage and resilience when implementing pricing strategies. Finally, firms defer pricing decision expertise and influence to center-led pricing teams. Decision makers in business units rely on the expertise of these specialized centers of excellence to optimize pricing decisions and the firm's performance.

**HYPOTHESIS 6a, b, c:** *The firm's collective mindfulness will be related positively to (a) pricing orientation, (b) pricing capabilities and (c) relative performance.*

### ***Decision-making rationality***

Simon (1961: 93) posits that actual behavior of managers in firms when making decisions or making choices falls short of objective rationality in three ways: (1) the incompleteness of knowledge; (2) the difficulties in anticipation of the consequences that will follow choice; and (3) the choice among all possible alternative behaviors. Managers also suffer from a possible "bottleneck of attention" that impacts their ability to deal with more than a few things at a time (Simon, 1961: 90). Bounded rationality refers to the notion that rational actors are significantly constrained by limitations of information and calculations (Cyert & March, 1992: 214). Behavioral theorists conjecture that managers in organizations simplify the decision-making process by using various behaviors (Cyert & March, 1992: 264): satisficing (March, 1978); following rules of thumb (Schwenk, 1988) and defining standard operating procedures and organizational routines (Feldman, 2000; Pentland & Reuter, 1994). Others will define frames of reference (March & Simon, 1958: 159) that will be determined "by the limitations of the rational man's knowledge." Experienced managers will draw from their memory, training and experience (Simon, 1961: 134). They construct and use "cognitive heuristics" (Brownlie & Spender, 1995) or mental models (Porac et al., 1989) to simplify complex strategic issues and engage in intuitive and judgmental responses to decision demanding situations (Barnard & Andrews, 1968; Oxenfeldt, 1973). The resolution of uncertainty is "to create a rationality, a recipe or an interpretative scheme" (Brownlie & Spender, 1995) leading to a choice or a decision.

**HYPOTHESIS 7a, b, c:** *The firm's decision-making rationality will be related positively to (a) pricing orientation, (b) pricing capabilities and (c) relative performance.*

## **Methodology**

### ***Data collection and sampling***

Following the total design method (Dillman et al., 2009), a cross-sectional self-administered electronic survey was sent in April 2011 to 7,897 active members of the Young President Organization International (YPO). YPO is a for-profit organization with 18,000 business owner/executive members in 110 countries. Members of YPO must meet eligibility criteria, such as age (under 45 years old), title (President, Chief Executive Officer, Chairman of the Board, Managing Director, and/or Managing Partner), enterprise value (minimum \$10 million), number of employees (minimum 50) and annual sales revenues (minimum \$8 million for sales, service and manufacturing corporations, \$160 million for financial institutions and \$6 million for agency-type businesses). To our knowledge, no other empirical studies have used the YPO database.

Consequently, the survey was emailed to 7,897 targeted respondents of which 376 were returned for reasons of email discrepancies. Of the remaining 7,521, 902 surveys were returned partially or completed for a response rate of 12 percent. We deemed 557 usable for analysis. Our response rate is consistent with the surveys of other top executives (Hambrick et al., 1993; Simsek et al., 2010).

Eighty percent of the firms in our study identified themselves as manufacturing or service firms with the remaining classified as retail/distribution firms. Over half (61 percent) were business-to-business (B2B) firms vs. business-to-consumer (B2C). About 11 percent were publicly traded while 87 percent reported being privately owned. Seventy-three percent indicated they owned the firm. Half (50 percent) had fewer than 250 employees, 22 percent had 251–500, 13 percent had 501–1000 employees and 15 percent had more than 1,000 employees (of that, 3 percent had over 10,000 employees). Fifty-three percent reported the age of their firm as older than 10 years but less than 50 years old. Thirty-four percent indicated their firm had been in business for longer than 50 years. Business management was reported as the educational background of 48 percent of the respondents, 20 percent had technical, industrial or engineering backgrounds, 17 percent finance and accounting and 14 percent sales and marketing. Most (60 percent) of the firms were headquartered in North America, 13 percent in Europe, 11 percent in Asia/Pacific, 8 percent in the Middle East and 7 percent in Latin America.

### ***Measure development and assessment***

Although most scale items were adapted from those in the existing literature, a new scale was developed to measure a firm's pricing capabilities with slight modifications to reflect our focus. The scale was refined through pretests and pilot testing using established item development procedures and guidelines (Churchill, 1979).

Content and face validity were determined through a comprehensive review of the literature, pre- and pilot tests and assessment by a panel of practitioners and academics to ensure that measurement items covered the domain of the constructs

(Churchill, 1979; Nunnally, 1978). To assess the quality of the survey items, in-depth, face-to-face interviews with pricing practitioners were conducted using Bolton's "talk aloud" methodology (Bolton, 1993). We pretested all scale items with a small panel of academics and pricing and business practitioners. A pilot test involving 150 professionals representing pricing, business and general manager functions from companies in both manufacturing and service industries provided 70 complete responses. The survey was iteratively modified to incorporate all relevant test results. None of the pretest or pilot test participants was included in the final sample. The survey instrument is presented in the Appendix.

### ***Behavior of champion on pricing***

A 6-item scale adapted from Howell et al. (2005) was used to assess pricing champion behaviors (CBE). Each item was measured using a 7-point Likert scale anchored at the extremes by "strongly disagree" to "strongly agree."

### ***Pricing capabilities***

Since there was little empirical precedent to measure pricing capabilities (PC), a multiple-item scale was developed by the academic team in accord with an operational definition (Kerlinger & Lee, 1999), on relying on our fieldwork and on extant literature. We used 12 items ranging from 1 ("much worse than competitors") to 7 ("much better than competitors") to operationalize this scale.

### ***Pricing orientation***

We adapted the scales developed by Ingenbleek et al. (2001) to measure value-based pricing (VBP) (5 items), competition based pricing (COB) (6 items) and cost-based pricing (CB) (5 items). Items were measured using a 7-point Likert scale anchored at the extremes by 1 ("not at all taken into account in price setting") to 7 ("very much taken into account in price setting").

### ***Collective mindfulness***

The 12-item scale used to measure collective mindfulness (CM) was based on adapting existing measures (Knight, 2004) and conceptual definitions in the literature (Weick & Sutcliffe, 2007). Reluctance to simplify (4 items), sensitivity to operations (4 items) and commitment to resilience (4 items) were assessed using 7-point, Likert-type scales anchored with "strongly agree" at the extreme positive end and "strongly disagree" at the opposite end of the scale.

### ***Decision-making rationality***

Four items measured the level of analysis involved in decision-making. The four-item scale was developed and validated by Miller (1987). The 7-point scale was

anchored with “does frequently” at the extreme positive end and “does rarely” at the opposite end of the scale.

### ***Firm performance***

Similar to Morgan et al. (2009), firm performance was operationalized as a second-order construct consisting of three first-order reflective constructs – sales, pricing and profit performance. The measures for sales and profit were adapted from Morgan et al. (2009) and include six items, while the other two measures were from the work of Inglebleek (2007).

The use of subjective performance measures was required for a number of reasons. First, because our sample contained many privately-owned firms for which objective accounting data on their performance would not be accessible, we followed the convention (Simsek et al., 2005; Simsek, 2007) of asking CEOs to compare their *firm's relative performance* to that of their competitors' on eight different dimensions for the past year (e.g. growth in sales, return on investment, return on sales and so forth) using a scale ranging from 1 (“much worse”) to 7 (“much better”) than competitors. Second, since firms in our sample were of various types and from various geographical zones, a multidimensional measure based on perceptual firm performance facilitates comparisons across firms and contexts, such as across industries, time horizons and economic conditions (Song et al., 2005). Finally, earlier studies have shown that perceptual performance measures tend to be highly correlated with objective indicators (Dess & Robinson Jr, 1984) and are used in strategy research (Anderson & Paine, 1975). Taken in the aggregate, subjective or perceptual measures of firm performance can provide a broad indication of a company's health (Quinn & Baily, 1994).

### ***Firm-level control variables***

We controlled for a number of likely determinants of performance by including demographic characteristics of the firm, such as firm type, age and firm size (Amburgey & Rao, 1996).

### ***Non-response bias***

A commonly used method for estimating the bias in strategy research (for examples see Armstrong & Overton, 1977; Simsek et al., 2010) is to compare early – those who responded within the first week (74 percent) – and late (26 percent) responses among the study variables; a late respondent is considered a proxy for a non-respondent. First, chi-square tests comparing demographic characteristics across the two groups revealed no significant biases when number of employees  $\chi^2_{(4)} = 1.45$ ;  $p = 0.835$ ), type of firm  $\chi^2_{(2)} = 2.39$ ;  $p = 0.303$ ) and age  $\chi^2_{(4)} = 4.72$ ;  $p = 0.317$ ) were examined. Next, one-way ANOVA tests, performed at the item level, indicated no significant differences in data derived from early vs. late

responders, except on 1 of the 58 (1.73 percent) study variables. Consequently, it appears that bias present from the time of response is due to chance.

### ***Common method bias***

Surveys from a single set of respondents can introduce common method bias (CMB) in the data. Consequently, we took several steps to mitigate, detect and control for a common method bias. We carefully constructed all survey items and, wherever possible, used pretested, valid, multidimensional constructs (Huber & Power, 1985). We varied the scale anchors and format in the questionnaire, performed a series of scale-validation processes before distributions and randomized questions.

Several *post hoc* tests determined the extent to which common method bias was present in our data. First, using Harman's single-factor test, all 58 items were entered into an unrotated principal components factor analysis to determine the number of factors necessary to account for the variance in the variables. Accordingly, if a single factor emerged or a single general factor explained most of the variance between the independent and dependent variables, common method variance may be present (Podsakoff et al., 2003). Our results indicated the presence of 10 potential factors (all with eigenvalues greater than one); each factor explained roughly equal variance and explained over 65 percent of the total variance. These results provide initial evidence that response bias does not appear to be a problem in the data (Podsakoff & Organ, 1986).

Second, we used the confirmatory factor analysis (CFA)-based Harman's single-factor test in which we hypothesized a single CMB factor as causing all the indicators. The CMB factor extracted 17 percent of the variance. A  $\chi^2$  difference ( $\chi^2 = 17.021$ ,  $p = 0.000$ ) test between the baseline with all the CMB paths free floating and the CMB with all paths equal to zero indicated items loaded significantly on the single factor, suggesting that CMV might be a source of variance in the observed items.

Third, an unrelated construct, a *marker* variable, determined *ex post* to have no significant correlation with other items in the constructs was added to the measurement model (Lindell & Whitney, 2001). Since we did not measure an unrelated construct *a priori*, we used a modified test in which a weakly related construct – CEO perceptions of pricing – and a 4-item scale was used (Pavlou & Gefen, 2005). High correlations among any of the items of the study's constructs and pricing perception would indicate common method bias. Since the highest correlation of pricing perceptions and the constructs was  $r = 0.15$ , there appeared to be minimal evidence of common method bias.

Fourth, we examined multi-collinearity and CMB with linear regression analysis on the study constructs and found low variance inflation factors. Further, multi-collinearity can be ruled out because no two predictor variables correlated more strongly than 0.70 (Hair et al., 2010). Finally, we examined the correlation matrix, as shown in Table 5.1, and found no highly correlated factors (highest

Table 5.1 Descriptive statistics, reliability, correlations and discriminant validity

Construct	No. of items	M	SD	CA	CR	Construct									
						1.	2.	3.	4.	5.	6.	7.	8.	9.	10.
1. Champion on pricing	6	5.54	.99	.846	.84	<b>0.71</b>	0.170	0.153	0.131	0.086	0.022	0.075	0.035	0.069	0.061
2. Pricing capabilities	8	3.35	1.53	.855	.92	0.412	<b>0.67</b>	0.091	0.173	0.081	0.029	0.108	0.125	0.182	0.178
3. Collective mindfulness	7	5.96	.72	.863	.92	0.391	0.302	<b>0.69</b>	0.036	0.100	0.034	0.058	0.059	0.033	0.061
4. Decision-making rationality	4	4.58	.97	.768	.88	0.362	0.416	0.190	<b>0.70</b>	0.053	0.023	0.136	0.010	0.024	0.028
5. Value based	4	5.52	1.12	.852	.85	0.293	0.285	0.316	0.231	<b>0.77</b>	0.066	0.071	0.036	0.051	0.052
6. Competition based	4	5.48	1.19	.870	.85	0.149	0.171	0.184	0.150	0.257	<b>0.77</b>	0.091	0.013	0.001	0.003
7. Cost based	3	5.16	1.24	.700	.76	0.273	0.328	0.240	0.369	0.267	0.301	<b>0.71</b>	0.037	0.016	0.032
8. Sales performance	3	5.38	1.05	.830	.84	0.187	0.354	0.243	0.098**	0.190	0.112**	0.192	<b>0.80</b>	0.185	0.235
9. Price performance	2	4.80	1.08	.690	.70	0.262	0.427	0.181	0.156	0.225	0.016 <sub>n.s.</sub>	0.125**	0.430	<b>0.73</b>	0.370
10. Profit performance	3	5.21	1.21	.930	.93	0.246	0.422	0.246	0.166	0.228	0.059 <sub>n.s.</sub>	0.178	0.485	0.608	<b>0.89</b>

Notes: All coefficients significant at  $p < 0.001$  (one-sided test) except where noted.

M = mean; SD = standard deviation; CA = Cronbach's alpha; CR = composite reliability.

Square root of Average Variance Extracted (AVE) is bolded value along diagonal; values above diagonal are squared correlations.

\*  $p < 0.05$ ; \*\*  $p < 0.01$ ; \*\*\*  $p < 0.001$ .

correlation is  $r = 0.61$ ), whereas evidence of common method bias should have resulted in extremely high correlations ( $r > 0.90$ ). Based on these tests, multicollinearity is not present and common method bias does not appear to pose a problem with our analysis.

### ***Confirmatory factor analysis***

#### *First-order factors*

Four of the 6 constructs (champion of pricing, pricing capabilities, collective mindfulness and decision-making rationality) were measured as first-order constructs, while the other two (pricing orientation and performance) were operationalized as second-order factors in our CFA models. The measurement models were estimated using AMOS (Analysis of Moment Structures) software, a covariance-based structural equation modeling technique. In this model, no unidirectional path was specified between any latent variables.

The psychometric properties of the four latent constructs involving 25 items were evaluated simultaneously in one CFA.<sup>1</sup> The sample size of 557 was deemed sufficient, given acceptable values on the Hoelter's Critical N test,<sup>2</sup> and the model was expected to converge using maximum likelihood estimation.

As seen in Table 5.1, almost all correlations were significant. Discriminant validity was assessed by comparing the square root of the AVE associated with each construct to the correlations among constructs (Fornell & Larcker, 1981). To provide evidence of discriminant validity, the square root of the AVE associated with a particular construct must be greater than its correlations with other constructs (Fornell & Larcker, 1981). Accordingly, this is confirmed by the estimates provided in Table 5.1. Internal consistency reliability was assessed in two ways – using Cronbach's alpha (CA) coefficient and composite reliability (CR). Table 5.1 indicates each type of reliability exceeded the recommended 0.70 threshold (Fornell & Larcker, 1981; Nunnally, 1978), with one exception on the margin (CA = 0.69 price performance).

Convergent validity can be assessed by examining individual item loadings on their theorized latent variables (Hair et al., 2010). All individual items loaded on their intended constructs and no undesirable cross-loadings emerged. An item is significant if its factor loading is greater than 0.50 (Hair et al., 2010). As shown in Table 5.2, the standardized factor loadings of all the items were significant ( $p < 0.01$ ) and ranged from 0.53 to 0.86, meeting the threshold and demonstrating convergent validity at the item level.

It is recommended that multiple indices be considered simultaneously when overall model fit is evaluated.<sup>3</sup> We paid less attention to the sample size sensitive model chi-square ( $\chi^2_{(256)} = 466.77$ ;  $p = 0.000$ ). As an alternative to chi-square, we examined the Browne-Cudeck test of close fit (BCC) and compared the BCC value across the hypothesized, saturated and independence model (Browne & Cudeck, 1993). The BCC was lower than the saturated model, suggesting a good fit (Floyd & Widaman, 1995). Steiger and Lind's (1980) root-mean-square error of

*Table 5.2* Measurement model results for first-order constructs

<i>Constructs &amp; items</i>	<i>Regression weight</i>	<i>Standardized regression</i>	<i>Critical ratio</i>
<i>Champion of pricing (CBE)</i>			
CBE1	1.208	0.858	23.400
CBE2	1.000	0.806	21.991
CBE3	0.878	0.763	19.402
CBE4	0.782	0.559	13.732
CBE5	0.600	0.533	12.978
CBE6	1.003	0.650	16.504
<i>Pricing capabilities (PC)</i>			
PC1	0.918	0.691	16.993
PC2	0.860	0.660	15.816
PC3	0.912	0.770	19.889
PC6	0.894	0.590	14.122
PC7	0.833	0.617	14.708
PC8	0.775	0.575	13.483
PC9	0.814	0.556	12.875
PC12	0.851	0.585	14.039
<i>Collective mindfulness (CM)</i>			
CM5	0.797	0.763	18.864
CM6	0.708	0.645	15.649
CM7	0.569	0.617	14.721
CM8	0.600	0.642	15.345
CM9	0.610	0.680	14.978
CM10	0.602	0.659	15.837
CM11	0.660	0.713	16.473
<i>Decision making rationality (DMR)</i>			
DMR1	1.069	0.595	12.582
DMR2	1.430	0.713	13.596
DMR3	1.666	0.809	15.735
DMR4	1.296	0.616	13.020

approximation (RMSEA), with 90 percent confidence interval, was used to reflect both the fit and parsimony of the model at hand. The RMSEA, known as the most sensitive index to models with unspecified factor loadings (Hu & Bentler, 1998) was 0.038 and the 90 percent confidence interval was small (0.033 to 0.044), suggesting a close fit (Browne & Cudeck, 1993). The Normed  $\chi^2$  (1.823) at a ratio of less than 2:1 indicated a good “rule of thumb” model fit (Tabachnick & Fidell, 2007). We also used the Non-Normed Fit Index, NNFI (Tucker & Lewis, 1973), the Comparative Fit Index (CFI) (Bentler, 1990) and Incremental Fit Index (IFI) as other goodness-of-fit measures that are independent of sample size and reflect the proportionate improvement in fit of the measurement model over a more restricted baseline model. Hu and Bentler (1999) suggested values “close to .95” (p. 27) as indicating satisfactory fit. The NNFI, CFI and IFI all exceeded 0.95. Consequently, the measurement model was deemed acceptable to proceed to structural modeling.

## Second-order factors

We conducted a second-order CFA of pricing orientation and relative performance to provide empirical support for their measurement at the second-order level. We modeled the items for the first-order factors as reflective items because they are moderately correlated among themselves (Bassellier & Benbasat, 2004). For pricing orientation and relative performance, all first-order factors had a significant ( $p < 0.001$ ) relationship with their respective second-order constructs. The path coefficients indicate the factors' relative importance in reflecting the second-order constructs. Further, we assessed convergent and discriminant validity of the items and the contributions of the factors to the second-order constructs.

Figure 5.2a shows pricing orientation is operationalized as a second-order factor with the facets as its indicators (Gerbing et al., 1994). The facets define specific domains related to a firm's pricing orientation – value based, competition based and cost based. Each facet is defined by a one-dimensional set of items adapted from the literature (Ingenbleek et al., 2003). The items load 0.66 and higher on their respective factors, and the first-order factors are strongly related (0.50 to 0.59) to the pricing orientation dimension. Composite reliability ranged from 0.76 to 0.85, all AVEs exceeded the 0.50 threshold and squared multiple correlations ranged from 0.25 to 0.35, thus supporting H1a. Validation of this model

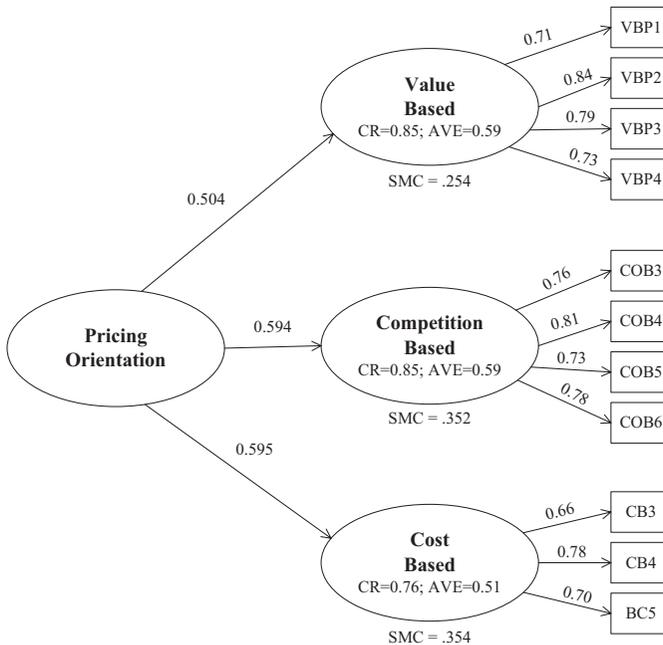


Figure 5.2a Second-order measurement model results for pricing orientation

Notes: Standardized estimates shown; Significant at  $p < 0.001$ .

Composite Reliability (CR); Average Variance Extracted (AVE); Squared Multiple Correlation (SMC).

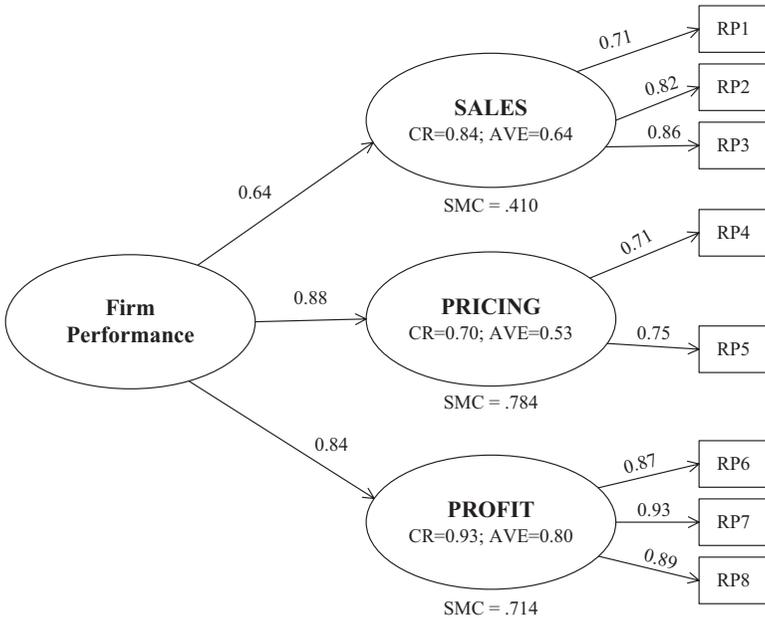


Figure 5.2b Second-order measurement model results for relative performance

Notes: Standardized estimates shown; All loadings significant at  $p < 0.001$ .

Composite Reliability (CR); Average Variance Extracted (AVE); Squared Multiple Correlation (SMC).

and support for H1b is demonstrated by several fit statistics (Normed  $\chi^2 = 1.735$ , CFI = 0.99, IFI = 0.99; NNFI = 0.98 and RMSEA = 0.036;  $CI_{RMSEA} = 0.02-0.05$ ).

As seen in Figure 5.2b, first-order factors for firm performance had high loadings (0.64 for sales, 0.88 for pricing and 0.84 for profit dimensions;  $p < 0.001$ ). Items loaded at 0.70 or higher on their respective factors and all were significant ( $p < 0.001$ ). Composite reliability ranged from 0.70 to 0.93 and all AVEs exceeded 0.50 (providing support for H<sub>2a</sub>) and squared multiple correlations ranged from 0.40 to 0.78 suggesting the correlations are below the 0.90 threshold considered acceptable (Bagozzi et al., 1991). Further, support for H<sub>2b</sub> was found by acceptable goodness-of-fit statistics ( $\chi^2/df = 1.806$ , CFI = 0.983, IFI = 0.98; NNFI = 0.98 and RMSEA = 0.05). These results suggest that it is appropriate to model pricing orientation and relative performance as multidimensional second-order factors (Anderson & Gerbing, 1988).

### Power analysis

We relied on the MacCallum et al. (1996) framework to estimate the power of RMSEA fit measure. Consequently, since our objective was to test relationships between the constructs of interest, we used a “test of not close fit” for RMSEA in order to assess the adequacy of the sample size. Using a desired alpha of 0.05 with

256 degrees of freedom, a hypothesized population RMSEA of 0.05 and a sample size of 557, we calculated the statistical power to be 0.99 (Preacher & Coffman, 2006), which exceeds the commonly accepted criterion of 0.80.<sup>4</sup> Accordingly, we can be relatively confident that the sample is large enough to support the statistical inferences made regarding the relationships between the constructs.

## **Results**

We tested our hypotheses using structural equation modeling (SEM). SEM was particularly appropriate because it allows estimation of multiple associations, simultaneously incorporates observed and latent constructs in these associations and accounts for the biasing effects of random measurement error in the latent constructs (Medsker et al., 1994).

The results are presented in Table 5.3. All hypothesized relationships are significant, except for two of the six (H3b and H7c), explaining 26 percent of the variance for relative performance, 28 percent for capabilities, 20 percent for pricing orientation, 15 percent for collective mindfulness and 13 percent for decision-making rationality. The fit indices for the model indicated this model reached an acceptable level for goodness of fit ( $\chi^2(17) = 27.79$ ;  $p = 0.047$ ,  $\chi^2/df = 1.635$ , CFI = 0.984, IFI = 0.985; NNFI = 0.96 and RMSEA = 0.034; CIRMSEA = 0.01-0.05).

First, the hypothesized impact of pricing orientation on pricing capabilities (0.175,  $p < .001$ ), H3a, was supported. However, pricing orientation (0.064) was not significantly related to performance (H3b not supported). Second, the champion of pricing had a positive and significant impact on pricing orientation (0.13,  $p < 0.001$ ), pricing capabilities (0.22,  $p < 0.001$ ), collective mindfulness (0.28,  $p < 0.01$ ) and a strong impact on decision-making rationality (0.56,  $p < 0.001$ ). These findings support H4abcd. Third, pricing capabilities (0.166,  $p < 0.001$ ) impact on firm performance provided support for H5. Fourth, collective mindfulness is both positive and significantly related to the firm's pricing orientation (0.287,  $p < 0.001$ ) and firm performance (0.173,  $p < 0.001$ ), thereby validating H6 and H6b. Also, collective mindfulness had a significant impact on pricing capabilities (0.152,  $p < 0.01$ ) providing support for H6c. Finally, decision-making rationality (0.132,  $p < 0.001$ ) relationship to orientation and pricing capabilities (0.166,  $p < 0.001$ ) provided support for H7a and H7b. Decision-making rationality (0.042) had no effect on firm performance, thus H7c was not supported.

We controlled for type of company, age and size. Since the firms participating in this study came from a variety of industries, it was necessary to control for the different industries under which the firms operated (manufacturing, service and retail/distribution). We controlled for firm size, which has frequently been used in previous studies involving firm performance (Morgan et al., 2009), and firm age. All three variables had no significant effect on performance.

## **Implications for the pricing field**

Our objective was to improve our understanding of how CEO and top executive championing of the pricing within their firms might influence relative firm

Table 5.3 Structural model results

<i>Hypothesized Paths</i>	<i>Regression estimate</i>	<i>Standardized estimate</i>	<i>Critical ratio</i>	<i>Hypothesis supported</i>
H3 <sub>a</sub> : pricing orientation → pricing capabilities	0.175	0.156***	3.882	Yes
H3 <sub>b</sub> : pricing orientation → firm performance	0.064	0.060	1.453	No
H4 <sub>a</sub> : champion behavior → pricing orientation	0.127	0.147***	3.355	Yes
H4 <sub>b</sub> : champion behavior → pricing capabilities	0.217	0.223***	5.336	Yes
H4 <sub>c</sub> : champion behavior → collective mindfulness	0.282	0.391***	10.026	Yes
H4 <sub>d</sub> : champion behavior → rationality	0.560	0.362***	9.164	Yes
H5: pricing capabilities → firm performance	0.432	0.452***	10.750	Yes
H6 <sub>a</sub> : collective mindfulness → pricing orientation	0.287	0.239***	5.802	Yes
H6 <sub>b</sub> : collective mindfulness → performance	0.173	0.134***	3.396	Yes
H6 <sub>c</sub> : collective mindfulness → pricing capabilities	0.152	0.112**	2.797	Yes
H7 <sub>a</sub> : rationality → pricing orientation	0.132	0.235***	5.781	Yes
H7 <sub>b</sub> : rationality → pricing capabilities	0.166	0.263***	6.637	Yes
H7 <sub>c</sub> : rationality → firm performance	-0.042	-0.070	-1.724	No
<b>Controls:</b>				
Age → firm performance	-0.035	-0.044	-1.044	
Type of firm → firm performance	-0.057	-0.046	-1.125	
Number of employees → firm performance	0.044	0.056	1.344	
Goodness-of-fit statistics:				
$\chi^2 = 27.795$ ; $df = 17$ ; $p = 0.047$				
Normed $\chi^2$ ( $\chi^2/df = 1.635$ )	$R^2$ collective mindfulness = 0.153			
CFI = 0.984; IFI = 0.985; TLI = 0.958	$R^2$ pricing orientation = 0.202			
RMSEA = 0.034	$R^2$ pricing capabilities = 0.286			
	$R^2$ firm performance = 0.264			

\*  $p < 0.05$ ; \*\*  $p < 0.01$ ; \*\*\*  $p < 0.001$ .

performance. Our intention was to construct a strong bridge between the fields of pricing and organizational behavior to contribute to the development of the pricing literature from an organizational perspective. Our findings shine a new light on the findings of previous studies and offer four substantive contributions.

First, our results support the proposition that a purposeful championing of pricing activities by top executives strongly influences the firm's organizational design to support the pricing process in critical areas (decision making rationality, collective mindfulness, capabilities and pricing orientation). Moreover, this study contributes to past research that readily acknowledges the importance of champions and the importance of fostering championing. "Without champions, organizations may have a lot of ideas but few tangible innovations. The challenge facing management is to identify, and effectively manage, existing champions and to nurture potential champions" (Howell & Higgins, 1990: 55). All relationships between championing behaviors and other organizational characteristics were positive and significant. Our study found strong links between championing in pricing, organizational design and relative firm performance. By providing evidence of these relationships, we uniquely begin the exploration of organizational drivers of the pricing function. Most scholars and practitioners agree that pricing receives scant attention from the C-suite (Hinterhuber, 2008a). Our conclusions suggest that once top executives realize the importance of pricing and purposefully decide to champion it, the impact on the organization and its performance is significant.

Second, our results support resource-based theory that pricing capabilities positively and significantly influence firm performance vis-à-vis competition. Previous studies on marketing capabilities suggest a positive link between pricing capabilities – a subset of marketing capabilities – and firm performance (Morgan et al., 2009; Vorhies & Morgan, 2005). However, these studies measured pricing capabilities as part of a much wider subset of marketing capabilities. Our findings show that pricing capabilities are significantly influenced by championing behaviors, decision-making rationality, mindfulness and overall pricing orientation. In turn, these capabilities in pricing positively influence firm performance vis-à-vis competition.

Third, our findings suggest that the role of executives in the corporate suite is essential for the design and sustainable implementation of pricing strategies in firms. A unique organizational architecture for pricing and the promotion of a culture of change and pricing knowledge diffusion should become a top priority for CEOs and other senior executives. By investing to build pricing capabilities that generate a sustainable and inimitable competitive advantage (Dierickx & Cool, 1989; Dutta et al., 2003), champions of pricing forge shared vision, a collective "can do" mentality and a sense of resilience in the firm that lead to superior levels of organizational efficacy (Bohn, 2001) and superior outcome. Dutta et al. (2002: 66) posit that "most CEOs will never set a single price. They can, however, give their managers the ability to win price wars, maintain price leadership and hold a competitive edge in pricing."

Finally, although we did not establish a significant relationship between decision-making rationality and relative firm performance, our results highlight

the criticality of creating an environment where pricing decisions are made on a more scientific and rational basis and not solely on intuition or gut feeling. Our findings indicate that greater levels of decision-making rationality influence the pricing orientation that firms adopt as well as their levels of capabilities in pricing. In recent years, there has been a resurgence of interest in intuition and gut feeling in decision-making theory due in part to the general dissatisfaction with the concepts of rationality and its limitations (Sadler-Smith & Shefy, 2004). Making decisions by intuition is increasingly viewed as a viable and acceptable approach in today's business context (Burke & Miller, 1999). Intuition may be an appropriate decision-making process in certain situations and business scenarios, especially in situations of uncertainty or turbulence (Khatri & Ng, 2000), novelty or in situations related to human resources. Scholars relate the intuitive skills of managers to the intuitive skills of chess masters or physicians (Simon, 1987). Experienced managers have in memory a large amount of experience, schemas and patterns gained through experience and organized "in terms of recognizable chunks and associated information" (Simon, 1987). Managers need to be able to combine both approaches to reach a greater level of decision effectiveness (Dane & Pratt, 2007; Simon, 1987). Intuition can then become a complement to an appropriate pricing decision after a thorough analytical and scientific process. This process conducted by pricing experts can help decision makers narrow the decision range and remove as much uncertainty and ambiguity out of the price-setting process as possible.

## **Limitations**

Although this study collected empirical data to test our comprehensive research model, we acknowledge certain limitations and provide suggestions for future research. First, the sample was derived from the entire worldwide listing of CEO and business owners belonging to a professional society. Consequently, the relatively small sample size is a limitation in this study. A broader empirical survey is required to generalize our findings. Second, the performance measures utilized in this research are perceptual, although using perceptual or subjective data has been advocated in the strategic management literature (Dess & Robinson Jr, 1984). We cannot rule out that the observed performance differences could be a function of different firm goals rather than of differences in objective firm performance. As a consequence, caution should be taken when interpreting the performance results. Third, we used the key respondent approach to our survey study and directed our questionnaire to the CEO or business owner because they were best positioned to answer the questions; however, their responses may not be without some bias. Fourth, our research model is tested using cross-sectional data; we can report associations but are not able to determine causality because we implemented a passive observation design (i.e. survey). Fifth, even though the relationships between the constructs in our research model are argued based on theory, longitudinal studies should be done to offer stronger empirical evidence for the observed relationships. Finally, multiple measurement methods and data sources should be used to control potential common method bias in future studies (Burton-Jones, 2009).

## Appendix: Constructs, definitions, coded items and source

Construct/Dimensions	Definition	Items	Source
<b>PRIMARY PRICING ORIENTATION</b>	The primary orientation used by firm respondents based on customer value, cost and competition information. Because the use of customer value, competition and cost information are a matter of degree rather than mutually exclusive categories, the result of the measure will report a primary firm orientation.	<p><b>To what extent does your organization take into account the following factors when setting prices for its products and services?</b> (<i>1 = Not at all taken into account in price setting to 7 = Very much taken into account in price setting</i>)</p> <p><i>Value-based pricing</i></p> <p><b>VBP1:</b> Advantages of the product compared to competitors' products/services</p> <p><b>VBP2:</b> Customer perceived value of the products/services</p> <p><b>VBP3:</b> Customer willingness to pay for the unique benefits of the product/services</p> <p><b>VBP4:</b> Balance between advantages of products/services and price</p> <p><b>*VBP5:</b> Differentiated value drivers of our products/services compared to substitutes</p> <p><i>Competition-based pricing</i></p> <p><b>*COB1:</b> Price of competitors' products/services</p> <p><b>*COB2:</b> Competitors' current price strategy</p> <p><b>COB3:</b> Likelihood of competitors' strength to react</p> <p><b>COB4:</b> Market structure (number and strength of competitors)</p> <p><b>COB5:</b> Degree of competition on the market</p> <p><b>COB6:</b> Competitive advantage of competitors in the market</p>	Adapted from Ingenbleek et al. (2003) Value-based pricing: 5 items (AC: 0.81) Competition-based pricing: 6 items (AC: 0.91) Cost-based pricing: 5 items (AC: 0.75)

(Continued)

(Continued)

Construct/Dimensions	Definition	Items	Source
	<p><i>Cost-based pricing</i></p> <ul style="list-style-type: none"><li>*CB1: Variable costs of products/services</li><li>*CB2: Price necessary to break even</li><li>CB3: Investments in products/services</li><li>CB4: Target margin guidelines</li><li>CB5: Target return on sales levels</li></ul>		
<b>DECISION-MAKING RATIONALITY</b>	<p>Rationality relates to the concepts of analysis, future orientation and planning, explicitness of the strategy and systematic scanning of the environment. These concepts all relate to the “synoptic and planning modes” and represent systematic, analytical decision-making. This contrasts with the purely spontaneous, intuitive modes found with severely bounded rationality.</p>	<p><b>Indicate the extent to which your organization does the following activities to support pricing decisions.</b> (<i>I = Does rarely to 7 = Does frequently</i>)</p> <p><b>DMR1:</b> Applies pricing research techniques, such as conjoint analysis and pricing/value simulations, to make major product/service pricing decisions</p> <p><b>DMR2:</b> Conducts brainstorming with senior management groups for novel solutions to pricing problems</p> <p><b>DMR3:</b> Conducts formalized, systematic pricing review process as part of the product/service development process (like Stage Gate)</p> <p><b>DMR4:</b> Uses staff specialists to investigate and provide recommendation on major pricing decisions</p>	<p>Adapted from Miller (1987). Level of analysis: 4 items (AC: 0.74)</p>
<b>PRICING CAPABILITIES</b>	<p>Pricing capabilities are part of marketing capabilities which concern the firm's adequate management of individual “marketing mix” processes such as product development and management, pricing, selling, etc. as well as marketing strategy development and execution. These capabilities may be rare, valuable, non-substitutable and inimitable source of advantage that can lead to superior firm performance.</p>	<p><b>Rate your organization relative to your major competitors in terms of its capabilities in the following areas:</b> (<i>I = Much worse than competitors to 7 = Much better than competitors</i>)</p> <p><b>PC1:</b> Using pricing skills and systems to respond quickly to market changes</p> <p><b>PC2:</b> Knowledge of competitors' pricing tactics</p> <p><b>PC3:</b> Doing an effective job of pricing products/services</p> <p><b>PC4:</b> Monitoring competitors' prices and price changes</p> <p><b>PC5:</b> Sticking to price list and minimizing discounts</p> <p><b>PC6:</b> Quantifying customers' willingness to pay</p> <p><b>PC7:</b> Measuring and quantifying differential economic value versus competition</p>	<p>Construct definition included Morgan et al. (2009) and the researcher qualitative research (Liozu et al., 2011). Result of the pilot survey with 70 responses yielded an AC of 0.885 with these 12 items.</p>

**PC8:** Measuring and estimating price elasticity for products/services

**PC9:** Designing proprietary tools to support pricing decisions

**\*PC10:** Conducting value-in-use analysis or total cost of ownership

**\*PC11:** Designing and conducting specific pricing training programs

**PC12:** Developing proprietary internal price management process

**To what extent do you agree or disagree with the following statements about your involvement with pricing?** (*1 = Strongly disagree to 7 = Strongly agree*) Adapted from Howell et al. (2005):

**CBE1:** I enthusiastically promote the pricing function

**CBE2:** I express confidence in what pricing can do

**CBE3:** I show tenacity in overcoming obstacles when changes in pricing are needed

**CBE4:** I get pricing problems into the hands of those who can solve them

**CBE5:** I get key decision makers involved in the pricing process

**CBE6:** I act as a champion of pricing

**To what extent do you agree or disagree with the following statements about your organization?** (*1 = Strongly disagree to 7 = Strongly agree*)

**\*CM1:** Seeks input from diverse sources to solve problems

**\*CM2:** Approaches unexpected events with novel solutions

**\*CM3:** Expects employees are familiar with tasks beyond their immediate jobs

**\*CM4:** Supports divergent viewpoints

**CM5:** Fosters a climate that encourages open, ongoing communication

**CM6:** Pays attention to real-time information

**CM7:** Believes that regular updating and refreshing of our employees' skills are essential

**CM8:** Strives to make ongoing assessments and continual updates in our operations

**CM9:** Does not give up on solving problems

**CM10:** Encourages employees to 'bounce back' from mistakes

**CM11:** Takes steps to correct errors before they worsen

**\*CM12:** Treats failures as indicators of reliability of operations

## CHAMPIONING BEHAVIOURS

Transformational leaders motivate followers to achieve performance beyond expectations by transforming followers' attitudes, beliefs and values. They take on the role of organizational champions by demonstrating specific behaviors to lead and support organizational implementations.

## COLLECTIVE MINDFULNESS

Weick et al. (1999) extended the concept of individual mindfulness (Langer, 1989)

to the collective entities, describing it as the widespread adoption and diffusion of mindfulness by the organization's members. Mindfulness helps organizations to notice more issues, process them with care, and detect and respond to early signs of trouble (Weick & Sutcliffe, 2007). They describe five cognitive processes that constitute organizational mindfulness: (1) preoccupation with failure; (2) reluctance to simplify interpretations; (3) sensitivity to operations; (4) commitment to resilience; and (5) deference to expertise.

Adapted from Knight (2004) based on the work of Weick and Sutcliffe (2007)

Reluctance to simplify interpretations: 4 items (AC: 0.80)

Sensitivity to operations: 4 items (AC: 0.84)

Commitment to resilience: 4 items (0.87)

(Continued)

(Continued)

Construct/Dimensions	Definition	Items	Source
<b>PERCEIVED RELATIVE PERFORMANCE</b>	Respondents' perceived evaluation of their organization's performance relative to their competition.	<p><b>Please evaluate the performance of your major line of business over the past year relative to your major competitors.</b> (1 = <i>Much worse/lower than competitors</i> to 7 = <i>Much better/higher than competitors</i>)</p> <p><b>RP1:</b> Acquisition of new customers <b>RP2:</b> Increase of sales to current customers <b>RP3:</b> Growth in total sales revenues <b>RP4:</b> Absolute price levels <b>RP5:</b> Pricing power in the market <b>RP6:</b> Business unit profitability <b>RP7:</b> Return on sales (ROS) <b>RP8:</b> Return on investment (ROI)</p>	Two items adapted from Inglebleek (2007). Six items adapted from Morgan et al. (2009). Market effectiveness: 3 items (AC: 0.90) and profitability: 3 items (AC: 0.95) Our pilot survey with 70 respondents yielded an AC of 0.929.

Notes: \*Item eliminated due to insufficient reliability and validity; AC = Alpha Coefficient.

## Notes

- 1 Nine items were trimmed from the model because of insufficient reliability and/or validity.
- 2 This is the largest sample size at which we would accept the model at the 0.05 (sample size = 276) or 0.01 (sample size = 286) levels. Since our sample is 557 we can expect decreasing significance of the  $\chi^2$  statistic leading to possible rejection of the model based only on that statistic.
- 3 We selected normed chi-square ( $\chi^2/df$ ), the comparative-fit index (CFI), the incremental fit index (IFI) and the root mean squared error of approximation (RMSEA) based on their relative stability, robustness, uniqueness of information provided and independence of sample size. Recommended thresholds indicating good fit are  $\chi^2/df < 3$ ; IFI, CFI and NNFI  $> 0.90$ , and RMSEA  $< 0.05$ .
- 4 This is the power level at which an RMSEA of 0.08 is excluded from the RMSEA confidence interval. If the hypothesized RMSEA were the same as observed (0.038), then statistical power would still be 0.99.

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## 6 Who is in charge of value?

### The emerging role of Chief Value Officer

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#### **Introduction**

The World of business and economics changes fast and is becoming more complex every decade. Firms are faced with the choice to adapt, reinvent and differentiate themselves or die. Over the past few years, the nature and intensity of these changes in the business landscape have created organizational disruption and a realistic need to redesign organizational structure and leadership approaches. As a result, the nature and structure of the C-suite has also been changing to respond to these exogenous trends. Whereas traditionally C-level positions were focused on operations (Chief Operations Officer), on finance (Chief Financial Officer), on information systems (Chief Information Officer) and on innovation (Chief Innovation Officer), we have witnessed the emergence of a flurry of new C-level titles emanating from new management theory (Chief Learning Officer, Chief Knowledge Officer), from increased business regulations (Chief Compliance Officer, Chief Ethics Officer, Chief Sustainability Officer, Chief Risk Officer) and from increased focus on markets and customers (Chief Customer Office, Customer Experience Officer, Chief Growth Office, Chief Commercial Officer and Chief Marketing Officer).

Today more and more firms realize that they cannot cut their way to prosperity and that their growth potential has been severely reduced due to the continued recessionary trends. Businesses are looking at their business models and reinventing their value propositions in order to generate customer excitement, boost value-creation programs and capture value through value-based pricing. This trend towards value begs the question of who is in charge of value-management processes and programs in firms and how they design and implement comprehensive, systematic, long-term value initiatives. For the past decade, the authors have promoted the role of Chief Value Officer in professional firms to lead such programs and initiatives (Baker, 2006). In this paper, we explore the need for the creation of a Chief Value Officer role for both service and manufacturing firms. We offer a practical comparison of the customer- and market-related CXO positions and propose two potential job descriptions for the role of Chief Value Officer (CVO). Our goal is to recommend the creation and adoption of the CVO role and to elevate the value discussion to the C-suite. There has never been a better time

to focus on the topic of business and customer value. Who is in charge of value in your organization?

### **What does value mean?**

Price is what you pay. Value is what you get.

—Warren Buffett

Adam Smith (1723–1790) was confounded. One of the greatest economic and social thinkers in the history of ideas struggled with the so-called diamond-water paradox, which Smith explained in Chapter 4 of Book I of *Wealth of Nations*: “Nothing is more useful than water: but it will purchase scarce anything. . . . A diamond, on the contrary, has scarce any value in use; but a very great quantity of other goods may frequently be had in exchange for it” (Skousen & Taylor, 1997: 27).

Most people confronted with this paradox – including Smith – would resolve it by replying that the supply of diamonds is sparse compared with water, and hence they command a higher price. This is an intuitive, and very reasonable, solution. After all, water is approximately 71 percent of the earth’s surface, while diamonds are found in only a limited number of places in the world.

Yet the scarcity theory lacks explanatory power. Just because something is scarce does not mean it is valuable. There must be a better theory that solves this puzzle, so let us explore the antecedents of the theory of value.

Throughout history, man has always correlated labor with value and inputs with outputs. In medieval English, the word “acre” meant the amount of land a team of eight oxen could plough in a morning. Even Adam Smith identified two separate forms of value – “value in use” and a “value in exchange,” which gave rise to the famous diamond-water paradox, since certain items for one’s own use were highly valuable (e.g. water) but commanded little in exchange for other goods, such as diamonds. In essence, Smith decided to ignore a commodity’s value in use and just focus on value in exchange. Indeed, to this day, one sees various pricing books distinguishing value in use from value in exchange.

Yet, Smith understood that there were factors other than labor that went into the cost of producing commodities, such as the cost of capital, equipment, rent and the risk the entrepreneur was assuming. All these factors also had to be compensated for in the price of the final commodity, so Smith posited a “cost of production” theory of value, in effect “adding up” labor, profit, rent and cost of capital to determine price. Of course, this still begs the question of how a company could ever lose money by following this theory, since even the most inept businessperson would be able to add up all these factors to derive a price that generates a profit.

Here we have an eminent economist – although called a moral philosopher in his day – who struggled to develop a unifying and credible theory of value. It would take another influential economist to popularize a theory of value that appeared to advance his utopian objectives.

Karl Marx is far from dead. His labor theory of value still wields enormous influence over our present-day concept of value and price. Here is how Marx explained his theory in *Value, Price and Profit*, originally published in 1865:

A commodity has a *value*, because it is a *crystallization of social labour*. The *greatness* of its value, or its *relative* value, depends upon the greater or less amount of that social substance contained in it; that is to say, on the relative mass of labour necessary for its production. The *relative values of commodities* are, therefore, determined by the *respective quantities or amounts of labour, worked up, realized, fixed in them*. The *correlative* quantities of commodities which can be produced in the *same time of labour* are equal. [italics in original]

(Marx, 1995: 31)

This, too, sounds quite reasonable, until you test this theory to see whether it can explain how people spend their money in the marketplace. Marx's theory cannot explain how land and natural resources have value, since there is no labor contained in them. Taken to its extreme, the labor theory of value would predict those countries with the most labor hours – such as China or India – would have the highest standards of living. But this is demonstrably false, and what we witness instead in countries with *less* labor inputs and more entrepreneurship – as well as secure private property and other institutions conducive to economic growth – are vastly higher standards of living, including shorter hours for workers.

If Marx's theory was correct, a rock found next to a diamond in a mine would be of equal value, since each took the same amount of labor hours to locate and extract. Yet we do not see many rocks in the local mall's jewelry store. If one were to have pizza for lunch, under Marx's theory, the tenth slice would be just as valuable as the first, since each took the same amount of labor hours to produce. One glaring flaw in Marx's theory was that it did not take into account the law of diminishing marginal utility, which states that the value to the customer declines with additional consumption of the good in question.

Another Marxian flaw is that the very nature of a transaction between a willing buyer and seller is based not on an equality of labor but rather on the *inequality* in the subjective value of the good bought and sold. This takes us back to one of Adam Smith's central insights: that both buyer and seller must gain from an exchange or it will not take place. Were this not so, a contractor could build any type of house *he* wanted, hire incompetent and lazy workers, tally up his costs, add a desired profit and still receive his full price.

In the middle of the 19th century, economic theory was at a dead end. Serendipitously, three economists, from three different countries, originated the marginalist revolution: William Stanley Jevons (1835–1882) from Great Britain; Leon Walras (1834–1910) from France; and Carl Menger (1840–1921), from Austria. Swedish economist Knut Wicksell, who lived through the marginalist revolution, described it as a “bolt from the blue” (Skousen, 2008: 169). What made this new

theory so revolutionary? As Menger explains in his book *Principles of Economics*, written in 1873 when he was 33 years old:

Value is . . . nothing inherent in goods, no property of them. Value is a judgment economizing men make about the importance of the goods at their disposal for the maintenance of their lives and well-being. Hence value does not exist outside the consciousness of men . . . . [T]he value of goods . . . is entirely subjective in nature.

(Ebenstein, 2003: 23)

The value of goods arises from their relationship to our needs, and is not inherent in the goods themselves. . . . Objectification of the value of goods, which is entirely subjective in nature, has nevertheless contributed very greatly to confusion about the basic principles of our science. . . . The importance that goods have for us and which we call value is merely imputed.

(Menger, 1873: 120–121, 139)

Value is like beauty – it is in the eye of the beholder. This theory has enormous explanatory and predictive capabilities because it explains, for instance, why people dive for pearls. Karl Marx would say that pearls have value because people dive for them (thus supplying labor, commensurate with his labor theory of value). The marginalists would retort that people dive for pearls because other people value them.

Philip Wicksteed, a British clergyman, wrote a scientific critique of the Marxian labor theory of value in 1884, in which he explained that:

A coat is not worth eight times as much as a hat to the community because it takes eight times as long to make it. . . . The community is willing to devote eight times as long to the making of a coat because it will be worth eight times as much to it.

(Howey, 1989: 157)

So why are diamonds more expensive than water? Water tends to be priced based on the marginal satisfaction of the last gallon consumed. The German economist Hermann Heinrich Gossen (1810–58) developed what is known as Gossen's Law: The market price is always determined by what the last unit of a product is worth to people.

While the first several gallons of water may be vital for your survival, the water used to shower, flush the toilet and wash the dishes is less valuable. Less valuable still is the water used to wash your dog, your car and hose down your driveway. The market price of water reflects the last uses of the good for the aggregate of all consumers of water. On the other hand, the marginal satisfaction of one more diamond tends to be very high.

If water companies knew you were dehydrated in the desert, they would be able to charge a higher price for those first vital gallons consumed and then gradually

adjust the price downwards to reflect the less-valuable marginal gallons. Since they do not possess this information – the cost of doing so would be prohibitive – the aggregate market price for water tends to be based on its *marginal* value.

As a consumer, if one is dehydrated in the desert, near death, a bottle of Evian water is *priceless* compared with the same quantity of water used to wash the dishes or dog. If one's basement is flooded with water, it now has a *negative* value, since one will have to pay someone to remove it. Value is not only subjective – it is contextual.

Economic historian Thomas Sowell explains how the economics profession finally overcame the absurd notion of the labor theory of value:

By the late nineteenth century, however, economists had given up on the notion that it is primarily labour which determines the value of goods. . . . This new understanding marked a revolution in the development of economics. It is also a sobering reminder of how long it can take for even highly intelligent people to get rid of a misconception whose fallacy then seems obvious in retrospect. It is not costs which create value; it is value which causes purchasers to be willing to repay the costs incurred in the production of what they want.

(Sowell, 2004: 177)

To argue that you can measure value by labor is to argue that the value of Jonas Salk's polio vaccine is based on how long it took him to develop. One might as well plunge a ruler into the oven to determine its temperature. Labor is the wrong measurement of value.

None of this discussion is meant to imply that businesses cannot *create* the demand for a product. No one "demanded" – or subjectively valued – a Sony Walkman or the Apple iPad before they were produced and offered in the market. Quite often, supply does indeed create demand, especially as it relates to innovations and new technologies. But there is no guarantee of consumer acceptance just because costs were incurred; the high rate of product failures is a testament to this fact. Nonetheless, in the long run, a product or service will only *continue* to be produced if people value it, and if its price can cover its full costs of production, including profit.

### ***Value at the organizational level***

"Value" is probably one of the most frequently used words in business. Yet it is extremely difficult to define, to assess its drivers and to fully capture it with customers. Given that most companies create their own social construction of value, we propose to explore what it might mean and introduce some practical steps to increase your understanding of it.

Why is it that few suppliers in business markets are able to define and measure value? In a 2008 survey of business executives, 79 percent attributed this difficulty to a lack of capabilities and skills needed to assess value, apply the appropriate

methods and extract the exact value differential between two products (Hinterhuber, 2008a). Second to the value-assessment issue, communicating value to the market was associated by 65 percent of the executives with difficulty in elevating the value message above the advertising noise in the market. Bottom line: There is a need for more research related not only to theory on value (Uлага, 2001) but also to marketing tools for understanding, assessing and delivering value in business markets (Cressman Jr, 2010). Scholars agree that there are six characteristics of business value that make value difficult to measure: value is (1) a subjective concept, (2) a trade-off between benefits and sacrifices, (3) multidimensional, (4) defined relative to competitors, (5) segment-specific and (6) future-oriented (Hinterhuber, 2008b).

We conjecture that value must be elevated to the organizational level. Firms must put customer value at the center of their existence (Forbis & Mehta, 1981; Slater, 1997), make it part of their DNA (Liozu et al., 2011) and focus on creating sustainable value for stakeholders. Figure 6.1 depicts a framework for the creation and capture of customer value. This framework highlights the fact that business value exists at various stages of the commercial cycle and resides in multiple functions of the firm: innovation, strategy, marketing, pricing and financial management.

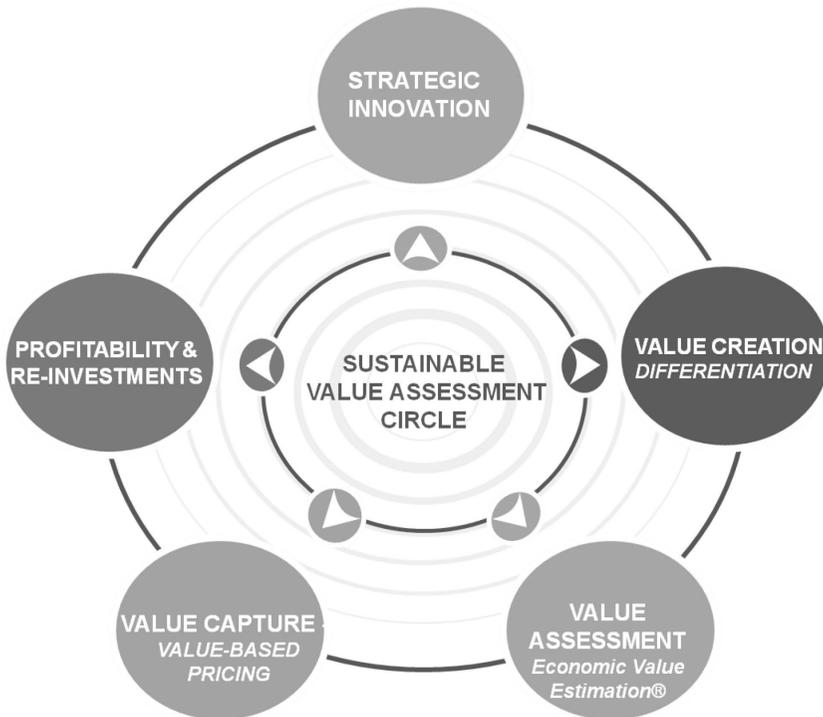


Figure 6.1 Sustainable value-assessment circle

By continuously creating, assessing and capturing value, firms can reap the fruits of their holistic value-management programs and can reinvest significant portions of their incremental profitability into innovation. Simply put, enterprises need to innovate for growth and price for profit. Profit is the price an enterprise pays to create the future; both innovation and profit depend on value creation.

## Who is in charge of value?

The final question needed in order to come to grips with business purpose and business mission is: “What is value to the customer?” It may be the most important question. Yet it is the one least often asked. One reason is that managers are quite sure that they know the answer. Value is what they, in their business, define as quality. But this is almost always the wrong definition. The customer never buys a product. By definition the customer buys the satisfaction of a want. He buys value.

Peter Drucker, *Management: Tasks, Responsibilities, Practices*, 1973

Whenever this question is posed to a group of businesspeople – “Who’s in charge of value in your company?” – someone will inevitably shout out, “Everyone!” Really? If everyone owns something, no one does. Adam Smith demonstrated that the *division and specialization of labor* were a central cause of the wealth of nations; they are also the central cause of the success of a business. Not everyone can be good at everything.

In a company, someone needs to own the value and pricing functions, someone who can be held accountable for creating and capturing value across the entire range of customers. When you consider how much executive attention the purchasing function receives in most organizations – with the elevation of a new title, Chief Purchasing Officer (CPO) – shouldn’t the pricing function receive the same level of executive commitment, attention and resources as a function designed to control costs? A report by the London Business School and Ariba, a software company, claims that the new CPOs at 70 percent of European firms report directly to the board of directors, an increase of 20 percent over the prior year (*The Economist*, “A Rise in the C-Level,” 26 February 2005: 60). Many Fortune 500 companies have a Chief Revenue Officer or Chief Pricing Officer; and while these appointments are a step in the right direction towards making pricing a core competency within a company, we posit that there still exists a lacuna in most companies – understanding and measuring value.

Since price, ultimately, is determined by value – and now that we have explored in detail the subjective theory of value, we have a better understanding of this concept – shouldn’t someone within the company be in charge of comprehending, communicating and capturing value? All businesses talk about value, and all agree it is essential to create and constantly add to, but who is in charge of it? Until it is elevated to the executive suite, it is not going to receive the attention, resources and alignment with overall corporate strategy that it merits. After all,

a business exists to create wealth – value – outside of itself, and until someone is held responsible and accountable for understanding the impact on customers, companies will continue to operate below potential in the value-creating function. Let us appoint a CVO in order to take a stand for customer value within the organization.

Unlike a biological organism, the true test of a company's success lies outside of its four walls. As Peter Drucker wrote, "All results are external, there is no such thing as a profit center"; there are only cost, activity and effort centers. The only profit center in your company is a customer's check that doesn't bounce.

Yet in many companies, according to McKinsey & Company, marketing is poorly linked to corporate strategy. According to a McKinsey survey of 30 large U.S. companies, more than a third reported that their boards spent less than 10 percent of their time on marketing- and customer-related issues. How can a company continually create value, let alone capture it with more effective pricing strategies, if it does not have someone overseeing this responsibility?

Any company that does not understand the value of its own offerings will, by default, perform a suboptimal job communicating it to its customers. Yet your customers purchase relatively infrequently while your company sells many more times. Is it not worth gaining a deeper understanding of value so you can leverage that knowledge across your entire customer base, rather than just a few sales? This is precisely why the role of CVO was created. The CVO role grew out of an experiment conducted with professional knowledge firms around the world. Initially, a pricing council was established, composed of a group of people who would have ultimate responsibility for pricing across the entire firm.

In any company, pricing exists at the crossroads of almost every other discipline, such as marketing, sales, finance, project management and even research and development. Yet these various functions sometimes have conflicting objectives and priorities. Marketing tends to focus on brand awareness and market share, Finance may insist on maintaining certain margins and Sales is interested in making the next sale. Pricing tends to become an afterthought, taking a backseat to these other functions that normally secure executive attention and clout.

What was learned with the pricing council experiment was enlightening. While every firm that implemented the idea became a better pricer and focused on the customer more effectively, some of the councils degenerated into what Paul Kennedy, partner at O'Byrne & Kennedy, chartered accountants in the United Kingdom, described as "an auction house." He said:

We'd sit around and discuss a particular contract for a client and when we finished with scope and an obligatory nod to value, we started throwing out prices. One member would say £10,000, the next £12,500, on up to £20,000. It dawned on me after this scenario was repeated several times we were becoming as inward focused as cost accountants. Yes, we had moved up from costing the job to placing a more strategic price upon it, but we were still not giving proper attention to the outward value we were creating, or should have been creating, for the customer. This was an epiphany for us. Soon thereafter, we created a value council, whereby the focus is, first and foremost on value,

then price. This has been much more effective, and has resulted in happier customers and greater profits for the firm.

In this particular firm, the value council has become the eyes, ears and voice for the customer. Rather than merely setting prices, they have begun to think strategically about value – we have become “obsessed with value,” as Paul now says – which should be the basis for how prices are set.

Brendon Harrex, at age 31, was the world’s first CVO, appointed in March 2005 by his former chartered accounting firm in New Zealand. In May 2007, he launched his own firm, The Harrex Group. Brendon describes what he learned as CVO in his prior firm in Case Study 1.

### **Box 6.1 Case study 1: what Brendon learned as CVO**

- I am learning so much in the CVO role. It is like climbing a mountain – just when you think you are nearing the top, you find it merely another ridgeline and the horizon still is a distant vision.
- I am coming to realize what a wimpy pricer I really am. I think sometimes we price for the 80 percent of the job that everyone else can do and forget to capture the real value that being focused and fanatical brings to a customer.
- I am learning very quickly that as an individual and a business you cannot be all things to all people and you have to say no quite a lot more than I am used to.
- I am learning how scared many of us are of change, even if there is no logical or illogical argument supporting the status quo.
- I am learning that business value is maximized when we realize that the customer owns the shop.
- I am learning that fun is maximized when we realize the customer owns the shop and start acting like it.
- I am learning that, as in life, control in business is just an illusion. Yet we allocate valuable resources into sustaining the illusion.
- I am learning that vision drives the structure and sometimes the structure needs changing to assist fulfillment of the vision.
- I am learning the value of a decision and the high cost of indecision.
- I am learning that the less we focus on our own importance, the more important we become.
- I am learning that one wrong doesn’t overcome another.
- I am learning the importance of laying the foundation before beginning to build.

Brendon Harrex, Founder, The Harrex Group, Invercargill, New Zealand

No customer buys costs, efforts or activities, yet many businesses continue to price on a cost-plus basis. The customer wants to see the baby, not hear about the labor pains. However, consider how most companies have traditionally been taught to think of the pricing function.

### ***Cost-plus pricing***

Product → Cost → Price → Value → Customer

Notice that you start with the product (or service), determine its cost, mark up that cost with a desired profit to set the price and then pray that the customer values the output at a level higher than the price they are being asked to pay. Notice where the customer is in this chain of events – at the end! Value-based pricing inverts this chain to correspond with the economic realities of the marketplace.

### ***Value-based pricing***

Customers → Value → Price → Cost → Product

This value chain recognizes that value is like beauty; it is in the eye of the beholder. It is in total alignment with the *subjective* theory of value. Customers do not care about your internal costs or your profit desires. They demand value higher than the price they are paying.

This inversion reveals a further fact of economic life: your costs do not determine your price; rather, your price determines your costs. This is anathema to a cost accountant but self-evident to a pricer. A firm needs to determine, before producing a product or service, whether the price charged – based on value – will allow it to invest in the costs required to develop the product or service at a profit the company can tolerate (*price-led costing*). If not, it should not undertake production. The important point about this process is *when* costs are considered – *before* the product is produced, not after. This is the problem with historical standard cost accounting – it can only allocate past costs once they have been spent.

CVOs understand that the hardest part of this new value chain is determining value. After all, cost is relatively easy to determine, since most companies employ cost accountants capable of allocating fixed and variable costs to each widget. Setting price above cost is also not difficult; even the most inept businessperson should be able to accomplish this. In determining value, cost accounting provides little help, since customers purchase value, not a bundle of allocated costs.

Since the CVO position is relatively new, more is being learned every day about this responsibility within firms. It is an unusual position, to say the least. The firms that have implemented it so far have reported favorable results, so much so that the idea warrants further testing. One question that continually arises is, “What are the traits of a successful CVO?”

## The framework for the Chief Value Officer

### *CVO versus other commercial-oriented C-level positions*

Our intention in this chapter is not to propose a detailed and final description of various C-level positions. We intend to launch a conversation about the role of the CVO compared with other C-level positions that are related to market and customer activities. The Chief Marketing Officer (CMO) and Chief Commercial Officer (CCO) positions have been more widely accepted over the past decade. While the role of CCO is relatively new, about 200 CCOs have been appointed worldwide since the role emerged (Abele & Stevenson, 2009). Similarly, the number and presence of CVOs is accelerating around the world. In 2006, Spencer Stuart identified more than 30 CMOs in FTSE top 50 companies. In the U.S. among Fortune 100 firms, 23 had a CMO as the head of marketing in 2008 (Grewal & Wang, 2009). The acceptance of the role of Chief Pricing Officer (CPO) and Chief Value Officer (CVO) has a long way to go. First of all, in most companies, the pricing and value-management function receives limited attention. Data from the Professional Pricing Society, the world's largest organization dedicated to pricing, reveal that fewer than 5 percent of Fortune 500 companies have a full-time function exclusively dedicated to pricing (Mitchell, 2011). After an in-depth review on Google, only two or three firms have a clearly identified CVO function.

Reviews of the published roles of CVO, CPO, CMO and CCO allowed us to prepare the summary data shown in Table 6.1. We propose that all four roles are different but present some overlapping characteristics or critical functions. While job descriptions might differ from firm to firm, we find that the CVO function best captures the systematic and holistic creation, assessment and capture of value.

*Table 6.1* Critical function of commercially related C-level positions

<i>Chief Marketing Officer</i>	<i>Chief Pricing Officer</i>
Product management	Firm pricing orientation
Market management	Pricing strategies and tactics
Strategic marketing excellence	Pricing realization excellence
Strategic pricing management	Value management process
Marketing communications	Systems, tools and infrastructure
<i>Chief Commercial Officer</i>	<i>Chief Value Officer</i>
Commercial strategies and tactics	Value management process
Commercial excellence	Strategic pricing management
Product management	Innovation management
Market and customer insights	Market and customer insights
Customer experience management	Learning and knowledge management

### ***The LACEY framework***

The acronym LACEY is a useful framework for identifying what characteristics are essential for a successful CVO. Let us examine each of these attributes, and discuss the functions required for each one.

#### ***Leadership***

A company will never rise above its leadership. CVOs implicitly and explicitly understand that the company's prices are the language in which they strategically communicate value to customers. Even though companies are becoming more sophisticated with respect to the pricing function, value too often has been put aside. Now that we have a theory for value – the subjective theory of value – it should be promoted to the executive suite as the basis for all pricing decisions.

CVOs understand that there is nobility in being paid what the company is worth. Nothing is more satisfying than customers who believe, and act on the premise, that they get what they pay for. Perhaps the first important characteristic of a successful CVO is high self-esteem; they believe that their company's products and services are worth every penny they charge. They are more concerned with developing a value proposition based on value, not price or cost.

In today's competitive business environment, low self-esteem is a competitive disadvantage whereas high self-esteem confers a competitive advantage. Yet, how can people feel good about themselves, their work and their service to the customer and the greater community if they believe they are commodities and are constantly being beaten up over their price? *You will never get paid more than you think you are worth.* And if a company's leaders do not think they are worth more than cost-plus pricing, why would its customers?

In addition to high self-esteem, a CVO must have demonstrable leadership skills while commanding respect and credibility across multiple functions within the company. He or she will be responsible for communicating the importance of pricing and value to the media, thereby negating price wars within the industry. Since competitors tend to judge a company's pricing behavior based on its most ruthless actions, think of the message that appointing a CVO would send to others in the industry about how committed a firm is to price for value and not engaging in self-destructive price wars.

The CVO is also responsible for establishing the value council, a group of motivated team members who look upon pricing as an enormous opportunity, not a limitation. The size of the council will vary by company size, industry and customer segment, but experience suggests that smaller is better. It should not consist of executives only but should comprise a cross-selection of disciplines, from finance, marketing, sales and so forth. Some companies have made one-half of the positions rotate, perhaps on a two- or three-year basis, in order to bring in fresh perspectives, while spreading the value message throughout the organization.

The final determination of the value council's membership should be made by the CVO, possibly in conjunction with the CEO. But it is important to emphasize

that the council is not a jury; it does not require unanimous consent to make decisions. The CVO always holds the tie-breaking vote in order for there to be true leadership and accountability. Margaret Thatcher, former Prime Minister of Britain, was fond of pointing out, “Consensus is the negation of leadership.”

Examples of mission statements for the value council are:

- To ensure [company name] prices on purpose, according to the value received by the customer, not the costs incurred.
- To make pricing for value a core competency within [company name].
- To change the marketing culture within [company name] to one that comprehends, creates, communicates, convinces and captures the value of the products we provide to our customers.

### ***Attitude***

The CVO and members of the value council must view pricing as an enormous opportunity for the company to create and capture value rather than a limitation imposed on them over which they have no control, like the weather. Pricing is far too important to assign to narrow minds. Pricers must be intellectually curious, constantly learning and studying why humans behave the way they do.

Look for a CVO who is constantly learning and who is moving through the five levels of learning: awareness, awkwardness, application, assimilation and art. Pricing is an iterative process of the mind. Although it may require substantial investment (to purchase sophisticated pricing software, for example), it will always require human judgment; otherwise, it will be the embodiment of garbage in, garbage out. Pricing strategy, ultimately, is a human endeavor.

### ***Commitment***

A CVO who does not have the support of the CEO is destined to be feckless. Effective centralized pricing must have total authority, which we believe needs to be vested in one individual so that there is one throat to choke. Taking it a step further: If value creation is truly the purpose of a company, the CVO should report directly to the CEO. This will send a powerful message throughout the organization, and to competitors, that the leaders are serious about value and pricing, thereby possibly reducing the threat of price wars.

The commitment to a CVO also provides a competitive advantage, since competitors can monitor only historical pricing, not value. Value creation and pricing competence create a sense of self-worth among team members, and although nearly impossible to measure quantitatively, they can certainly be observed in morale.

### ***Experimentation***

CVOs must take a stand on behalf of the customer, constantly asking how the organization can provide more value. They must be willing to experiment and

cannot be prisoners of the past. “That is the way we have always done it” draws nothing but contempt from CVOs, since they have little respect for the status quo. They seek change not simply for change’s sake but to fulfill the purpose of the organization.

If you have ever been bribed off an oversold airplane with a free flight voucher, upgrade or airline money equivalent, you have the late economist Julian Simon to thank. Until 1978, travelers were bumped off overbooked planes rather capriciously – the airlines preferred to bump old people and military personnel on the theory they would be least likely to complain – and this caused enormous amounts of customer complaints and ill will. Sometimes an entire flight would be cancelled and rebooked at proper capacity, causing even greater outrage. Worse yet, the problem fed upon itself because passengers began to expect being bumped and so would book several flights under various names to ensure a seat on at least one; this caused the airlines to increase bookings even more in order to ensure decent load factors. A flight attendant friend who worked for United Airlines told Simon of this problem:

The next day when shaving it occurred to me that there must be a better way; indeed, an auction market could solve the problem by finding those people who least mind waiting for the next flight. The practical details fell into place before the shave was complete.

In 1966 and 1967 I wrote to all the airlines suggesting the scheme. The responses ranged from polite brush-offs, to denials that they overbooked, to assertions that the scheme could not work, to derision.

[. . .] I was unable to persuade any airline (or the Civil Aeronautics Board) to conduct an experiment for even one day on a single airline at a single airport at a single boarding gate – an experiment that I believed would be sufficient, even with the inevitable breakdowns in any new activity.

(Simon, 2003: 289–294)

Had the airlines employed a CVO, Simon’s idea would have been tested much sooner, to the benefit of both the airlines and their customers.

Soren Kierkegaard wrote, “Purity of soul is to will one thing.” What is more important than to champion the cause of value creation within today’s companies? A CVO is never satisfied with the status quo because he or she will constantly be searching for new ways of doing things, all while eliminating procedures and processes that do not add value to the customer. This is the CVO mandate.

## **Youth**

*Age is, of course, a fever chill  
that every physicist must fear.  
He’s better dead than living still  
when once he’s past his thirtieth year.*

—Paul Dirac, 1933 Nobel Laureate in Physics

Of all the characteristics in LACEY, there is a certain amount of uncertainty about the implications of this last one. Facts are indeed stubborn things; we are all entitled to our *opinions*, but we are not entitled to our *facts*. Consider these facts:

- The average age of the signers of the Declaration of Independence was 45, Benjamin Franklin being the oldest at 70 and Thomas Lynch, Jr. (South Carolina) the youngest at 27.
- The average age of the delegates to the Constitutional Convention was 43, the oldest being Benjamin Franklin at 81 and the youngest Jonathan Dayton at 26.
- The average age of the Marginalist Revolution economists was 35.
- Adam Smith was 36 when he wrote his first book, *The Theory of Moral Sentiments*, containing the genesis of his later masterpiece, *Wealth of Nations*.
- Blaise Pascal, who proved Euclid's 32nd theorem, was 28 by the time he completed most of the scientific work for which he is famous.
- Albert Einstein developed his theory of relativity at age 26.
- The average age of the Manhattan Project scientists was 25.
- Steve Jobs was 21 and Steve Wozniak 26 when Apple Computer was founded; they were 29 and 34, respectively, when the Macintosh was launched.
- Walt Disney was 27 when Mickey Mouse was introduced to the world.

Charles Murray, Bradley Fellow at the American Enterprise Institute, wrote an absolutely fascinating book, *Human Accomplishment*, wherein he identified 4,002 individuals who basically invented, developed or proved the most consequential ideas in the history of the world, from 800 BC to 1950:

It is a fact that takes some getting used to, but the evidence for it is overwhelming: When you assemble the human résumé, only a few thousand people stand apart from the rest. Among them, the people who are indispensable to the story of human accomplishment number in the hundreds. Among those hundreds, a handful stand conspicuously above everyone else.

(Murray, 2003: 87)

We truly do stand on the shoulders of these giants. The mean age of these individuals was 40. What does this all mean? We will admit to not being entirely sure. One thing is certain: If organizations want innovation and dynamism, they will have to confer greater authority and responsibility onto their youthful team members. Organizations, like people, tend to calcify with age, and youth can keep the blood pumping at a more vigorous pace. No doubt they will make more mistakes and incur more failure, yet risk is where profits come from. What is the alternative? Ossification is not an option.

### ***Chief Value Officer job description***

CVOs are focused on systematically creating, assessing and capturing value across all processes and functions of the firm. CVOs make sure that all programs,

actions, initiatives, new products, services and investments create and capture customer value. They challenge the decision-making process to bring forward customer needs, value propositions and value models as well as how value is captured in the process. CVOs live and breathe value management as the eyes, ears and voices within the organization advocating value creation for the customer.

There are two options for designing the role of the CVO, as shown in Figure 6.2. A first way is to establish a project management office (PMO) dedicated to the management of value and driving all programs, processes and systems associated with value management. We call this approach a process-focused CVO.

The second approach proposes to design this role by grouping all functions associated with value management (marketing, innovation, pricing, value, strategy) and to fold them under one function reporting to the CEO. This approach resembles a more traditional one, closer to the role of Chief Marketing Officer with innovation and strategic responsibilities. We call this approach a functionally-focused CVO with more direct responsibility. The selection of one versus the other approach depends on the firm's process orientation and its capacity to change at the organizational level. Our opinion is that both approaches offer great potential to put value management where it belongs, that is, in the C-suite.

In this chapter, we also propose to go further and to offer readers a potential job description for a process-focused CVO. For this we build on the work of Deloitte (Dalton & Wortman, 2004) and add additional dimensions to the position, as shown in Figure 6.3.

While the initial job description was well designed and captured more important elements of the role, we added the dimensions of learning and knowledge management and the required skills in change management. Putting value at the center of the firm's DNA requires an organizational transformation (Liozu et al., 2011). The CVO will be required to drive this difficult transformation with passion. He or she will act as a champion of value in the firm and will reinforce collective efficacy by expressing positive evaluations (Tasa et al., 2007), showing confidence in people to perform effectively and to meet value challenges

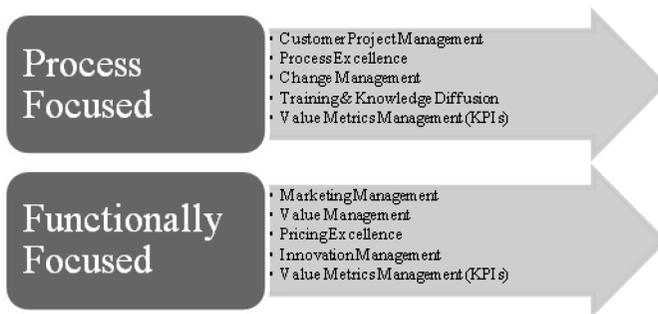


Figure 6.2 Two options for CVO role design

***Job title:***

Chief Value Officer (CVO)

***Reports to:***

ECO and Board of Directors

***Objective of the role:***

To lead the development and execution of an integrated performance management process focused on the creation and capturing of long-term business value.

***Scope:***

This role encompasses all elements of performance management, including development and update of strategic plans, management of the project portfolio, determination and approval of capital investments and new product introductions, establishment of performance measures and targets, and the evaluation and reward of performance. Organizational scope includes an overall corporate perspective with responsibility for providing direction to all business units, aligning their strategies within the context of enterprise value and optimizing the enterprise portfolio.

***Main responsibilities:***

- Lead the continuous assessment of the business environment, customer trends and value models and assessment of possible scenarios, as well as the changes in direction implied by potential changes.
- Review and approval of all plans, projects, investments, measurements, targets and performance assessments for completeness and consistency with overall corporate value-creation and value-capturing goals and objectives.
- Establishment, review and maintenance of a consistent, integrated performance management process across all parts of the organization including timelines, outputs and systems to be used.
- Review and approval of all compensation and reward programs for consistency and alignment with corporate goals.
- Develop training and intellectual capital management programs to promote the value management.

***Experience & skills required***

A demonstrated knowledge of marketing, value assessment, pricing and finance.  
Excellent business acumen including a passion for delivering superior outcome. The ability to lead and direct diverse cross-functional teams to a common goal. Strong experience leading value-creating and capturing processes.  
A passion for holistic thinking and continuous improvement.  
An ability to manage and direct the corporate and multi-functional project portfolio.  
Strong change management experience and passion for communication.

Figure 6.3 Proposed process-oriented CVO job description

(Nadler & Tushman, 1990), awakening spirits to rally the troops (Hacker & Roberts, 2003) and energizing members across the organization (Nadler & Tushman, 1990; Thompson, 2009: 100).

## **Discussion**

In this chapter we have attempted to bring forth arguments for why firms should comprehensively and systematically manage business value at the organizational level. We have also highlighted the need to have customer value managed centrally through the creation of the position of Chief Value Officer. Since the first edition of this book in 2012, the acceptance of the CVO position has not gained much traction. However, tremendous progress has been made in the area of value management and the adoption of value-based pricing in firms is improving. Value and pricing have been researched a lot more in academic journals, justifying the need for more attention and intention towards them. For example, scholars in Scandinavia have embarked on a research project on the topic of value specialization. The goal of this research project is to identify differences in performance between firms that have dedicated value specialists and those that do not. Other scholars are also studying the definition of roles and responsibilities within the pricing organizations. Should pricing experts be called pricing professionals or value professionals? Should organizations have dedicated value management teams and should these teams be embedded in the marketing or in the pricing organization? These research projects fit well in our discussion for the need for a CVO. Specialization in tasks and roles is at the heart of the CVO question. In the field of practice, we can see that more and more organizations have elevated value responsibility at the Vice President level. If you search LinkedIn, you can indeed find lots of VP of Value Management, VP of Value Excellence or VP of Value Realization. This is a good sign for the future of value management and also supports our case for CVOs in the C-suite. The business world is changing and resources are becoming scarce every year. Firms have to become better at managing the value of their existing assets. There has never been a better time to invest in value management.

## **Implications for innovation in pricing**

In this chapter, we make several contributions to the field of marketing, value and pricing management. First, we propose a different definition of customer value and also support the need to elevate the value discussion to the C-suite. Many CEOs believe that it is their role to manage value day in and day out. We take a different position and argue that CEOs cannot improvise and focus fully on comprehensive value management. They need a full-time pool of resources that will make value leadership a priority project with the intent to create, assess and capture value. CEOs need to put business at the center of the firm's existence and delegate that mission to value experts. CMOs, CPOs and CCOs may be able to assist in the management of value but they will also suffer from the same issues

of multitasking, attention misallocation and lack of dedicated expertise that CEOs contend with.

Second, we propose a couple of different design options for CVOs and a potential job description based on Deloitte's 2004 work (Dalton & Wortman, 2004: 31). We hope that further research will be conducted on the role and function of the CVO and that practitioners will draw from our work to advance the cause of value management in the C-suite.

Third, we clearly establish a separation between pricing management and value management in the firm. While they are not separated in the overall process, they must be managed differently and cannot be integrated with each other. Pricing strategies and tactics are used to capture value in the marketplace with customers. Prior to being captured, however, value must be created and assessed. Reciprocally, value cannot be captured without sound pricing strategies. Therefore, we posit that pricing belongs in the value-management process led by a CVO and not simply a CPO reporting to the CEO or working in the C-suite.

If you are competing against a company with a CVO – either for customers or talent – you may be at a severe competitive disadvantage. The Roman God Janus had two sets of eyes: one set to see what lay behind and the other to see what lay ahead. A CVO is an outward-looking position with duties carried out in a world of risk, uncertainty, innovation and faith in the future, where value is solely determined by the customers your company is privileged to serve. If the only set of eyes you possess look behind you – at historical costs and efforts – you are destined for a perilous future.

So, who is in charge of value in your company?

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## 7 Interview

### How a vice president of value can drive profits in B2B

*Andreas Hinterhuber and Todd Snelgrove*

*A. Hinterhuber:* What does a Vice President of Value do?

*T. Snelgrove:* That's a great question because you don't see the title in a lot of organizations. However, companies that create value and want to deliver that value to their customers realize that value quantification needs to be pulled together in a dedicated function.

A VP of value essentially coordinates value quantification and brings the voice of the customer inside, enabling companies to understand what customers really value, asking questions such as "What is the value that we're building into our products?" "Are my customers willing to pay for that?" "Do we have tools to quantify this value or is it just generic case studies that don't resonate well with my customers?"

A VP of value, for example, calculates the return on investment (ROI) on customer-specific business cases. A VP of value ensures that value messages are incorporated into marketing communication. A VP of value generates insights for the sales force to enable them to justify an only apparently high price by documenting and quantifying that the value in fact far exceeds price. A VP of value also works with new pricing models, exploring new ways to monetize competitive advantages. Finally, a VP of value also has the responsibility of driving a culture change. At least with my experience with all culture change projects, if companies do not have a full-time function, sales managers won't become experts and change programs become stale. In order to successfully implement change management, organizations need to have somebody whose full-time job is to constantly improve, refresh and drive relevant messages internally and externally.

*A. Hinterhuber:* A VP of value creates the organizational momentum in order to avoid that value quantification becomes stale. A number of companies already manages for value and quantifies value to customers. Tell me something that is counterintuitive or not yet widely known.

*T. Snelgrove:* I think there's one thing: value quantification might not be as hard as you think. Too many companies just throw their hands up and say, "We can't quantify the value," and I think there's a few reasons for that. One, they might have an engineering background where they want guarantees of future exact numbers, where with value quantification it is mostly about probabilities. Over time, you gain case studies that you can go back to and say, "We have done this. This is the average impact." It's not as hard to start the journey as one might think, but it is a journey and it needs focus.

One of the suggestions I have is that it's usually best to get somebody from outside the industry. People from the industry or from the company might be so myopic; they assume things are always the same as they have been. They don't ask those questions: "Why?" "What is that worth?" They don't get it as much. Having a fresh set of eyes come in and say "Okay, let's really challenge what is that feature, benefit and value worth." I guess that's point one. Point two is that customers are demanding it. They might not specifically say in the RFP, "Please demonstrate and document the exact value of your solution," but all the research shows that it's the predominant driver they're going to use to make the business decision.

*A. Hinterhuber:* Yes, B2B customers increasingly demand value quantification. What are main challenges of value quantification?

*T. Snelgrove:* I think there is a few things. One, and I think we've talked about this over the years; it starts with a company's culture. It does take time; it does take effort. It takes a little bit of resources. The payback is huge. Some companies might be measuring, rewarding and focusing their sales force on market share or sales volume, not on profit generation, value quantification and customer satisfaction. Yes, that might help the company hit a number today, but it's not going to help differentiate that company in the future, allowing more of these me-too copycats to come in.

Really working with customers prior to them starting the journey, the buying process journey. Getting there ahead of time so that they start to think differently of how they buy whatever you're selling in a product or service. To have the discussion, it's a complete cultural change for most sales organizations and it's not a normal selling process to go to a customer. You need to be proactive. What I always say is, "Where are they learning?" "Where are they challenging their own perceptions so that when the time does come to have a discussion around your offering, you frame the discussion around something different?"

A CEO once said to me – I’m somewhat paraphrasing – “How many ways do I have to discount in the marketplace, whether that’s by competitive situation or market or whatever reason?” He said, “We have hundreds of different ways to discount. How many ways do I have or systems do I have not to discount and to get paid for my value?” Maybe I’ve got my focus and tools and processes on the wrong side or the wrong focus.

*A. Hinterhuber:* How would you describe the behavioral or psychological traits of those sales and account managers who are exceptionally well versed in value quantification? How, by contrast, would you describe the behavioral traits of sales managers who seem to struggle with value quantification?

*T. Snelgrove:* I think people must have an open mind because they might be continuing to hear procurement cares about price and does not care about value. So people have to stop and say, “If I can do this, if I can prove this, is there a benefit in doing this?” The answer frequently is positive. I spend a lot of my time with procurement, and I know that it is possible to have a meaningful discussion with procurement around what value is.

Next: Understanding that life is about ranges and probabilities. I say, “No, I can’t guarantee that if we do X today that this will happen in the future.” However, the technical background says it should be between this and this. Maybe we could set up a payment model that if this occurs, I get paid this, and if this occurs, this happens. A lot of technical people have difficulties with probabilistic models. Life isn’t about guaranteed future states. It’s about having reasonable, justifiable ranges and say, “We believe X will occur; here’s why, here’s how,” and then working out contingency models that specify what happens if some of the assumptions are not met. I have always found that working with probabilistic models requires a culture change with technical people.

Finally, the openness to understand that you have to have the experts or the technical background, but that technology needs to be converted into a financial understanding. Value quantification requires an ability to convert advantages into an ROI analysis. Either sales managers become educated in financials – costs, revenues, risks – themselves or they bring somebody in. Sales managers need to be able to say, “Okay, what I’ve learned is technical. I need to now become just as conversant in the financial impact of that technical discussion.”

*A. Hinterhuber:* Great comment. My take is: Many of the relationships we discover through research in business are probabilistic, not deterministic.

*T. Snelgrove:* Very well said. I will use that quote in the future. If someone could guarantee the future, they should probably be in the stock market.

*A. Hinterhuber:* Let us assume that you have a differentiated offer, that you have quantified your value and that you are dealing with a procurement organization that is convinced of the benefits that you offer but that is afraid of putting a criterion in the bidding documents where your company is the only one able to offer it. Any advice?

*T. Snelgrove:* Great question. A few things there. I think you need to highlight so much earlier in the sales cycle. To get the customer to buy into the logic, most companies I know that do call on government, but they admit that to get the initial order, they don't talk about the value differentiation as much because they're going to make up the value and the profitability for themselves afterwards. That's how they get the contract changed. Changes are where they make their money after contracts have been vetted.

Second, there is a lot of research that suggests that even government procurement is better off when including non-price factors in the bidding process. Public procurement is quickly moving towards purchasing based on total value and total profit added.

*A. Hinterhuber:* It means working with the procurement organizations to convince them that again, buying on value is in their own best interest, even if this means excluding some suppliers.

*T. Snelgrove:* Yes, procurement agencies need to define what they care about. Suppliers then need to think about how they can minimize the risk for the procurement function. Vitasek (2017) suggests that defining a value and a price model are highly effective in minimizing the perceived risk to procurement; in a very simplified way, these models specify in advance the payment accruing to a supplier based on pre-defined outcomes: the supplier will get X percent of the value created. As long as suppliers charge less than the value created and customers agree on the model, it's a win-win.

*A. Hinterhuber:* Let us discuss a case study of value-based pricing and value quantification.

*T. Snelgrove:* A large global paper company had requested that all major suppliers come and bid for being a supplier of industrial parts. While the commercial and pricing discussions were being discussed between the customer, the distributor and my company, I went for a plant walk.

An hour later we were meeting with the customer's procurement team. Our technical expert asked the customer group if they had any specific issues or problems that should be discussed.

All the representatives said, “Nothing . . . all good . . . the paper machines are running at specification.” Then dead silence. I, as the non-technical person, asked if I may ask a question. I said, “I was just on a walk and noticed that you have a lot of pumps in your facility: What is the average mean time between failures (MTBF) of your pumps?” The technical person smiled and said that they were very satisfied as they were able to increase the average life of this pump population, from 2.5 years to 3 years, i.e. a 20 percent improvement. I congratulated them, then said “Just something to think about: Our company just did some work for a large global petrochemical company on increasing MTBF of pumps, and we were able to extend it from 13 years to 14 years.” So I asked about the number of pumps and the number of facilities globally. To my knowledge the cost to repair these pumps, refurbish, replace was approximately \$4,000. So I said, “So let’s see how much cash could be generated by increasing the life of these production assets.” I noted down the following summary calculations, noting that they referred to the impact of our products on just *one* critical outcome (see Figure 7.1).

Price of own offer:	\$6,000,000
Price of next best alternative:	\$4,500,000
Total cost of pump replacement: (150 pumps at 20 factories, at \$4,000 each)	\$12,000,000
Cost of yearly pump replacement:	\$4,000,000
Benefits of increasing pump life by 5 years:	\$20,000,000
Incremental investment over 5 years:	\$7,500,000
ROI:	167%

The discussion was reframed from the price difference to what else we could do, what the expected financial impact would be, where we had done it before, how we would do it and how we would be rewarded if we beat the target or missed the target. As a “salesperson” I knew we were having an implementation discussion.

After the value-based agreement was signed I attended our first implementation meeting; the same group representing the customer was involved. They told me, “Todd, what we all liked about the ideas you brought us was that all your competitors wanted to talk about our key assets, ones that we know more how to operate more than you suppliers would ever, but you brought us a best practice from another industry, showed us some big financial impacts and calculated that number for us, and then were willing to get paid based on really delivering us a result.”

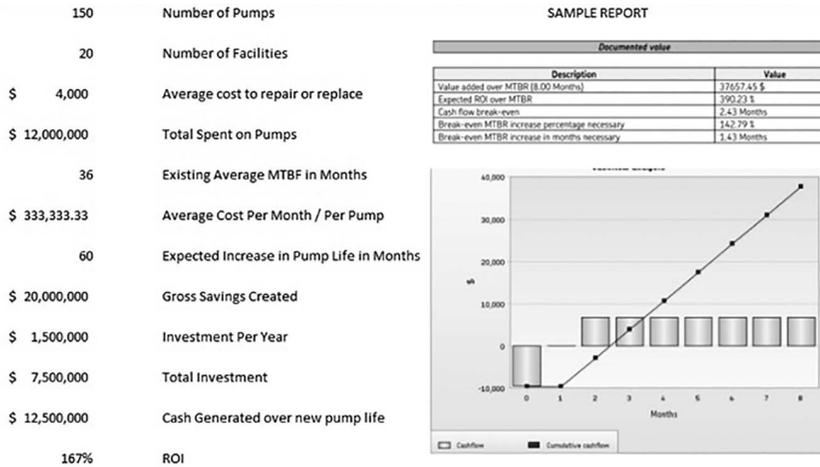


Figure 7.1 Case study on value quantification

*A. Hinterhuber:* Great example. I will start the next question with a statement. Value-based pricing does not imply performance-based pricing. If you buy a Volvo, you pay ex ante for value. Likewise, performance-based pricing does not imply value-based pricing. Key performance indicators (KPIs) are routinely added to cost-based pricing contracts. There is, however, an area where value-based and performance-based pricing intersect. This leads to the question: under which circumstances is ex-ante value-based pricing most appropriate in B2B? Under which circumstances is ex-post performance-based value-based pricing most appropriate?

*T. Snelgrove:* As sales people, pricing people, we need to give customers a choice and maybe not always say: “This is how you have to buy.” If a company is just buying a product, one widget, one something, it has to be ex-ante. You cannot guarantee; it’s not financially reasonable to invest the resources to track what actually happens. In the example we used in our book (Hinterhuber & Snelgrove, 2016) SKF would show what the value could be, but that means that customers installed it right and used it right and maintained it right.

In a one-off relationship, pricing is typically ex-ante: we would show hundreds of examples, the probability, the minimum and maximum. As long as the customer feels that the numbers are reasonable, that the risk is low and the speed at which it happens is quick, that’s a great situation. An example,

energy savings. You can do a very simple calculation to show what that is worth. I would be willing to pay for that; it is a hard dollar; it's not a bunch of maybes and hopefuls in general.

Ex-post performance pricing really requires a holistic view and a very deep relationship with customers. In an outcome-based contract suppliers and customers typically need to work together to achieve high-level KPIs jointly defined.

But the point is suppliers need to give customers choices. We cannot tell customers how to buy. Each choice needs to be clear and concise with risks and rewards.

On a side note, I would also say I spend a lot of time with procurement and I tell procurement if the supplier is going to claim that they're better and they have all these case studies of why they're better, and they may have a tool to calculate it, but then you push them, and this is a negotiating tactic and you say, "Mr. Supplier, okay, fine. Are you willing to get paid partially based on achieving that benefit for me?" They throw up their hands and say no. I start to question how much does that company really believe in its value if that company is not willing to be paid based on value.

By contrast: the fact that you as a supplier are willing to get paid based on value just dramatically increases your credibility vis-à-vis customers. You take the risk. It is also a negotiation tactic.

If you as a supplier claim to be better, but are not willing to get paid that way, I'm going to challenge you even more.

*A. Hinterhuber:* In the example we mentioned – SKF at 15 versus the competition at 10 – the price structure is ex-ante, I presume?

*T. Snelgrove:* Very much so. We're going to tell your maintenance people how to lubricate this. We're going to tell them what, how to install it so the energy usage is lower. Telling somebody to do something and making sure they do it the right way are two different things. Like you said, this is an ex-ante situation. If the customer said, "Well, I want to guarantee I get that result," we'll say, "Okay, now that relationship has just changed. We will come in, install, operate and maintain your machines, and therefore we guarantee you're going to get this. Now because you're going to get a guarantee of value, I'm going to need to get an investment to pay for all that." You give them the choice.

In this example the question is thus: Do I believe that it's reasonably going to happen? Is the risk reward good enough? You're asking me to pay \$5 for \$30, it's a 6 times ROI. That leaves me a lot of wiggle room. Let's say that I don't need to get it perfect to get a win for me. A lot of those examples that are listed there are immediate. I'm much happier to pay more for

that because it's measurable, it's quicker. There's a high probability. If the ROI was much smaller, very long term and very vague in how it would be done, the premium you'd be able to get for that is much, much lower.

*A. Hinterhuber:* In a nutshell: value-based performance-based pricing requires a strategic, collaborative relationship with customers where value is co-created.

*T. Snelgrove:* 100 percent, there's got to be trust, it has to be much more holistic. I believe that more and more of this will occur. Outsource the mailroom. I want a result. I'm willing to pay you to bring me that result as long as the result can be clear and concisely measured, and there's value for both sides in the discussion. I think there'll be a lot of businesses moving toward that in the future.

*A. Hinterhuber:* I am skeptical on this point. As I highlight in a current paper, value-based performance-based pricing has its own challenges: substantially increased transaction costs, an incentive for suppliers to reach minimum performance thresholds and cheating are just some of the typical problems that customers experience with this pricing approach.

*T. Snelgrove:* Very much so; that's why I mean again, the business case has to be there for both sides and the reward needs to be there. You shouldn't take on risk just to get back to your threshold. There needs to be reward that's good enough for both sides to make the investment, so of course, I agree with you 100 percent.

*A. Hinterhuber:* Back to value-based pricing: what are typical value-capture rates? In our example – price difference 5, value difference 30 – the rate is 17 percent. In your own experience is this typical or is this rather on the low side?

*T. Snelgrove:* Very good question. According to research by Jim Anderson (Anderson et al., 2014) tiebreaker sales, where product features are not quantified, still justify price differences of 4 percent to 6 percent: terms are better, conditions are better, the return policy is better, whatever those things are. He says here you have to stop and say when the term value pricing is used, are you trying to find just a minor differentiator to get you that minor price difference? Or is the product or service going to be measurably different? I think that's one thing to stop and think about.

Two, as you said, the range. I think a lot of it depends on the hardness of the value. The more risk I have to take, the less I'm willing to pay for it.

If it was a situation where you came to me and said, "Todd, I'm going to save you \$1 million in energy this year" and if the calculation was sound, I would be willing to pay say 90 percent of that value. I can see it, I can touch it and I can feel it.

It really comes down to credibility and to who is willing to take on the risk. If I really, really, really believe that it's going to happen, I'm willing to pay more. If I believe there is a small chance, I'm willing to pay less. I think you run anywhere between 10 percent and 90 percent. Sorry to give such a huge range, but I think those are some of the characteristics to look at.

Finally we should remember an important point: Sometimes you can get compensated not just by price premiums but also by volume. One of the things that procurement can do relatively easily is increase market share. Maybe you are only going to get a 10 percent price premium or 20 percent price premium, but you double your market share. Don't always look at the price as the only way to capture the value you created

*A. Hinterhuber:* I appreciate the comment. You suggest that looking only at price could be shortsighted because there could be a way to realize price through volume.

*T. Snelgrove:* Very much so.

*A. Hinterhuber:* Back to price structure: In your experience, what is a typical split, assuming that pricing is based on value, between traditional, ex ante value-based pricing and performance-based, value-based pricing?

*T. Snelgrove:* It probably is 50 percent for ex ante value-based pricing, based on brand, experience, performance or other elements.

Performance-based pricing will come in two variants: only 5 percent of volume might be 100 percent performance-based because of the numerous reasons we talked about, such as the amount of investments required on both sides to make it happen.

For the other remaining 45 percent of volume or so we could implement simpler versions of performance-based pricing. If we didn't create X amount of value, we were at risk: we would have to write a penalty, or discount after the fact, something if we couldn't prove the value. If we did prove the value, we would get more. Sometimes more was more price. A lot of times more was more market share.

Again as I said, in performance-based pricing we should take continuum view rather than an either-or view.

If you're selling through an OEM to their end user, it becomes a little more difficult to have a pure performance-based. Yes, you can work on warranty reduction cost or things like this, but because the value chain is so long, it becomes a little muddled of where the value was created and realized. I think it's also the type of customer relationship or market strategy channel.

*A. Hinterhuber:* Value quantification relies heavily on collaboration with customers. How do you get customers to sign off case studies of quantified customer value?

*T. Snelgrove:* That's an interesting and good question. I think they have to see there's something good for them, not a negative. I mean one, what we always did was say, "Here's the process we will use to create, define value. When it goes to this stage of the implementation, this happens. When this happens, somebody signs off on it." They're signing off on it so that they get credit within their own company. This happened, this is what it was worth, etc. Again, some of that can be projection, some of it can be actual; it depends on the calculation.

I've seen situations where people that were signing off on value were actually being punished financially. For example, if you sign off on a cost savings, Mr. Maintenance Person, we're going to take that money out of your budget. We basically disincentivize them for doing anything. Too often, the benefit goes across a total organization. It happened here, here and here. We make it very clear early on what the processes are. Best-case scenario is we agree on the formulas that will be used and on the numbers that will be used.

The reason why, if you're trying to calculate the value after the fact then this comes back to that zero sum game mentality. If I agree with your calculation, that means you're going to get a bonus or there won't be whatever, so maybe I don't believe energy's 10 cents, it's only 6 cents. At the beginning we say okay, sometimes energy's 10, sometimes energy's 6, it depends on all these different variables. Let's call it 8 cents as an average.

The more you agree up front about the numbers and the formulas, the less reluctant people are. We always put something in our value agreements like the following: If we find out that there are processes or procedures in place that will minimize the effectiveness of the agreement, then everything is null and void.

One example was where a copy of an email was obtained with inter-company people from procurement saying if anybody signs off on a cost savings, it'll come out of your budget and with a strong hint that you would be reprimanded. Not fired, but reprimanded. Right away I was like: "Okay, you didn't bargain in good faith."

I also spend time seeing the more people buy into it, the more they'll want to do more of it. Some companies are good at saying okay, we have cost savings or value targets for each of our division, shift, etc., so they want to be involved in having their name say, "Hey, look what I did for my company." It is also about individual motivation to be able to contribute to something of value for the company as a whole.

*A. Hinterhuber:* Let us assume a customer is unwilling to sign off on a quantified value proposition. Are there softer ways a supplier could use to get to a similar result? A case study or a testimonial might work as well in the end.

*T. Snelgrove:* Yes, 100 percent, all this is part of a negotiation. If the customer wants X, they have to agree to maybe do a case study with us if we do Y. If, on the other hand, the reluctance to sign is the result of a perceived confidentiality of information, we will take ranges or round numbers.

Just a final note there, I've heard that some companies or some people are reluctant to sign things off because they take it as a personal detriment to their past history or their past experience: By me signing this, I'm admitting that for the last 10 years I've been costing the company a half million dollars a year because I wasn't doing something. By signing off on this, I look bad. It actually becomes a negative.

The message needs to be reframed. We as a company are only going to win if we become more efficient in the future. This is about us all getting better and replicating those things, so I think it's how it gets presented and rolled out.

A short story: We had a benchmarking tool that would allow companies to see opportunity for improvements. Then we would use a value quantification tool to show the profit improvement opportunity in monetary terms. I was in Saudi Arabia at the time. The customer was very resistant. It was going very badly. The customer spent the whole time explaining why the opportunities for improvement were not applicable to them because they were in the desert. They had all these excuses.

We took a coffee break and I said to my colleague, "Do you mind if I just try to reframe this when we come back in?" He goes, "Hey Todd, try anything right now." I said, "Gentlemen, I think what's important to know, and it's our fault for not explaining this earlier, is that we believe that you, your team can be much better if you had the resources, the training, the people that you need. Your management team is not giving you those resources because they don't see the payback. What we're giving you now and saying hey, here's the business case. If we have this amount of money or this investment, this is the payback we could get."

I was amazed at how it changed the mindset. It wasn't you're doing bad because it was you, it's not. You guys have been firefighting and doing the best you can. Boss, give me the money, whatever that is, \$100,000 and look how much better I could be.

This is to help you get the tools you need to do your job better, which at least in my world; everybody wanted more resources and this. They need to see value quantification as a way to help them get those resources. Value quantification is a business case that they can bring to their management.

*A. Hinterhuber:* Todd, this is great. Framing is essential in value quantification. Your experience suggests focusing on future opportunities, not on past problems. Great piece of advice.

*T. Snelgrove:* Thank you.

*A. Hinterhuber:* One more question on value quantification. What is the role of intangible elements in value quantification? How easy is it for B2B customers to accept the fact that they have to pay at least in part for something which is intangible?

*T. Snelgrove:* I think there are a few things there. One, it's important to enumerate all the intangibles or value placeholders, to use a term coined by Jim Anderson and colleagues (Anderson et al., 2006). Maybe I don't have a specific number, but there's value in my responsiveness. There's value in our relationship. I always challenge myself to not give up too easily in the ability to quantify what that value is. Again, maybe we don't have to give an exact number to it, but to make the intangible element a little harder.

An example I use, relationship. We've had a 10-year relationship. My engineers know your engineers, etc. I say okay, the price savings you could obtain by switching us out is where I'm going to make a number, \$50,000. Yes, that's a lot. That \$50,000 equates to 2 1/2 weeks of your purchases. Okay. Do you not think that the relationship we've had for 10 years is going to take you more than 2 1/2 weeks for the next company to come in, find out who they should talk to, find out what the top 10 problems are, start the five projects we got going half-way through the system and they're coming out the other end with actual results. . . It's a reframing of the number, not to be threatening but just to reframe. What I find is people saying, "I never looked at it that way."

It's a value placeholder but they'd be taking the numbers and reframing them in a way that makes them say "Wow, you're right. I mean it would take us so much longer to switch in cost or startup cost with the other vendor. It's not worth it." One, enumerate them and again, just put a basic number there. Two, don't give up on trying putting a number to it. The example that's used a lot is buying from offshore suppliers. Start doing, how much more time do you think on average the engineers need to talk just to clearly understand what the other one's saying? Even if it's only 30 minutes a week, whatever, these types of "what ifs" make a difference. I'm not guaranteeing anything.

I'm just doing reasonable what ifs. It gives them a little more comfort that there's some reasoning behind it.

*A. Hinterhuber:* On which intangible elements do you get the biggest pushback from customers? Which elements, by contrast, are easier to sell?

*T. Snelgrove:* I think that's where the sales force stops and they leave the customer phrases like "With well we have a good relationship". When you're dealing with professional procurements, the word, "relationship," means you get together and have coffee. I mean, I mind paying for that. Until you discover and you can prove that the relationship means speed, for example.

Again, I think it's our responsibility to do a little more work there. One example, brand. For my world, my product inside somebody else's product, a brand will be more important. The user's buying a big machine and it's coming equipped with the best product in the marketplace on it. I would then be saying to their sales force, "You should be selling that as part of your sales value proposition to your customers." Even if you could get 1 percent more for your machine because you're using our stuff versus somebody else's, you'll have this ROI.

Professional procurement, when they hear the word, "Brand," they hate it because to them they're paying more for a logo and they actually think it's a big waste of money. I wouldn't use the word "brand" unless you've got something behind it. You have got to show what an intangible element, such as a brand, actually means.

*A. Hinterhuber:* The key is to turn an intangible element into a tangible element that matters. The sales force has to be able to convert intangible elements into revenue/margin growth, cost reductions, and so on.

*T. Snelgrove:* Yes, and they don't need to be perfect. You just need to give them a little more meat. Even if, based on our reports, I just put \$1 there and say we know it's worth more. We don't know what the number is, but I mean our people work together, they know each other. Just think how long it'll take for them to get to know the next person. Again, I'm trying to take an abstract element and make it more tangible. I also find using day-to-day examples makes it more relevant to people. They can smile and nod and go, "Okay, that makes sense, okay, you're right, you're right, I didn't think of it that way."

Another final comment: whenever you're doing a value quantification, don't stretch for every last dollar. Too often people will say brand and then let's put a number, \$100,000, that's what it's worth. The number's so big it doesn't make sense. Now I'm going to be resistant. I'm not saying it has to be a \$1 or for sure not worth 0, but even if you put a range in there. Say it's between this and this or something; don't try to oversell.

- A. Hinterhuber:* Credibility is paramount. You rather err in the customer's favor.
- T. Snelgrove:* Yes, for sure. I think that that makes the customer feel even happier when they know that they will get X amount in value, but that a lower number has been assigned in the value quantification models. We actually get this but he only put that number down.
- A. Hinterhuber:* Do you have any further comment on pricing and value quantification that we missed so far?
- T. Snelgrove:* I just think really quickly and I'll quote here you in this. You and Stephan Liozu talk about the difference between price setting and price getting (Hinterhuber & Liozu, 2012). It needs to have the pricing people work with the sales people as part of the team to figure out how do we do this and have the same kind of metrics and KPIs so they're part of the same group and working toward a common goal. If your organization has plenty of ways to discount, but you don't have plenty of ways to get paid more for value to price properly in the beginning, or to get a risk reward for the work that you do, I think maybe that's an area to reinvest with. Finally, the rise of professional procurement will continue. We're seeing it in industries I never thought would be possible, such as the medical world. Your value proposition, if you're not the lowest priced person, needs to be tangible and take the time and effort to quantify it, and you've got to start somewhere with value quantification and you can build something that has credibility, resonance and improves the competitiveness of your customers.
- A. Hinterhuber:* Todd, this was a great exchange of thought on the emerging role of a Vice President of value. I thank you for the privilege of a first-hand intellectual exchange.

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# 8 B2B pricing systems

## Proving ROI

*Mark Stiving*

### Introduction

Data, data, data. Virtually every transaction today is conducted electronically. Consumer purchases are rung up on scanners. Most business-to-business (B2B) transactions involve electronic data interchange (EDI). Sales call information is stored on customer relationship management (CRM) systems. Businesses have computerized every aspect of their operations including quotes, invoices, shipments, inventory, reports and more. The quantity of this data is growing rapidly. The trouble is that the *quality* of useful information derived from it is not. That's where pricing systems offer a competitive advantage. Pricing systems turn that data into information that feeds best practices for pricing products and creating day-to-day quotes.

Although pricing systems have been around for a long time (PROS, a leading pricing system company, was founded in 1985, for example), adoption remains low (Gartner, 2016). This low rate of adoption is especially surprising considering the huge potential payback. Pricing system vendors provide case studies of customers increasing profitability by 5 percent or more of revenue annually. This is \$50 million per year for a \$1 billion company. Gartner research verifies that implementing pricing systems typically grows margin by 0.5 percent and grows revenue by 2–4 percent. Yet companies have been reluctant to adopt them for two basic reasons:

- 1 Implementing a pricing system is like any other major strategic pricing decision; it requires a massive change management effort. Pricing touches or is touched by many different departments: sales, sales operations, marketing, finance and every P&L center. That means executive commitment is required for both resources and active support, which in turn means executives must first be convinced the investment is worth the effort.
- 2 Pricing systems are confusing. It is difficult to understand what a pricing system is, what it does and how it is different from current processes. It comes down to, "Prove it!"

In order for a pricing organization to convince management that a multi-million dollar investment in a pricing system is warranted, they must clearly articulate

the return. They must explain the problem, provide examples of the increase in profitability and then demonstrate through number crunching that the return is real. Many pricing organizations, guided by system vendors, make broad claims regarding pricing system return on investment (ROI). Although such claims are likely true, they rarely convince executives. Data and facts move executives much more quickly than vendor-backed claims of ROI.

## **Observations related to pricing systems**

What exactly is a pricing system? Several vendors offer these software applications (see Appendix), and many firms create their own custom pricing systems using their Information Technology (IT) resources, their Enterprise Resource Planning (ERP) system and their CRM system.

Pricing systems support one or more of the following three major pricing functions: execution, analytics or science.

### ***Execution***

Pricing execution is the process of getting a price delivered to an end customer. Start-up companies and small enterprises have it easy. Someone asks for a price and the CEO or vice president of marketing sets the price that is then delivered by the salesperson.

As the company grows in size, in scope and in depth, so does the complexity of delivering prices. Then the trouble starts. Early on, the business is quoting enough customers that management creates guidelines and processes so that the executives don't have to be involved. As the company continues to grow, quotes come in from international locations, from multiple channel partners and from customers of all sizes and for many new products. The rules become more confusing. They conflict with each other. The people quoting prices to the customers are overwhelmed with the number of products, customers, channels and rules – mistakes appear more frequently.

Not surprisingly, this scenario is filled with profit leakages:

- Customers and channels aren't represented in a single intuitive system, and the rules don't always get followed.
- Accounting is often unable to properly invoice the customers since the systems don't easily collect all of the pertinent data points.
- The person at the quote desk doesn't have easy access to all of the quote history and so will make mistakes.

Each of these leakages and many more cost the company revenue and profit. The company's typical solution? Throw some IT resources at the problem, one issue at a time. This band-aid approach grows with the company until someone makes a decision to install a proper system to replace it. This is the execution portion of a pricing system. Execution minimizes leakage by enforcing the pricing rules and making it easy for both the quote desk and accounting to successfully complete their jobs.

Besides the potential large financial return (discussed later) that comes from implementing the execution advantage of systems, this function also helps companies collect more and cleaner data that are vital to analytics.

### *Analytics*

Imagine a product manager looking at a scatter plot, with price on the y-axis and volume on the x-axis. The green dots are won quotes; the red ones are lost. Something looks funny in the plot between 1,000 and 10,000 volume, so they zoom into that section. She or he clicks on a green dot that was below market pricing and discovers it was an unknown customer. Why would a small customer get such a great price? She or he pulls up that customer history to see what else they purchased. At the same time they look at the customer's overall pocket margin and finds it is very low. All of which means new action should be taken. Analytics makes this possible.

Analytics in pricing systems offer two significant advantages over traditional business intelligence tools like Business Objects and Cognos. First, analytics in pricing systems come with expertise. Each pricing system company calls on their industry and pricing expertise to provide ready-made charts and graphs. In addition, the systems often come with hands-on consulting and/or playbooks outlining what to look for and even what actions to take once discovered. The second major advantage is that pricing systems are much faster at analytics than business intelligence tools. This speed makes them easier to use, and therefore more people are inclined to use them. They provide simpler user interfaces intended for pricing that both examine the big picture and allow drill downs to greater details. This is especially valuable when trying to determine why something happened. For example, if revenue in Singapore fell last month, what was the cause? One customer? Average sales price (ASP) decrease? Product mix?

Although analytics are useful to many actors in the firm, the quote desk and the product managers responsible for pricing will benefit most. The quote desk can quickly determine appropriate pricing for situations slightly outside of normal yet still within their authority levels. And product managers can use these tools to set more appropriate pricing guidance for the quote desk to follow.

### *Science*

Pricing system vendors offer "science." They call it science to identify the process used to create hundreds or thousands of segments. "Science" in this context really means micro-segmentation. Science is especially valuable for companies with tens of thousands of customers. The pricing system vendors gather a year or two of historical transaction and/or quote data and use statistical techniques like cluster analysis to group similar customers together into segments. Each segment is then broken down into quartiles based on how much each customer actually paid. For any given micro-segment it is soon apparent which customers got away with paying too little. When future customers that fit in that segment request a quote, their price will be closer to, if not above, the median price for that segment.

This simple act of knowing which micro-segment each customer belongs to more closely identify that customer's willingness to pay. This, in turn, allows companies to win more business at the highest margins possible. Note, however, that science is not possible without reasonably clean data and an execution mechanism designed to deliver the best price to each customer.

### ***The data elements***

Pricing systems turn data into information, but that data has to be clean. The old phrase "garbage in, garbage out" is extremely appropriate here and always represents a huge risk. Therefore, companies may focus on four types of data to achieve the cleanest results possible: Master Data Management (MDM), transaction, waterfall and competitor pricing.

For pricing systems, MDM typically refers to a clean customer master – a list of customer names and locations so every customer location is represented exactly once. Such a customer master offers three important capabilities:

- aggregate duplicate customer names
- the ability to link customers between disparate systems
- the ability to provide one or more hierarchies.

This is the foundation of a pricing system. Without knowing the customers, a pricing or quoting tool cannot correctly interpret historical data. As a quick example, a salesperson could enter a quote for I.B.M. Then the quote desk gets a quote request from a distributor for business to IBM. Another distributor then asks for a quote for IBM Corp. All three may be the same piece of business, but a computer thinks they are all different customers. An MDM system links these three customer interactions under a single customer name, even if sales and the quote desk are using different systems.

Once the customer master is in order, transaction data is the next most important to capture and clean. Transaction data includes quotes, purchases, point of sales reports from channel partners and even leads. There is immense information available when an opportunity can be completely tracked from lead to quote to end customer purchase to repeat purchase. Pricing execution systems excel at managing the data from these customer interactions and making the resulting information available to product managers and quote desks.

Waterfall charts are common in pricing systems, but they require specific data that is not always captured (the cost to serve any given customer). Customers are treated differently depending on their size, their location, their industry and even the capabilities of their purchasing departments. One common example is payment terms. Different customers may negotiate different payment terms. Each different payment term has a different cost associated with it. In order for a company to truly understand its customers, know which ones are more profitable and which ones may even be unprofitable; the costs to serve each customer must be tracked. Pricing systems can provide invaluable information on customer type and profitability if this type of data is collected.

Competitor pricing data in the world of B2B is hard to come by. However, companies that truly believe in value-based pricing know that value is measured relative to their competitors' prices. Efficient and effective price maintenance means some mechanism to monitor competitor prices must be in place. Many business-to-consumer (B2C) companies use web scraping to monitor competitors' websites. Third party companies have also sprung up to collect and sell industry pricing data. Unfortunately, it is not always that simple. Some companies collect competitor pricing during the quote process, but the accuracy of the data is certainly suspect. A more reliable gauge (though not perfect) is pricing data collected from distribution channels, either directly through channel partners or by web scraping partners' websites. Yet this dataset is traditionally ignored.

Understanding, collecting and managing the appropriate data types ensures realistic ROI is achieved as well as increased profitability.

## **Where to find ROI**

There are five ways to impact profitability (ROI): higher margin, higher win rates, increased number of opportunities, reduced costs and reduced liabilities.

### ***Higher margin***

Higher margin is where every pricing system rightfully claims to help. By providing the tools and the proof to raise prices (even a little) without affecting demand, margins can increase and profits rapidly improve. Improved margin likely drives the largest portion of ROI, but understanding where else to look can add significantly to the overall ROI case.

Increased margin due to a pricing system comes from many places. In execution, simply eliminating quoting and invoicing errors improves margin. Analytics and science enables the marketers to set better prices and, possibly just as important, provide confidence to the sales force that they can win at those prices.

### ***Higher win rates***

High win rates come from winning sales opportunities that are typically lost. These are driven by price segmentation and faster quote times. Typically, lost deals could have been won with lower pricing, but the company must be careful not to lower pricing on deals they would otherwise win at higher prices. The key is knowing which opportunities should be priced lower. This is where pricing science helps. Getting this balance correct increases win rates, and that translates to increased profits (but not necessarily margins).

A second key way to increase win rates is faster response time when quoting, typically provided by the execution portion of a pricing system. Many companies focus on how long it takes to get a quote to a customer believing they want to get the business "off the street," sometimes before their competitors can even quote.

### ***Increased number of opportunities***

Pricing systems can help companies realize more opportunities through better customer relationships. When companies price quickly, consistently and fairly with their customers and channel partners, it is very likely that these customers and partners will rely on them more often. This increases the number of opportunities the company sees.

As pricing becomes more automated and the data analysis becomes easier, it will require fewer resources to accurately quote. Similarly, pricing systems often simplify the process of accurately invoicing customers the correct price, eliminating the need for manual reconciliation.

### ***Cost reductions***

Not only can the company reduce costs through reallocating resources normally used in the pricing process, pricing systems typically make the remaining employees more satisfied since they are contributing more with the proper tools. The increased profitability from these reduced costs is typically small compared to the profit growth when growing margin or revenue with a pricing system. However, some companies overvalue cost savings and undervalue revenue growth when making large investment decisions. The cost element shouldn't be ignored.

### ***Reduction of liability***

Finally, pricing systems can reduce liability. Companies enter into contracts with customers and channel partners, sometimes with clauses on pricing. These clauses are frequently yet unintentionally violated, creating potentially huge liabilities. One common example is a Most Favored Nation (MFN) clause, which guarantees that the price a specific customer pays for a specific part is less than or equal to the price any other customer pays. When the quote desk inadvertently quotes a customer price lower than the MFN price, the company is contractually obligated to lower the price to the MFN customer, giving away unnecessary margin. Without a systematic method of tracking, these clauses are challenging to comply with.

### **Proving ROI**

Companies that offer pricing systems commonly claim a return of 1–5 percent of revenue in additional profit. They base their claims on results from previous installations. Unfortunately, few executives are willing to commit millions of dollars based solely on vendor-claimed case histories.

Thus the first step of successfully proving ROI is to find specific examples where the pricing system can anecdotally and numerically demonstrate one of the five areas of return cited above. These examples typically come from interviewing the people involved in pricing, quoting and sales. Questions revolve around what is wrong with current pricing processes and how it affects the company. These interviews will bring many examples and areas for improvement to light.

The next step is to select several areas for improvement where a pricing system can both address the problems at hand and offer a very high potential return. In each of these areas a few anecdotal stories will help explain the issue, but quantitative analysis determining realistic ROI must also be performed. This often requires manual work, looking at transactions for specific behaviors.

As an example, here is one way to quantify the liability of a MFN clause. Start by collecting all contracts that have MFN clauses. List all of the products covered by that clause. Then find the price at which each MFN customer purchases. The lowest of these prices can be called the MFN price. Then search all sales and quote history for transactions and/or quotes with prices lower than the MFN price. Finally, add up the financial impact of lowering the prices to the companies with the MFN clause to meet the lowest prices for the parts. This is a solid estimate of the liability for one specific area that can be reduced through a pricing system.

A detailed and quantitative estimate of return should be done in every area where a pricing system could potentially yield a substantial return. The total return from all of these areas is the numerator in the ROI analysis. Most of these areas are annual returns, making the results even more significant.

Although this process seems daunting, it is critical to acquiring executive commitment to such a large and all-encompassing system. Yet, the pricing system vendors are able, and usually willing, to help. They have the experience to help. They all have case studies that can be used as examples or guidance. Many will analyze potential customers' transactional data, look for areas of return and provide estimates of the value of fixing the profit leaks. There is still a lot of work for the customer, collecting and cleaning data, but the expertise of the system vendors can prove valuable.

## **Conclusions**

Implementing a pricing system requires executive level buy-in and commitment, which does not come easily. Before committing, the executive must understand what a pricing system is and then believe it is the best place to invest the available resources. Pricing professionals need to be well prepared in three areas:

- 1 A clear explanation of what it is. Pricing systems can be confusing. It is imperative that the pricing professional understand and be able to explain the functional areas of execution, analytics and science. Each function solves a different set of pricing problems. Also, pricing systems are always driven by data. The pricing team must clearly articulate the issues with the data both before and after the implementation of a pricing system.
- 2 Anecdotes of problems that will be fixed. Before and after stories are effective at describing the value that can be achieved through a pricing system. Anecdotes are required for each area where a hard ROI estimate will be presented, but this is also the best opportunity to present important areas that are harder to put numbers to. For example, a critical element and advantage of a pricing system is the management of complexity in pricing and the overall

business. This is hard to capture in numbers, but an example or two could prove useful.

- 3 A hard estimate of ROI based on historical data. This is the challenging work of listing all of the problems solved, prioritizing them based on a rough estimate of a return and then gathering and analyzing a sample of the necessary data. Although the focus will mostly be on increased margin, there are several other potential ways for a pricing system to put additional profit on the bottom line: higher win rates, more opportunities, lower costs and reduced liabilities.

## **Implications for the pricing field**

Pricing is one of the most fascinating topics because it requires knowledge of almost every aspect of business. Every customer touch point either creates or destroys value; pricing captures it. Product development, done well, creates more value for pricing to capture. Well-executed marketing creates perceived value, which pricing can capture. Pricing touches all of the business, so effective pricing professionals must be conversant and trusted in every one of these areas.

Convincing corporate executives to invest in a pricing system adds even more complexity to the pricing team's role. Without knowledge of how executives think, or experience proposing huge projects, pricing professionals frequently struggle.

Our experience shows that convincing companies and their top executives to invest in pricing systems is not an easy task. Many attempts to convince them succeeded while others failed despite strong relationships and experience with pricing system vendors. Here is a summary of relevant observations:

- Most business people do not understand what a pricing system is and what it can do. Many pricing professionals are in the same boat as well.
- Many pricing professionals think “getting a pricing system” solves their problems, but they have not taken the time to figure out what those problems are or how a pricing system actually solves them.
- Pricing professionals often submit ROI numbers that are too small, thinking it's easy to justify them. A return of 5 to 10 times the investment is needed to get executive level attention.

Our contribution to the field of pricing is to demonstrate that pricing systems do solve real problems. They can have phenomenal ROI and give companies the ability to execute leading-edge pricing strategies. But pricing professionals must realize they have to sell this concept. Executives do not invest millions of dollars to solve a few problems. They invest millions of dollars on things they understand and that they believe will earn many more millions of dollars than they invest.

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## **Part III**

# **Innovation in pricing strategy**



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# 9 Ten considerations for your pricing model innovation process

*Stephan M. Liozu and Katie Richardson*

Over the past few years, business model innovation (BMI) has emerged as an inevitable innovation methodology used by leading organizations around the world. Under the impetus of a few practitioner-scholars, these companies are using business model and value proposition canvases to visualize innovation opportunities and to develop revitalized value propositions for new and existing offerings.

As thousands of leaders involved in go-to-market activities are being trained in BMI, only a few companies are considering pricing model innovation as an equally important step in the development of unique, innovative and tested business models. Literature on BMI does not focus much on new pricing or revenue models. Alex Osterwalder's business model generation canvas proposes nine blocks for mapping out a business model. One of these blocks addresses revenue modeling and discusses high-level options for innovators. This methodology offers by far the best-in-class knowledge on the topic. But it falls short in making the necessary connections between customer segmentation, value propositions, differentiation and pricing model innovation. It does not offer a pragmatic roadmap for pricing model innovation.

Most practitioners we have talked to and trained as a Business Model Innovation Coach have real difficulties in moving away from traditional and legacy pricing models. In this chapter, we propose ten considerations as you prepare your business model for pricing model innovation. These considerations are related to strategy, to organizational design and to the quality of the segmentation and value proposition design within the business model generation process. This list is incomplete, but it is a good start to thinking differently about pricing model innovation and improving your chances of capturing more value from the targeted markets. Let's get started.

## **1 Is there a fit between your business, marketing and pricing strategies?**

Business model innovation requires a great level of fit. A business model canvas is a puzzle composed of 9 blocks that must fit well. Without fit, the model crumbles and cannot be fully operationalized. Fit is also critical between business, marketing and pricing strategies. Business model innovation does not replace corporate and business strategy. It complements it. A business model is a visual picture of a new idea, concept or offering that is brought to the world within the context of a business and marketing strategy. Think about a company with a low-cost strategic

positioning introducing a new business model with potentially a high level of customer value. The specific business model might make sense, but operationalizing it in an organization used to low-cost tactics might be very difficult. The fit is also essential when practitioners turn the business model into business actions. The potentially new revenue model needs to fit into the existing marketing and pricing strategy. It needs to make sense to internal and external stakeholders. Alex Osterwalder and Stefano Mastrogiacomo recently developed an alignment map to address this dimension of fit. We strongly recommend that you read more about it.

## 2 Have you integrated your new pricing model into a robust new business model?

Pricing model innovation does not begin with pricing. It begins with the essential parts of business models: customer segmentation and value proposition. Pricing model generation is one of the last things to develop and test in a business model. First, you need to understand the customer profile, the job to be done and the differentiated value proposition versus competition. Once you understand these elements, you need to truly and realistically determine whether you can execute on this new business model by focusing on key partners, key activities and key resources. Next is to understand the value pool and the level of uniqueness of your opportunity. Finally, you can discuss and test potential revenue and pricing models. In the first consideration, we discussed fit. In this second consideration, we are emphasizing logic. Figure 9.1 shows what we are referring to.

First we recommend that you map out the overall business model and focus heavily on a value proposition for each customer segment. Next, you should dollarize the differentiation value of each value proposition versus that of your

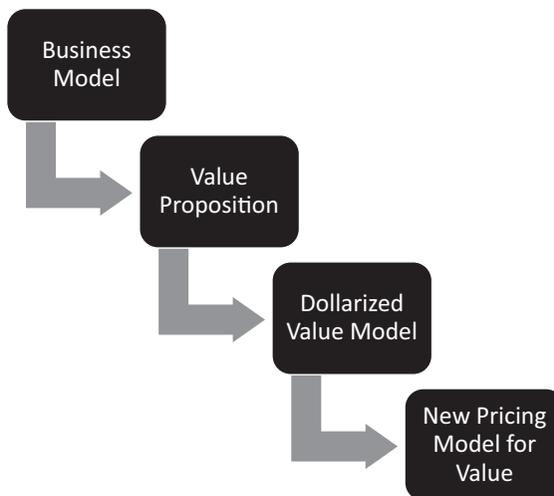


Figure 9.1 The path from business model to new pricing model

competition. Finally, you can decide whether you have an opportunity to innovate with your pricing model. We discuss this further in the fifth consideration.

### 3 Have you thoroughly considered integrating services and software?

Before thinking about value proposition in the business model, you also need to think about the scope of your innovation. Did you limit yourself too much from the get-go? Is there an opportunity to include services and software in your value proposition? Have you gone deep enough into your customer segmentation process and found clusters of customers who might be interested in integrated systems?

Business models are more and more solution-oriented, as shown in Figure 9.2. We are giving more and more business modeling workshops in the area of software and services as manufacturing companies realize that product-centric business models are not good enough to maintain differentiation. A change from a product- to a solution-based business model orientation requires a greater customer orientation (segmentation, value propositions and value-based pricing).

### 4 What customer segments are the most receptive to this new pricing model?

Your business model will be as good as your customer segmentation. We call this the “garbage in, garbage out” effect. In BMI, a one-size-fits-all approach does not work. You will have to get to know your various customer segments – your buying center – and understand why each stakeholder would buy from you. That includes segmenting based on purchasing behaviors, user needs or jobs to be done. The next question is how to test and validate your new business model and value

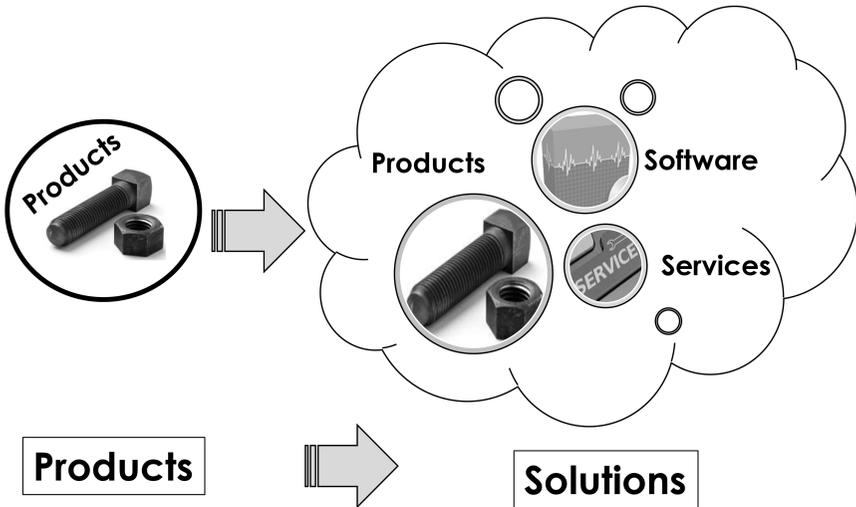


Figure 9.2 The trend is toward integration

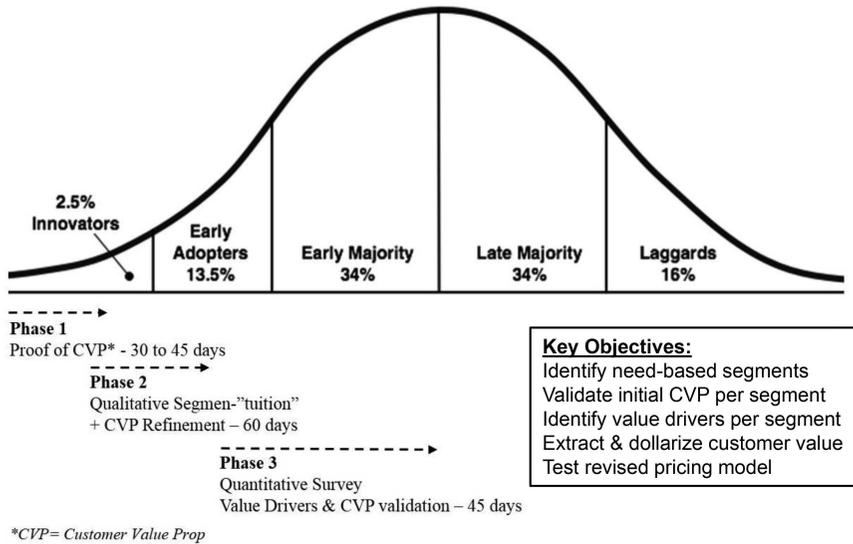


Figure 9.3 New offering and Roger’s Diffusion Model

proposition. Many companies we interact with introduce their innovative offering too fast and to everyone. We always recommend that you consider Roger’s diffusion model, as shown in Figure 9.3.

This model blends Roger’s diffusion of innovation curve with the customer value proposition (CVP) testing process. Not every customer of yours will be a target of your new CVP. So you have to go in phases and conduct robust testing. Phase 1 might be a quick qualitative testing of your CVP with your pioneer customers and not with the customers that are conveniently located next to you or simply available. In phase 2, you can validate some of the critical elements of your CVP and extend the research to your early adopters. Finally, if your customer base is large enough, you can further validate the jobs-to-be-done and differentiators with some customers in the early majority. All of this can be done as part of a 90-day innovation sprint. The key message in this fourth consideration is three-fold: (1) you need to conduct customer segmentation, and that process needs to be robust and progressive; (2) you need to test your CVP in phases; and (3) you have to pick the right customers to do the testing with. Choose customers based on value fit instead of convenience and pick carefully. A business model cannot succeed without robust testing and validation. It begins with segmentation and value proposition. There is no way around this!

## 5 Are you able to quantify your differentiation value pool?

Your ability to quantify the differentiation value of your CVP and extract the overall value pool is critical to determining whether you can introduce a new pricing model or not. In Figure 9.4, we propose two situations. If your business model and

**BM & CVP That Are:**

Disruptive  
Highly Differentiated  
Solution-oriented  
High Value Pool

*New Pricing Model to Capture Value Using a **New** Value Metric as Part of a **Unique** Profit Formula. (New Pricing Frame of Reference vs. Competitors)*

**BM & CVP That Are:**

Incremental  
Quickly Imitable  
Product-oriented  
Low Value Pool

*New Pricing Model to Capture Value Using an **Existing** Value Metric as Part of a **Traditional** Profit Formula. (Premium vs. Competitors Based on Value)*

*BM = Business model / CVP = Customer value proposition / WTP = Willingness-to-pay*

Figure 9.4 Factors influencing pricing model generation

value proposition are disruptive, differentiated, solutions-oriented and generating a high value pool, you have an opportunity to change the profit formula and introduce a new value metric and pricing model.

If your business model and value proposition are incremental, quickly imitable, product-oriented and generating a low value pool, then chances are you will need to stick to an existing value metric and traditional pricing model. You might think a binary approach is not appropriate. We agree fully, but this offers a way of thinking about how innovative and value-creating your business model is. If you do not create a lot of value for your customers, you will not be able to give them an incentive to try a new pricing model. Competitors will copy you very quickly. The reality of business today is that many industries are stuck in a traditional mindset that will prevent the introduction of new pricing models. That is something we have to deal with. Pricing model innovation is not for everyone or for every innovation. It is easier to innovate in pricing when the value you bring to your best customers is high, validated and highly demonstrable.

**6 What are the internal functions that need to be on board to adopt your new pricing model?**

Bringing a new CVP and pricing model to market is not as easy as designing it. You will face enormous resistance internally before you experience potential pushback from your customers. We see this every day. The sales force might not agree to change their way of pricing and selling. Your financial team might not be able to provide the right costing information for the components of your new value propositions. Your IT team might not be able to adjust to new value metrics and units of measure in the ERP system. Your top management might be stuck in traditional pricing and revenue models. Manufacturing and engineering might not agree to change the product design to adjust your offering to specific customer segments. And the list goes on. In essence, you will have to think *change management* early on in the business model design as part of the key activities to deploy.

Designing the business model and the pricing models might be easy conceptually. Operationalizing them is something else.

## **7 How will you train your sales force to sell with your new pricing model?**

Another consideration in the key activities of your business model is the training of your sales force on the new pricing models. If your sales force is used to selling equipment or products using a traditional transactional pricing model, it will be hard for them to sell usage- or subscription-based pricing models. The transition will not happen on its own overnight. Some sales reps will get it and run with it. But the vast majority of your sales force is not wired, trained or incentivized to make the switch. So you might have to create a commercial model based on (1) a new sales force pushing the new business model offering to market, (2) sales champions within the existing sales team who will support all efforts to sell using the new pricing models or (3) a transformational training program to equip your entire sales force with the right skills to sell using both pricing models. You can imagine the complexity of such a task. That also tells you that a disruptive innovation might need to be hosted in an incubator outside the traditional core business. This is very common in the area of big data and the Internet of things. Many of these initiatives are killed by a traditional culture within the core business. You will also discover the painful discussion on the topic of sales attribution, meaning who gets credit for sales of new things.

## **8 What are the channel implications of this new pricing model?**

To add to this complexity of selling using a new pricing model, you have to consider your trade channels if you are using them. Do you go around your channels or do you bring them on board? Do you sell service subscriptions online on your website or through an ecommerce platform? How do you convince your trade channels to adopt a new pricing model when their entire operations are organized around traditional units of measure? The business model canvas helps with this discussion by focusing one of its nine blocks on trade channels and key partners. Both are needed when considering the introduction of a new pricing model. If your core business model relies heavily on traditional distribution channels, you will face much internal resistance. Your new pricing models will also require a lot of marketing investment to help distribution and help partners jump on board your new business model. Remember that segmentation of your distributors will also be essential to make sure you work with the right channel partners. Imagine you sell commercial machinery using a traditional \$ price per machine, through regional one-step distributors. Your innovation team comes up with a new service model that includes maintenance service and monitoring software. You create a new revenue model whereby you reduce your selling price on the equipment, and you begin charging a monthly maintenance fee and an annual subscription to a cloud-based software application. So you are introducing a new pricing model that has three value metrics: price per unit, monthly service fee and subscription fee. In this scenario, who sells what, and what is the role of distribution? Do they resell your entire package or do you give them a

cut of your direct sales of maintenance and software? If they already sell services, do you compete against them or partner with them? That is the discussion you need to have when designing the business model and, specifically, the value propositions, the trade channels and the revenue model blocks.

## 9 How do we integrate new pricing models with legacy transactional models?

Naturally, the next consideration is to discuss the integration of new pricing models with existing ones. This cannot happen overnight, and you cannot let it destabilize your core business. You have to develop a roadmap for change over time using Roger’s diffusion map and making changes incrementally. In Figure 9.5, we propose two types of pricing models. One is traditional pricing based on a legacy transactional structure. The second shows new pricing models that you can read about in Alex Osterwalder’s 2010 book *Business Model Generation*. The trick is the design, development and validation of hybrid pricing models that you introduce slowly over time. It is impossible to move from a pricing-per-machine model to a machine-performance-based-pricing model overnight. There are too many organizational questions to answer and too many implications for cash flow. Imagine Hilti moving from selling construction equipment to a leasing model whereby equipment is rented and customers pay a monthly fee. The changes are incredibly difficult. The cash conversion cycle is also considerably disrupted. So you have to go slow and work with the right customers first. You have to get the internal teams on board. You have to gauge the maturity of your customer segments to move from a traditional pricing model to a hybrid pricing model to a new pricing model.

The secret sauce in the pricing model innovation process is the management of the transition over time and all the relevant changes. GE Digital is going through this transition right now and has not yet fully introduced their performance-based

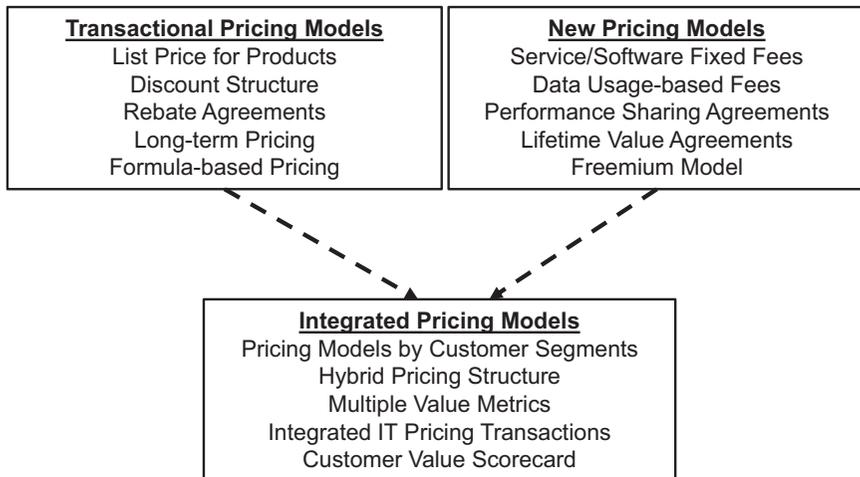


Figure 9.5 Designing a hybrid pricing model

pricing model for Predix. It takes time and a high level of customer intimacy to make the required step-by-step move. Even if you decide to launch a dedicated business unit or a separate company to introduce your business model with a new pricing model, you will face issues of customer confusion, brand overlap, cannibalization and channel conflicts. This process is not easy, and there are many strategic implications. And that brings us to the last consideration for this chapter.

## **10 Have you designed a robust testing plan for your new pricing model?**

Have you crossed all your Ts and dotted all your Is? In other words, have you conducted enough testing for your new pricing models? We never do enough testing and validation. Many companies spend millions on R&D and on software design and nothing on customer and price testing. How is this possible? You will need to spend a considerable amount of time testing for desirability with your customers and for viability for your bottom line. There are pricing research techniques you can use to test your hypotheses and change your roadmap. Make sure you include testing of pricing models early on in your business model design. You will have to prepare for it and have the right skills, methods, budgets and customer access. The reality of testing is that you might not get the result you expect and will then have to go back to the drawing board. Testing and validation has to be concrete, mindful and robust. If the data do not support your thinking and hypotheses, it is time to sit down, take a step back and have a chat with the right folks. We want to remind you of the JC Penney debacle and the change of their pricing model. We are not sure how much testing they conducted, but it almost sent the business into bankruptcy.

The objective of this chapter is to raise your awareness of the need to conduct both BMI and pricing innovation work. Both require a methodology, both need skills and business acumen and both necessitate robust testing. Designing a business model for a new or an existing offering requires a lot of work. Most companies will spend time on the majority of the 9 blocks of the Osterwalder business model canvas. But most companies will neglect the block dedicated to revenue and pricing model. With these 10 considerations, we wanted to raise the following points:

- The nine blocks require fit and logic.
- Pricing models cannot be designed and introduced in a vacuum.
- Change management in pricing model innovation is critical to managing internal and external stakeholders.
- Pricing model innovation requires intense work in customer segmentation, value proposition and customer value modeling.
- Designing a new pricing model is not complicated per se. Introducing this new model and transitioning from traditional to new models is the most complex challenge. Do not make brutal changes in your pricing model. They never go well.

We hope we've stimulated some new thinking and raised your level of curiosity about pricing model innovation. You cannot introduce a new business model or an innovation using legacy pricing models. If you do so, you will most likely leave money on the table. Be bold. Join the pricing revolution.

# 10 Effective pricing strategies in B2B markets

*Rafael Farrés*

## **Alternative pricing methods in business-to-business (B2B)**

Pricing has gained much importance in recent years. Now that companies have exploited all other possible ways to improve the bottom line, pricing is widely seen as the biggest lever for profitability.

Companies must build up not only knowledge and experience in pricing, but also an infrastructure around it. A common pricing language, effective pricing metrics and supportive IT systems are key elements in this infrastructure. What is not measured cannot be controlled. Managing pricing requires a gradual replacement of subjective interpretations by analyses of hard data. Pricing requires a dedicated approach. Many pricing initiatives start with the first available information without questioning whether it is appropriate or not for pricing. Let's analyze this in the next section.

### ***Pricing segmentation***

Market segments are often defined to suit marketing purposes. Customers can be segmented by business profile, technological requirements or other criteria. This helps to define what products are appropriate for the segment and the appropriate go-to-market strategy. But these segmentation criteria do not always coincide with the pricing requirements. Customers may be interested in the same products but be prepared to pay for them in different ways. A pricing segment can be defined around a group of customers that will be sensitive to a full-bundled price offer, while others prefer to pay for the individual components. Some will prefer on-time delivery, expecting the supplier to hold the inventory, while others will prefer to place orders in advance with a scheduled delivery. Price segmentation needs to identify these differences. This means that, irrespective of the already existing marketing segmentation, dedicated price segmentation may be needed.

Capturing the full value from a price segment is not easy. Specific customer offerings must be designed. These differentiated offers need to consider the cost of these additional services versus the price the customer is prepared to pay.

### ***Strategy around pricing***

Companies tend to be simplistic in their pricing strategies or to have no strategy at all. Often the question is limited to “Should we go for volume or price?” But the answer to this simple question cannot in itself define the strategy. The business environment today tends to be more complex and companies are confronted with rapidly changing requirements as well as multiple product offerings, which will be at different stages of their lifecycle. A pricing strategy should include all these different dimensions in order to capture all the value potential.

There is a lot of hype around the so-called Value Pricing, to the point that one may think that, as value pricing seeks to capture the maximum value from a product, this strategy should be applied in all circumstances. But is this advisable, and is it even possible to do so? Let’s analyze this in more detail.

Most companies are confronted with existing product portfolios – some not ideal, existing investments still to be amortized, ongoing R&D projects to which much effort has already been deployed and often a limited budget. In other words, a number of business constraints. This means that it will be necessary consider products that are not necessarily better than the competitors or from the existing investments because those required to bring the product offer to the desired level are not affordable or require a long implementation time. In many cases, it may be necessary to maximize sales of a product to achieve a critical volume in order to justify a defined investment. In general, companies are confronted with business restrictions related to budget availability or business-intrinsic limitations that can make the desired roadmap impossible.

In my view, it is better to take a realistic approach to pricing, considering the real situation of the different products and markets, and then to define an appropriate strategy. Taking a realistic approach will always lead to a more effective strategy.

Let’s look in some detail at the three different pricing strategies.

### ***Value-based pricing***

If a product in a given segment has the potential to provide a specific value to its customers in comparison to the other available products, then the price can be defined around this value instead of the product cost. This is what we call value pricing. In a value-pricing approach, the price of a product is based, not on a markup on its cost or on a competitor’s price, but on the value it provides.

In this situation, a good evaluation of the product’s value is critical to defining its price. Applying value pricing implies identifying advantages of the product for its customers, which may not be visible at first glance. Conjoint analysis and Total Cost of Ownership (TCO) are techniques that can help to determine the value that the product provides to its customers. Then, with this information we can set the price around this value.

But let’s not forget the obvious. It may be that the perceived value of a product is close to its cost or even lower. What to do then? Value pricing is interesting

when the perceived value of a product is greater than the market price or its cost. But when this is not the case, value pricing cannot be applied.

But even in this case, it should be considered whether there are features that can be added to a product to provide specific advantages versus the competitors or if the product can be bundled with others to offer an advantage. The costs of constructing this advantage should be considered as well.

If the analysis shows that the product offers a significant advantage above the market price, the sales price can be set around this value. This will give the company an additional margin, and the customer will remain satisfied because they will benefit from these advantages. We will elaborate further on the value-pricing implementation with a special focus on B2B companies.

If after the analysis a differential advantage cannot be built at an affordable cost, it is better to follow a different pricing strategy.

### ***Market-based pricing***

There are many situations in which market pricing cannot be ignored. Following a value-based price strategy when there are no differential values can be very ineffective. Trying to set the price around a nonexistent product value will shift focus from the important parameter in this case, which is the market price.

In market-based pricing it is important to differentiate between the perceived market price and the real market price. This perceived market price, especially in B2B, where prices are less transparent, tends to be lower than the real market price. The reason for this is the following.

In B2B, pricing is defined between two companies – where a price is agreed between the supplier and the customer against certain conditions. These may include specific delivery, service or payment conditions. In B2B, prices are not visible like they are in retail shops. The price agreement between these two companies may include a multiplicity of terms. It will often start from a list price, going down to a net, net–net and often triple-net price after all discounts and conditions are applied. Therefore, comparing competitors' prices implies a good understanding of these trading conditions, which are normally not visible.

Smart purchasing managers will try to make suppliers think that they have a very good competitor's price in order to force them to come back with more attractive prices. In addition, sales executives receive biased information on competitor price levels: They receive immediate feedback when their own prices are higher than competitor prices but far less feedback on instances where competitive price levels are higher. All these combinations imply that the perceived market price is often lower than the real market price. If B2B companies could sell at the real rather than the perceived market price, they could enjoy a price differential.

Thus, a market-price intelligence process to identify this real market price is a key element in a market-based pricing strategy. But measuring market price is not easy and requires, among other things, a systematic analysis of contracts gained and lost. The conditions in which companies gain or lose contracts and in which competitors' conditions are confronted can provide a good overview of the true

market price. Many companies forget this and leave a lot of value on the table by following the perceived market price.

But market-based pricing also has its limitations. When a market price is not high enough to cover the costs, companies must find another limit to define how far to go without destroying value. This brings us to the next pricing strategy.

### ***Cost-plus pricing***

This is also not a simple topic. Pricing based on cost may look simple, but it is not. If there is no other option than to pursue a cost-plus model, it is important to do it effectively.

Pricing based on cost instead of on value or market price may be required in certain circumstances, such as when there is a lot of excess capacity in the market and competitors have difficulty removing this capacity or transforming it to produce other products. Competitors may fight to be the last one standing in a given technology, trying to force others to close available capacity earlier. In these situations companies may be competing with prices that are close to cost or even below it.

To manage cost-plus pricing requires strong price controlling to ensure that price agreements strictly follow the price policy defined and that all costs are effectively monitored so that any deviations from the strict agreement can be charged for separately.

But the main difficulty with the cost-plus model is measuring the cost itself. The cost of a product is not a fixed number and is influenced by many factors, ranging from achievable volume to sales conditions.

The volume achieved has an important effect on a product's costs. The amount of fixed costs that can be absorbed in manufacturing depends on the volume produced. If a production line works at full capacity, fixed costs per unit produced will be much lower than when the line works at 70 percent. This means that a straight cost line cannot be defined. The cost-plus model requires a sound cost analysis that takes into consideration all these elements. A good overview of the full costs per different volumes and the incremental costs can truly define the price limits.

This notion of incremental costs is important. By incremental costs, we mean the sum of all variable costs, excluding fixed costs. This corresponds to the costs of incremental production. To understand this better, consider a given product line with an capacity utilization of 70 percent, and calculate the cost to produce an extra 10 percent to reach 80 percent utilization. We take this because we know that exceeding 100 percent capacity will require new investments, adding a new element to the costs that we will not discuss at this point.

In the case we were describing, fixed costs and amortization are already covered by the current production level and only extra variable costs, such as raw materials, incremental energy and direct labor will be needed. Whatever can be gained on top of this cost will contribute to covering part of the fixed costs. If

prices are set below this level, value is effectively being destroyed because the price does not cover the incremental cost of this extra production. These incremental costs define a true price floor. It is important to know this floor thoroughly before applying a cost-plus strategy.

It is also important to consider that cost-plus models require a strict de-bundling. If prices are defined at the cost limits, the additional services that are provided need to be charged for as well. Shipping conditions, payment conditions and built-in services need to be either added to the incremental cost as cost to serve and included in the selling price or given to the customer as an option and charged for separately if the customer demands them. In cost-plus pricing, these extra services do not create a perceived value that allows for the setting of a higher price. Pricing is defined at the limits of profitability, and these variables should be known and controlled in full detail.

### ***Conclusion***

In practice, companies must set prices in a variety of products and markets. The solution is not to apply value pricing everywhere, but to have a well-formulated pricing strategy that considers the situation of each product and to apply the chosen strategy effectively. This means that there will be areas (product–market combinations) where value pricing can be applied, and others in which the strategy will be market price or cost-plus based.

Whether pricing is based on value, market price or cost, it is much more effective to apply it effectively than to pursue the wrong strategy. It will be highly ineffective to apply cost plus in a situation where value pricing applies because much value will be left on the table. But it is also inefficient to look for value pricing in a situation where a value difference cannot be identified.

### ***The real nature of B2B business***

This chapter deals with the pricing strategies in B2B companies, so let's analyze the nature of B2B first

B2B companies can be seen as part of a value chain. A B2B product is not a finished product in itself, but an intermediate product or service to create the final one that will reach the consumer. For example, a company producing and selling perfume will buy from many B2B companies the different components needed, such as chemicals, bottles, packaging, advertising material, marketing services, legal services and so on. The company supplying the bottles will also buy products and raw materials from others. This means that in B2B, a product or service provided to another company is an element in a value chain. As part of this value chain, a product or service will be part of the product cost of this company, either as an operating cost or capital expense. This is, in my view, the essential difference between B2B and Business-to-Consumer (B2C) companies.

When a consumer buys a product, the motives influencing this decision are mainly of personnel need or preference, and it is the individual consumer that views the price–value relationship. The appearance of the product or the reputation of the brand, amongst others, plays an important role in the value perception. We can see this in many areas. In the food industry, for example, products should not only taste good but also look tasty. Consumers' buying motives may be very different, but, with some exceptions, will not be driven by long seller–buyer negotiations, Return on Investment (ROI) calculations and the like. In B2C, perceived value is key, and conjoint analysis can be a good tool to analyze it.

In the case of B2B companies, different people in the buyer organization will challenge the proposed price. These people, normally from different departments, will have differing views on the product. Not only will the purchasing department have to be convinced by the seller, but the departments using it will also be involved in this decision. This introduces a different element into B2B: the multilevel price negotiation.

### ***How B2B companies perceive value***

In B2B, the customer cannot measure perceived value in the same way it is measured in B2C. As indicated above, in B2B the value is perceived not by an individual but by a team of people in the company. This means that the perceived value will be a combination of the values perceived by this group of people. In addition, B2B companies will try to translate this perceived value into monetary terms. Since the product represents a cost to the company, customers will try to evaluate it in terms of savings potential, the extra margin generated or its ROI. In B2B, this needs to be considered when defining product values. The ROI and/or the TCO that the product provides to the buyer's P&L is an important and tangible measure of the product's value that cannot be ignored. The risk is that if the supplier does not consider these calculations, the customer will perform them in its own way.

This does not mean that subjective value perception does not count in B2B. Brand value, as an example, is important. Brand value and previous experience with the company will result in a lower risk and higher security perception. How much value can be attributed to this is difficult to calculate and must be considered, but the former objective elements such as ROI or TCO cannot be ignored.

On the other hand, measuring the impact of a product in the full value chain can unveil unexpected value. If the analysis shows that a product adds value to the customer's value chain, a price differential can be established around it.

The ROI and TCO that a product provides can also be different from one customer to another. This introduces another element: market segmentation. How value chains vary within different customer segments is an element that a company needs to take into account in order to set prices effectively.

### **Box 10.1 Identifying value in B2B: case study**

Let's take the example of a company that launched a new product that does not require chemicals for its processing when the standard and competitors' products require process chemicals for its use. At first glance, the perceived advantage is the reduction in chemical costs for the company using the product. In principle the product could be sold easily at a premium price by increasing the price just below the costs of these chemicals.

Extensive testing and customer focus-group meetings revealed that this was not the only advantage. By not using chemicals in the process, customers saved additional money associated with the recycling and disposal costs of the chemicals. These costs involved the amortization of the recycling units, the labor involved and fees to external companies to take care of the disposal of the residual chemicals. But this was not the only advantage. By not using chemicals, the production process was more stable because one of the production variables was eliminated. Customers could reduce start-up times as well as the cost of the materials used in the start-up process. Service maintenance costs could also be reduced.

The result was that the value that the new process provided was much greater than just the cost avoidance of the chemicals. A strict analysis of these elements made it possible to quantify each one. They included chemicals consumption, recycling cost, recycling units amortization, disposal fees, reduced start-up costs, reduced maintenance and increased productivity.

Each of these elements had an impact on company performance, whether product costs, capital expenditures or increased output. This gave this company a very good basis for defining a premium price and a solid sales argument to support the sales actions to increase the market penetration with this product.

This example also illustrates excellently the pricing segmentation mentioned above. Not all customers used the same process, meaning that the value of the different elements varied from one customer to the next. These different processes were linked to a special application. Therefore, the customers could be segmented based on this concept, which made it possible to differentiate pricing between these segments. In addition, recycling costs are linked to environmental regulations, which vary also from country to country.

Segmentation provides a good basis for defining a price premium, introducing a level of differentiation per segment or country and being able to exploit all the value potential.

## **Pricing analysis, metrics and key performance indicators (KPIs)**

The pricing building requires solid foundations. This is the only way any the pricing strategies can work and deliver results. Let's look at the different elements of this in more detail.

### ***The pricing language***

This may look weird, but one of the first elements in this foundation is the language used. Companies involving multiple departments and countries will find different price terms in use. These different terms may have the same meanings; conversely, different meanings may be associated with the same term. This may result from local terms wrongly translated from other languages or from misinterpretation of terms used by different departments. It is important to identify these pricing terms and redefine them in order to create a harmonized language in the company. The new pricing language needs to be defined, the terms well described and communicated internally to avoid confusion. The price language should include the pricing terms used and clear definitions of all of them. This pricing language harmonization will be fundamental to internal communication and to define the new pricing metrics required.

### ***Pricing metrics***

Price must be measured. To do so, several KPIs must be defined as part of the pricing language. The pricing metrics are another key element in the pricing foundation. Once the language is in place, one must formulate how to measure pricing. In reality there are many ways to measure pricing and each will have its own interpretation, so it is also important to define internal price-metrics conventions and pricing KPIs.

Many companies do not measure price effectively because they take the first available pricing data rather than the data that is effectively used in the customer negotiations. Most IT systems have been designed around stock keeping units (SKUs) to support logistics and accounting purposes. So it is very easy for most IT systems to provide a price per SKU. This provides easy and immediate price information that companies can use from day 1. But they must also consider whether this is the right information to measure price –whether this pricing corresponds to what is used in price negotiations and whether this is the way that customers understand pricing.

As indicated above, SKUs are normally defined based on logistics criteria, as they must serve this purpose. But this may not necessarily coincide with pricing requirements. Customers may or may not recognize a price per SKU, but may instead use other metrics like liters, kilograms, m<sup>2</sup> or some other unit of measure they use to compare it with the competition. If this is the case, the systems must be redesigned to reflect this market metric. In other cases, customers are offered

bundles of SKUs. Again, if this is the case, the IT systems should capture this element and measure the price of these bundles rather than individual SKUs. The conclusion is that price needs to be measured as it is going to be used in the market rather than as it is used in internal processes.

But this is not the only complexity to address. Price is the result of product turnover divided by volume. So far, this is a simple definition, but the issue in measuring price is how these two denominators are defined.

*Turnover* is the result of the net value we invoice, taking into consideration all discounts, rebate provisions and the like. In addition to the price conditions agreed upon with the customer, *ad hoc* discounts or further given conditions that may reduce the agreed-upon price must be analyzed. Here we are confronted with different turnover values: the turnover from the invoice, the turnover that we see after all other non-invoice conditions are applied and the final turnover we obtain. What is the turnover that we want to analyze in order to calculate the price? In our view it is interesting to analyze all of them and to be able to differentiate the turnover resulting from the agreed-upon terms versus the final turnover after all effects are eliminated. These two values are important because the difference indicates how much our final price deviates from the one that was agreed upon.

The *turnover per product* corresponds to the previous definition applied to a given product, but the issue now is how a product is defined, either as SKU, product group or product category. If a group of SKUs are priced based on the same criterion, such as a unit of measurement, then this is the price we need rather than the price per SKU. In the same way, SKUs may be grouped to form a package or a bundle, and in this case the price we are interested in is the price of this selling unit. The conclusion is that we cannot always take the first price we get but must take the price around the sales units that are recognized by the customers.

*Volume* is another of the key denominators in the price calculation. Similar to what we have defined above, we need to consider the unit we use to measure volume, whether it is number of units, kilograms or any other unit of measurement. Whatever measurement we take, it should be aligned with the language used in sales because the objective is to obtain price information that can be understood by those in the organization who can act on it.

Once all these variables are defined, we will obtain a pricing that the organization can recognize. With this we can establish the pricing KPIs and analyze price variations.

### ***The price waterfall***

The price waterfall is a graphic representation of the different elements that impact the price, from the list to the final net price.

If we combine the different price points obtained by dividing the different turnovers by the volume, we can obtain a price waterfall that clearly illustrates our pricing structure (see Figure 10.1). A price waterfall shows how pricing goes from the initial list price to the final net price after all discounts and special terms given to customers are applied.

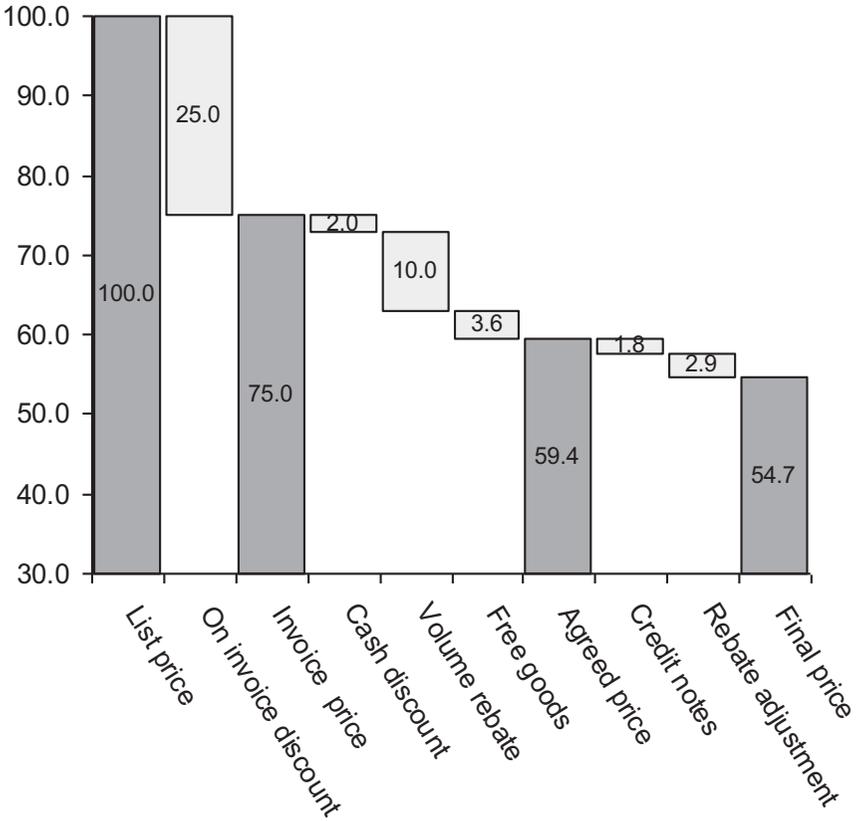


Figure 10.1 The price waterfall

Visualizing the different discounts that contribute to the final price can help us understand when these are given in excess and define policies that can reduce them to improve pricing.

The price waterfall is also a good way to illustrate the price language. Pricing tends to use a terminology based on common knowledge, but everyone often does not understand these in the same way, as we have already shown. The pricing department needs to obtain consensus and define a price terminology with clear definitions of the terms used.

***Different price levels***

Everybody understands the concept of *list price*, but the term *net price* can be unclear. One could argue that some discounts linked to a performance, like cash payment or others, triggers a lower cost and therefore should not be included in

the net price. But often this discount exceeds in value the financial gain, and, therefore, unless the performance discount fully coincides with the cost reduction gain, it should be included. In our view, the net price should be calculated after all discounts, regardless of the reason of these discounts. This makes things easy and more transparent. The cost decreases related to price agreements can be measured and compared with the price as well. But whatever position one takes, this needs to be defined and agreed on upfront. There are many other debatable elements in the net price, such as special credit notes, complaint-related concessions and so on. All of these render the meaning of *net price* unclear, and this is precisely the term that must be well defined. For this reason, we introduce the concept of 3 net-price levels.

### ***Net1 price or invoice price***

This is the price after all invoice discounts have been applied, and it is the price that is visible on the invoice.

### ***Net2 price or agreed-upon price***

This is the price after applying all agreed-upon customer terms, which may include non-invoice concessions, such as volume rebates or free goods, to be delivered at the end of a given period or any other agreed-upon condition, such as advertising, training support or similar. The key is that this price reflects all agreed-upon conditions of any nature.

### ***Net3 price or the final net price***

This is the price after applying all agreed-upon conditions plus any *ad hoc* concessions that may be given, such as credit notes or those similar to the ones mentioned above but that were not part of the initial price agreement. This is the final price from which the net turnover is built.

These definitions help to introduce different measurements, such as the deviation between the net price and the agreed-upon price. In other words, price setting versus price getting. The formula  $(\text{Net2} - \text{Net3}) \times \text{Vol}$  gives the value differential between the final price and the price agreed upon with a customer. This is a good calculation for determining whether the pricing problem arises from poor price agreements or from a lack of enforcement of negotiated prices. We will elaborate further on this in the next section.

### ***Pricing targets and KPIs***

As in any other areas of the business, pricing requires targets. Therefore, it is important to introduce, as part of the pricing language, terms like *target price* and *price floor*. These are both important terms. The use of the term Target Market Price (TMP) can be very effective. This term refers to the price estimate made

by marketing and should reflect the marketing view of the price that is achievable in the market. This price can be different by region or country, depending on the market conditions. A TMP is, by definition, a dynamic price in the same way that market conditions change. It is important that marketing departments define a methodology for calculating and updating TMPs using measurements that are as objective as possible. We indicated before the need to determine the pricing strategy: If value-pricing strategy has been chosen for a product, then the TMP should be defined based on conjoint analysis, ROI or TCO calculations. If market price is the defined strategy, then TMP should be defined from an estimate of the competitors' price following a price intelligence analysis of it. The deviation of our final pricing from TMP can be analyzed and discussed to define the corrective measures.

Price floors are also important. Price floors are typically a level below the TMP. A price floor is defined as the level at which top management wants to be informed so that they formally approve the prices. This helps the VP of sales, in particular, to focus on the large negotiations with critical pricing issues. Like TMPs, pricing floors need to be dynamic as the market conditions change so as not to overload management with requests for price exceptions. In this way, management can use this to set an example of how to analyze and decide on critical price negotiations and to establish a model for price decisions through the whole organization. Price floors can also be defined at different management levels if needed.

## **Integrating price into the organization**

Once price foundations are in place, the different departments in a company can be involved in pricing actions. This is very important because price improvement is not the result of the actions of a single department but of a collective action. Sales are at the front end of pricing, but they require support and guidance to achieve optimal prices.

Many companies have started pricing actions by appointing a pricing manager and creating a price department, and the first question that comes to a manager's mind is the following: Where should we put the pricing department? Or, in other words, to whom should the pricing manager report?

### ***The role of the pricing manager***

Pricing is a discipline that involves multiple departments, not only sales. And a pricing manager should have the capacity to involve all the different departments, often breaking company silos, and make them work together on pricing issues. The personality of the manager and the level of support he or she receives will be a key success factor. Strong hierarchical companies typically will have more difficulties working this way unless the pricing manager has a high hierarchical status. Companies that are more used to working on projects, and that have lower

hierarchical barriers, will have less issues implementing pricing actions across departments, even if the pricing manager is not at the VP level. Starting a pricing action as a project, with a project team guided by the different VPs involved, can help break down these barriers because the pricing person will have sufficient authority and support to be accepted at all the levels required.

In the end, when all pricing measures have been taken and the entire infrastructure is in place, marketing is the ideal department for pricing because it is already at an intermediate point between sales and the other departments of the company.

The link to new product development is also important. Pricing has to do with the way a product is designed for the customer, and this involves all areas of the organization. Reaching pricing excellence requires combining the way the product is designed, its features, its service and how it is presented, delivered and even invoiced for. Understanding the complexity of all the different business processes and being able to create new products or new ways of presenting them will be key to the pricing manager's success. This is not easy and will require not only support, but also a good learning process. The pricing manager should be able to understand the additional cost of these requirements and balance them with the estimated price advantage. It is important to have a good evaluation of the expected pricing gains. This will help in the discussions with the departments involved, as they will have to consider the additional costs of changing a product or process.

### ***Price decision support: selecting appropriate pricing tools***

The selection of appropriate tools is also important. To do so we need to consider what information is needed to make effective pricing decisions. Let us look at the information requirements to support our pricing decisions.

### ***Defining pricing at launch: price–value graphs***

When a product is launched, it should be positioned on a price–value graph that illustrates its intrinsic values and a clear comparison with its competitors' equivalents (Figure 10.2).

Price–value graphs position the prices of a product against its competitors' equivalents. The above example depicts three competitors as ovals with three different product types. The lowest group of ovals covers the low-cost area; the middle group, the middle-cost area; and the highest, the high-performance segments. Price is indicated along the y-axis, and the x-axis represents the value of the product. As product may have a different value for different segments of customers, it is advisable to select the most important value or a combination of them. If a product is above the solid black line, its price is too high compared with its competitors' equivalents. Additional values not considered in the graph can be subject to discussion. If the products fall below the line, the immediate conclusion is that their price is too low and may need to be reviewed.

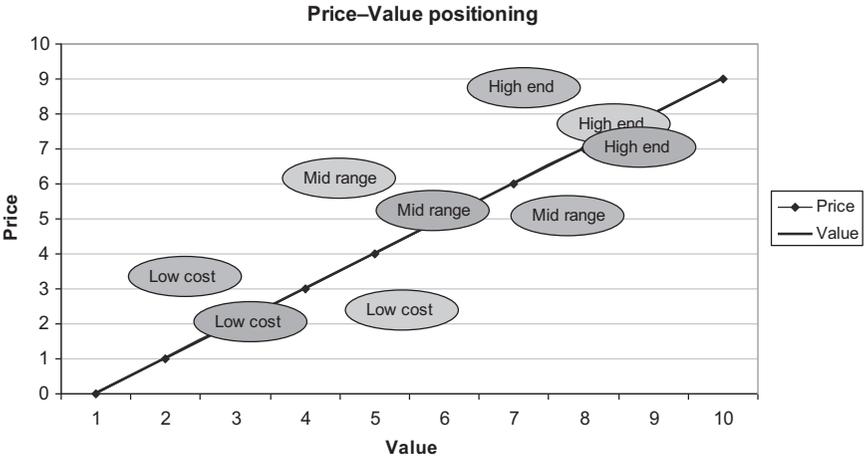


Figure 10.2 The price-value map

**Deciding on price-volume trade: turnover build-up**

The first KPI to get a quick overview of pricing is the turnover build-up (Figure 10.3). Using the price value as the price change between two periods multiplied by the volume involved can provide an overview of how turnover has

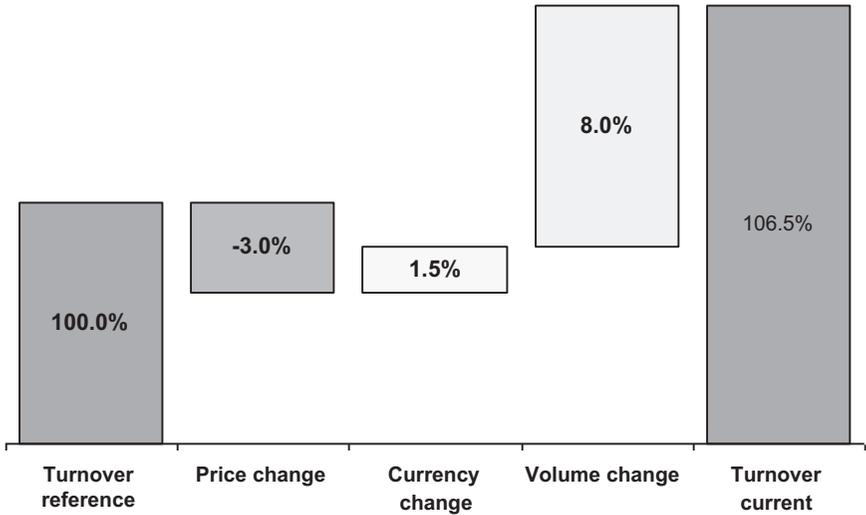


Figure 10.3 Turnover build-up

changed from a given reference, such as the previous year or a defined target, to the actual results.

In the above example, a turnover increase of 6.5 percent is the result of a price decrease of 3 percent in price, a 1.5 percent currency gain and an 8 percent gain in volume. Depending on the average margin, one can easily determine whether the volume increase has been high enough to compensate for the decrease in price. In the example, if the average gross margin is below 37.5 percent, the price decrease is not compensated for by the margin generated by the new sales.

The percentages indicated in the graph can also be shown in terms of absolute value. This KPI is very intuitive, and it provides a quick overview of price-change impact.

### ***Pricing clouds***

A price cloud is a graphic representation of the prices per customer and the volumes they bought for a given product. In Figure 10.4 below, every dot represents a customer's product's price position and the volume purchased during the period. The cost of the product and the floor price can be added for information. This provides an immediate overview of the customers that deviate from the pricing policy so that we can focus on the prices to be reviewed first.

### ***Correct leaks in the pocket price: price waterfall***

The price waterfall is a good way to understand the details of the price agreements and the price realized. The price waterfall starts with the list price and it should reflect all discount elements from Net 1 (Invoice price), to Net 2 (Agreed price) and Net 3 (Achieved price). A good pricing tool should be able to show the price waterfall for any product and customer.

The analysis of price waterfalls makes it clear whether pricing problems are the result of poor agreements or poor price realization. If the low price is driven by offline concessions, these may need to be reviewed and programs established to enforce the agreement. If the agreement already delivers a low price, it will be necessary to review the price negotiation process. The waterfall is a good way to identify these issues and correct them.

### ***Document the price agreements: the terms and conditions (T&C) tool***

Documenting price agreements in a structured way is very important. A T&C tool should provide a way of documenting the complete price agreement for a given customer (Figure 10.5). It should include all possible discounts and rebates for each product, like in the price waterfall, until Net 2. Pricing thresholds should be included in the tool to show whether the price proposal is above or below the target price and floor. Different color scales can be used to indicate (a) that the price

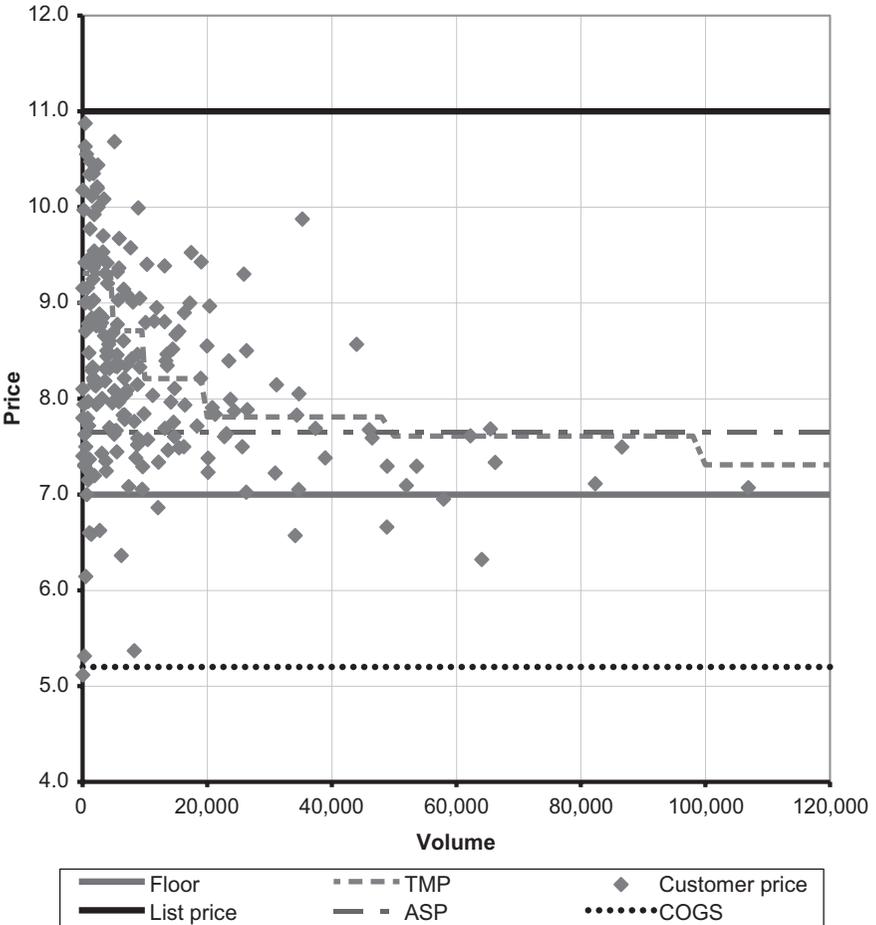


Figure 10.4 Price floors, list prices and target prices

is above the target price, (b) that the price is below the target price but above the floor price and (c) that the price is below the floor price. This facilitates following up on the price-approval process.

Adding the volume estimates to the T&C tool permits pricing managers to quantify the price change versus the target prices or the previously agreed-upon prices using the price-value formulas indicated above. This provides very valuable information for making pricing decisions. A section for comments allows further explanation for any elements not covered by the numbers.

Keeping track of these T&Cs also makes it easy to review issues related to price deviations. It also permits good documentation to analyze lost deals when the customer does not accept the proposed prices.

**CUSTOMER TERMS & CONDITIONS OVERVIEW** **Business Group Graphic Systems**  
Price Data 03/09/2005 (Benelux Digital Plate, Europe Analog Plate and Film)

New/Existing Customer:

Customer name:

Sold to no:

Country:

Sales rep:

Proposal date:

Valid date from:

Valid date to:

Reasons for proposal:

Change	Product Level	Product Code	Product Description	Expected Volume (per line)	Base Price	Customer Discounts			Invoice Price	Cash discount	Customer Rebates			Net Price	Old Price	Target Market Price
						Discount 1	Discount 2				Rebate	Bundle	Chemistry Free			
	New	YSS					%	%		%	%	%				
	New	YSS	RFAD P970 30	10,000	15,00	30,0	%	%	10,50	2,00	10,00	%	9,28		8,60	
	New	YSS	RFAD P970 30	10,000					10,00	2,00	20,00	%	7,84		8,60	
	New	YSS	RFAD P970 30	10,000	11,00	30,0	%	%	7,70	2,00	20,00	%	6,04		8,60	

**ANNUAL REVENUE FORECAST CONSUMABLES FILM AND PLATES**

	Film	Analog Positive	Analog Negative
Annual Forecast:	0	0	0
Last Year:	Thermal	Silver	Polymer
Annual Forecast:	30,000	0	0
Last Year:			

**COMMENTS**

Rebate Agreement:  Check the rebate agreement template for complete condition!!

Other Comments:

**COMMISSIONS TO THIRD PARTIES**

Commission %:  Payable to:  On:  For products (condition lines):

**APPROVAL PROCESS**

Account Manager	Sales Manager	GS Manager	Global Sales
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Figure 10.5 The terms and conditions (T&C) tool

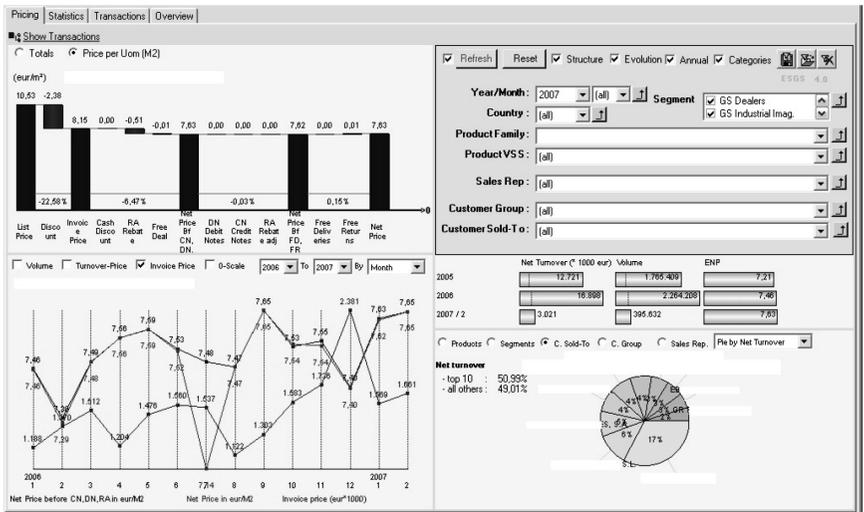


Figure 10.6 The pricing explorer

**Pricing explorer**

All these tools can be combined in a master tool to analyze customer profitability from the price agreement to the price finally realized, volumes purchased, price and volume evolutions per period and the price waterfall (Figure 10.6).

Pricing clouds can also be included for every sales region so that the price distribution per region can be analyzed in detail.

The main objective of these tools is to provide the information necessary to make effective pricing decisions. As there will be a lot of information to analyze, it is important to select or develop a tool that helps visualize critical data to facilitate the decision-making process.

There are many other KPIs and variables that could not be considered in this chapter. However, we have described the most important ones that should provide a good basis for a professional analysis. Price improvement is a long journey, and companies need to build up experience and know-how around it. This can only be accomplished by building up knowledge and experience inside the company by implementing these new methodologies. Companies are very different and face many different situations in the market. In the same way, pricing actions will have to be company-specific.

## **Implications for innovation in pricing**

In the first section, we have analyzed three different pricing strategies: cost-plus, market-based and value-based. It would be wrong to link innovation to value-based pricing only – there is much innovation potential in cost-plus and market-based pricing as well. In a cost-plus model, for example, by analyzing in detail the product cost structure and its dependencies, suppliers can see which of these costs are influenced by customer behavior. The same applies to market based pricing to build up a good understanding of competitors price behavior and its limits. This can help companies define specific price models in order to obtain a reasonable price level while reducing unnecessary costs. It is by looking at supplier–customer processes integrally that one can identify inefficiencies and propose creative pricing solutions.

A company tends to look at its own universe, understanding it in terms of itself and its customers, but this is not enough. A B2B company is part of a complex value chain in which several companies cooperate to produce a product, and this integral value chain should be well understood.

The value chain involves our suppliers, our customers and the customers of our customer. It is the understanding of this value chain that can help identify which new products can be more attractive and which pricing methods can maximize value. This is well illustrated in the VAT concept, according to which companies are taxed, not for the product they produce but for the value they add to the raw materials or intermediate products they buy. In the same way, we need to look not at the product we make, but at the value we add to produce the final one.

In B2B, more interesting than customer satisfaction interviews are focus group discussions in which the different participants of a given value chain can be involved. Let's not forget the importance of teams in B2B negotiations. This can be a very effective way to identify opportunities for profit improvement via pricing. Some companies have done it very successfully, taking the initiative to involve representatives of the industries they serve, as suppliers of other

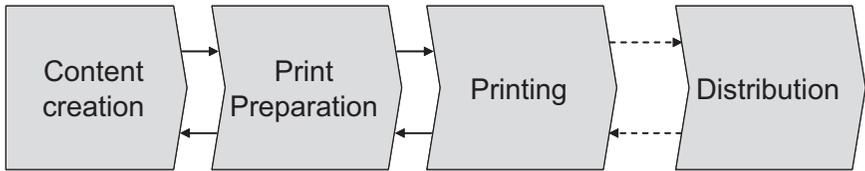


Figure 10.7 Sample value chain

products, their customers and representatives of the industries these customers serve. This provides an integral view of the industry and the opportunities to optimize the processes in an integral way and helps to find the right balance between the product they are providing and the conditions in which it will be used in the full value chain.

Let's illustrate this with a practical example: The production of a printed material, whether a book, magazine or newspaper. As illustrated in Figure 10.7, the main steps in the value chain are the creation of the content, the print preparation in which the content will be put into the appropriate format, the printing itself and the distribution. This process can take place within a single company that executes it from beginning to end or in multiple companies, each one performing a step in the process.

If this is done in successive steps, this process will be slow and inflexible with a lot of intermediate inventories that become easily obsolete. But if the different companies around a given publication can share data in an effective way, this process will be much more efficient. Making content work available to all parties involved helps print preparation and can be initiated before all content is readily available. Printers can also source all the necessary elements to begin the printing as soon as the preparation is finished. In the same way, distribution can be initiated much earlier. The result is a true print-on-demand model that is much faster and that requires much lower intermediate inventories.

With this connectivity, missing elements can be identified very easily and corrected in less time to avoid publication delays and extra costs. When the different steps are done in isolation, the process can only begin when the other company has finished it. In addition, the price of a product or service must contain provisions for process inefficiencies. In an integrated process, these inefficiencies can be easily identified and corrected, and a price can be set for the process itself without any or lower extra provisions for inefficiency risks.

In B2B, a good understanding of complete value chains in which various companies are participating is key to pricing innovation. These complex value chains often involve many different companies, which at the same time may participate in different value chains in other industry segments. The way to analyze is to try to see how the process would work if the full value chain were to work within a single company. This defines a new way to operate that can be easily translated to the different companies that are now in the chain defining creative pricing models.

# 11 Why segmentation matters

*Linda Trevenen*

## Introduction

Segmentation matters, especially when firms face the challenge of intense competition and eroding profitability brought on by declining prices. Consider the case of Dow Corning (Gary, 2004). As a perennial leader in the silicone market, they admittedly had become complacent in the face of aggressive competitors who were offering lower prices. They also faced increasing costs for innovation and service. To cope with these challenges, they employed market segmentation to better understand the structure of their market. In their segmentation of the market, they learned that not all customers had the same set of needs. Some required more service than others, some valued innovation more than others and others were trying to improve the profitability of their own businesses. They also learned that one segment no longer needed the added value of service, innovation or a broad product assortment of the silicone products they purchased; instead they just wanted the best price.

Dow had been treating all these customers the same, yet each of 4 identified segments required a different bundle of benefits. It became painfully evident to their managers that they were providing expensive services to some customers who did not even need them. Therein lies the most critical reason why segmentation matters in business – *profits can be lost by treating all customers the same in terms of their pricing*. This is not just a practical matter, but one grounded in traditional economic theory.

As Thomas (2012) notes, the theory that supports segmentation is based primarily on the economics literature of price discrimination developed during the 1920s and 1930s (Chamberlin, 1965; Pigou, 1920; Robinson, 1954) and is widely accepted in the marketing literature (Smith, 1956; Frank et al., 1972). The theory suggests that customer heterogeneity supports the existence of demand-based segments from which firms can generate greater profit by shaping different offerings and prices for segments than by providing the same offering and price to the whole market. This is exactly what Dow Corning did to overcome their predicament.

The segmentation approach by Dow Corning actually redefined their entire business strategy. Instead of offering their products and services at the same prices to all customers, they created different offerings for the needs of the different

segments. They allowed each customer to choose the types of products and services they needed and these were priced accordingly. However, the segment of customers who wanted only low prices with little or no service posed a special problem. Dow Corning could not just offer them low prices because other customers would want those low prices as well. To create a barrier between this segment and the others, Dow Corning chose to launch a new brand called Xiameter. Through this brand they offered a limited number of their most popular products at competitive prices with no services. They used an Internet-based business model to maintain a low-cost approach to manage the business while meeting this segment's needs. Their entire needs-based segmentation approach was so successful that it was reported to have paid for itself in three months (Gary, 2004).

What we learn from this example is that segmentation is a promising management process that can lead to opportunities for improved profitability. However, these opportunities are not the same for all firms. Segmentation is highly situational and each firm must take the challenge to use it to achieve a business strategy, or alternatively, as in the case of Dow Corning, to completely revise its strategy.

This chapter will introduce some of the challenges pricing professionals face related to conducting customer needs-based segmentation and how to overcome them. In addition, pricing professionals will learn best practices for implementing segmentation so that their price plan takes advantage of the value in their offering and maximizes the profit relative to their customer segments. Three important objectives addressed in this chapter help to understand why segmentation should matter a lot for pricing professionals:

- 1 To recognize the importance of segmentation and how to offer value through optimized solution offerings for customer segments.
- 2 To learn the strategic and practical activities and implications for needs-based segmentation.
- 3 To understand how to implement segmentation best practices into the organization so that a segmentation strategy realizes greater profitability.

## **Segmentation, value and pricing**

Many companies view segmentation as expensive and requiring more effort than the expected return. This raises one of the more important first steps in segmentation: Is it right for your firm in your business situation?

### **Lesson 1: Know exactly why you want to use segmentation and what its expected benefits might be for you.**

At the outset, write down the outcome you expect from using a segmentation approach to improve your pricing decisions. In general, I recommend using segmentation when you must make one or more market-based decisions that are important to your firm's performance and when you face a high degree of

uncertainty around the outcome of these decisions. For example, you may have some high costs-to-serve programs that you offer to your customer base as part of your offering. If your sales representatives are providing these high cost services to *all* customers without regard for return on sales, then you are losing money. To that end, segmentation could benefit by determining which customers value the programs and are willing to pay for your services and which ones believe these programs are less useful. Or, you may decide that your sales force is spread too thin given the base of customers who require field support and you are looking for a way to improve their efficiency and productivity per visit. If the customer base is not well understood, then your sales representatives are inefficient and calling on customers who may not deliver revenue given the resources spent on visiting them. For less important decisions in which you are fairly certain about the outcome, you may gain little from segmentation.

Among the more important decisions facing firms is pricing. Pricing is the gateway to customer purchases as well as the firm's profitability. Pricing professionals instinctively know many of their decisions are important but often do not have the necessary marketing competency in segmentation to effectively complete their pricing plan. Also, some pricing decisions will vary in the amount of uncertainty faced in the marketplace. Without a proper understanding of the segmented structure of the market, a pricing decision that is important and facing uncertainty may miss its mark. Understanding what makes your customers different from one another based on what they value is the required ingredient for a successful needs-based segmentation that leads to more profitable pricing. Only then, can pricing professionals establish the appropriate fences that their customers find meaningful and distinct. Surprisingly, very few companies have successfully implemented segmentation on a regular basis as part of their pricing plans, let alone their entire marketing plans (Thomas, 2012). This is why I advocate a rather systematic approach to this process.

The second important step in performing segmentation for pricing is recognizing the variables you will use to divide your market into meaningful groups that are similar within each group and different between each group.

## **Lesson 2: When it comes to pricing, segments based on value will be most productive.**

Value is the relationship between what customers perceive as benefits in an offering and the price they pay for those benefits. Customer benefits are driven by their needs and hence are helpful in implementing needs-based segmentations. By identifying customer needs and formulating benefits to meet them, a basis for weighting them against willingness to pay for those benefits can be established through marketing research. Pricing professionals will recognize market research as a key element in their pricing plan – understanding the customer's willingness to pay for different offerings.

There are several types of market research that can be applied to understanding how your customers value the elements in your offering. Before doing any

research, a list of all offering elements, including those that may be considered undesirable, are important to include when doing research. An incomplete list of offering elements might undermine the credibility of the list or show a lack of knowledge of your customer's business operation. Three types of market research scales are commonly used:

- 1 Likert scales – measures importance on a 5 or 7-point scale with 5 or 7 being the highest rating and 1 being the lowest. Challenge with this tool is that it allows respondents to grade all benefits as equally important, thus not getting any meaningful data to know differences between your value elements. That said, this tool is perhaps the easiest one to deploy if you don't have professional market research assistance.
- 2 Constant sum scales (e.g. assign points that sum up to 100 for the various elements of value) – improves value measurement by forcing some trade-off thinking to prevent respondents from saying everything is important as with Likert scales. Nevertheless, it is still possible for respondents to assign equal values across a variety of benefits, thus not revealing the points of parity or points of difference among the offering elements. One challenge with the constant sum scale (and the Likert scale) is that respondents are asked to weigh each element separately, which may make it difficult for them to conceptualize all elements of value together as a whole product.
- 3 Conjoint or trade-off analysis (i.e. a quantitative survey to elicit customer preferences) – may be one of the more valuable measurement approaches because it enables a more realistic derivation of value by including price as one of the key elements of the offering. Price needs to be part of the offering set presented to understand price sensitivity for a given offer among respondents. The value of price in relation to the other elements enables the identification of some segments that may tolerate a higher price point for a certain mix of offering elements than other segments. Other segments may not tolerate the higher price, but may tolerate a different mix of offering elements at a different price. For each segment, the goal is to establish a price with a corresponding set of benefits that resonate with that segment. For needs-based segmentation, conjoint is preferred because it is based on the tradeoff of price against other benefits. While some firms have the in-house capability to conduct conjoint analysis as an advanced analytical tool, professional market research support is often required to properly implement a good conjoint analysis.

Once your organization conducts the market research and collects the data at the individual customer level, it is possible to categorize customers into clusters according to their willingness to pay for the different benefits. Cluster analysis (and its variants) provides the primary tool for identifying similarities within groups and differences between groups. The purpose of this chapter is not to describe the details of cluster analysis or other statistical tools, but rather to make sure that managers involved in pricing recognize there are analytical tools and techniques available that can help realize the promise of segmentation.

The next step in the segmentation process is to identify potential market segments and describe them.

**Lesson 3: Accept the fact that most value-based segments will not be precisely different, yet they will be sufficiently different to guide pricing decisions.**

One of the challenges in a segmentation project is determining the segments that make sense for your business. The database generally contains many variables, such as how your customer receives information, how they obtain referrals, the type of purchase experience they desire, what types of brands they prefer, how they perceive educational programs, whether they value sophisticated methods of managing their business information, size of firm, formalized business plans and/or attitudes toward vendors to name a few examples. Many firms utilize research companies who have experience in segmentation and are familiar with the different techniques for segmenting databases. These firms first look at how many clusters the data present to determine the number of possible segments. The minimum or appropriate size of a segment depends on the markets being analyzed. Statisticians look for natural clusters, specifically the number of customers who answered similarly for a particular variable or set of variables. When there are several customers who respond similarly to a variable or set of variables, they may be defined as a cluster. Once a set of clusters is defined, other variables may be used to better understand and describe who are the customers in each segment. For example, it may be useful to describe your segments with demographic and personality variables (assuming they have been included in the market research study). These characteristics that define the segment, coupled with the value-based drivers of the segment, makes it easier to understand and interpret the customer's motivation in that particular segment. This is how segments can be given summary names to define their overall profile. For example, names assigned to segments might include "The Efficiency Expert," the "Referrals Rule," or "The Risk Taker."

**Lesson 4: Uncover how much the firm is willing to change their behavior if the research findings suggest that they are required to make changes to messaging, field force allocation, resource allocation and solution offering.**

### **Keeping the end in mind**

When you first embark on a segmentation project, you need to ask yourself:

- What does success look like for your firm?
- How do you plan to use the segmentation information once you have it?
- What results do you expect segmentation to provide once implemented?

Write down your hypotheses about the segmentation and share them with key stakeholders at your firm. These people could be leaders in sales, marketing,

customer service, field support, technical support and/or R&D. It is important to identify your stakeholders and their perceptions of success if segmentation were implemented. Objectives need to be agreed upon by key executives in your firm so you have endorsement and support. Many firms want to drive more profitable growth without reducing their revenue base; however, they may not be willing to execute a specific “target” strategy with specific customer groups identified from the segmentation project. If a company decides to conduct a segmentation study and then identifies targets but does not alter the way they call on these targets so they can realize greater productivity from their sales force, then perhaps they should not start the project at all.

Establishing your starting point in a segmentation project is critical to determining its eventual success. Executive commitment, clear expectations and the ability to view its implementation are necessary before committing to conducting a segmentation project. Too often firms want to start with price setting but miss the point that price is simply the outcome of perceived value. Therefore, start with a segmentation plan first so you can identify how value differs among your customers and then link price to the total offering so a particular segment may view the entire offering set as just discussed in the conjoint discussion. Without understanding what your customers value, you will have a hard time assigning price, setting fences between offerings and managing your customer targets. Segmentation enables you to understand the key elements that matter most to your customers so you can develop the appropriate offerings and price.

**Lesson 5: Start with a good segmentation plan to identify customer value before thinking about setting price.**

It may be helpful to create your own Segmentation Preparation Plan (Figure 11.1) to ensure you are setting yourself up for success. The plan is broken out into three parts to ensure that you have a successful result.

- 1 Diagnosing your firm’s readiness (Q1, Q2)
- 2 Aligning business objectives across your firm (Q3, Q4)
- 3 Establishing metrics for your project (Q5, Q6)

<i>High influence in firm</i>	
<i>Challengers</i>	<i>Advocates</i>
Keep in close communication	Involve and communicate frequently
<i>Close-minded</i>	<i>Open-minded</i>
<i>Inform only</i>	<i>Inform and involve – create positive word of mouth</i>
<i>Low influence in firm</i>	

Figure 11.1 Segmentation preparation plan

- 1 List names of executives who have a high degree of influence and are open-minded to the idea of creating customer segments.
- 2 Uncover any prior experience with segmentation that these stakeholders have had in their careers. What type of segmentation experience have they had? How successful was it? (Understanding your internal stakeholders well will assist you with mitigating and managing expectations.)
- 3 List out the business objectives by stakeholder focusing on those in the “Advocates” box.
- 4 List challenges for your project using the closed-minded high influence group of stakeholders or “Challengers.”
- 5 List success factors based on the high influence stakeholders listed above.
- 6 Determine metrics for the top three business objectives that you listed in Question 3.

### **Developing your segmentation plan**

Now that you have established the outline for success, you will need to formalize your plan so it can be broadly distributed in the firm. Be sure to familiarize your plan with many stakeholders – the more who understand what you are trying to accomplish, the better. It is also important to establish up front that you plan to conduct a pilot to test your offering and the messaging on your target segments. Most folks agree that understanding your customers at a deeper level is worthwhile. You will need to remind folks throughout the project that your main goal is to uncover the elements that your customers truly value in your offering set so your firm can differentiate itself relative to competition with their offering set.

Your action plan should include the following elements:

- 1 Purpose
  - a This section describes your business problem and why you are undertaking a segmentation initiative.
  - b It lists the key strategic questions that you expect to answer with this initiative.
  - c It lists the business objectives (obtained by your pre-work).
- 2 Stakeholders/team members
  - a Core team members
  - b Executive sponsors
- 3 Tasks/deliverables and timelines for achieving field pilot (suggests a pilot before full approval)
  - a Measure of team’s success (this section includes metrics for a field pilot)
    - i inputs (Was the typing tool used to identify our target segments effective?);

- ii outcomes (Was the activity time spent with a key target more valuable than time spent with a non-target customer? Was pre-call planning more efficient as a result of the segmentation data?);
- iii process (Were you able to close your target customers more effectively given the targeted messaging tools created for these targets?).

Now that your plan is in place, assign teams who will be responsible for actively engaging in this project as it progresses. These teams are best if you have a few cross-functional members involved besides marketing, e.g. sales management, and sales operations. The duties of this team include:

- define: evaluating Request for Proposals (RFP) from the market research firms.
- data collection: performing qualitative interviews to determine the key areas of further research for the quantitative phase of the research: this step requires that your teams are trained in the proper techniques for collecting voice of customer data. If not, then you may want to have your market research firm conduct these preliminary interviews to determine the areas that will be surveyed in greater depth in the quantitative phase.
- analysis: ensuring quantitative immersion of the data once collected to associate the data groups with the clusters identified.
- name: naming of the segments.
- quantify offering elements: assign value to each of the prioritized offering elements in order to differentiate your offering and tailor it for your target segment.
- develop recommendation: formulating the strategy for developing specific offerings for each segment.
- pilot: deploying your segmentation offerings in the sales field to your predetermined clusters to test your hypothesis.
- measure: measure the outcomes of the pilot.
- confirm: determining price bands for specific target segments.

Documenting your plan, distributing it to a wide audience, holding update meetings and ensuring there is high involvement among marketing and sales will ensure you have a successful outcome. The reason for your pilot is to ensure you have a plan that can be executed by the average and below average sales person. By testing in the field, you will learn whether you met your stated objectives of the project, i.e. increased sales force effectiveness, improved pre-call planning, achieved willingness to pay and/or improved differentiation.

**Lesson 6: Conduct a field pilot involving sales management that measures the effectiveness of your segmentation data before rolling-out to the larger sales organization.**

If successful, then proceeding with a larger scale plan makes sense.

## Identifying what matters

The goal of segmentation is to identify what matters most to your target segments. One of the first steps is identifying your target segments based on the segment clusters identified from the database. Your clusters may have been presented to you, but deciding on which cluster is right for you depends on what is important to your firm. Many choose targets using a grid based on segment attractiveness and competency factors among the firm. Segment attractiveness criteria are generally chosen by your cross-functional team of sales and marketing personnel and may include:

- growth of a market segment,
- price sensitivity of customers,
- number of competitors/entrants,
- customer loyalty to competition,
- number of customers in that segment.

Competency factors may include:

- sales force effort required to meet segment needs,
- ability of product to meet needs of potential buyers,
- fit with corporate strategy,
- sales force competency to sell “solutions”
- uniqueness/differentiation.

Managers wishing to choose a target segment may use a combination of judgment and data to rate each segment on the above criteria and use this as a basis for selecting one or more target segments. It should be noted that more than one segment can be targeted, although if doing so, pay careful attention to defining a different offering for each segment. An offering is defined not solely as a technology but rather all the elements of the total solution including services, financing, programs, purchase and ownership experience, etc. This becomes especially important for pricing decisions when it may be necessary to establish boundaries or price fences between segments to better manage profitability. It should also be noted that a targeting decision is preliminary in the sense that as you learn more from designing a marketing strategy for the segment, you may need to revise your target.

By deploying value-based segmentation, whether targeting a single segment or multiple segments, you are focused on the “value elements” that matter most to your customers. Your clusters may reveal that educational programs are important to one segment and not important to another; or managing one’s database to drive new revenue is important for one group but to another driving new customer volume matters more. Recall that the key characteristics of your segments are identified during the clustering process. The next step is determining the value that each

of these characteristics have relative to your offering and whether your target is willing to pay for them.

As noted above, market research, such as conjoint analysis, is a useful tool in determining how much value each of your offering elements are worth among your different segments. An example of this quantification is shown using software as a service (SAS) from a medical device manufacturer I will call Technica (a fictitious name). Technica manufactures therapy solutions and then utilizes set-up suppliers who are contracted with insurance companies to set-up patients with their specific therapy at a specified reimbursed rate. In their contracts with insurers, these suppliers must show proof of use that the patient is using therapy devices, and if they can't show this proof then insurers will not pay for their therapy set-ups. These set-up suppliers have high labor costs and low material costs, yet must keep their referrals happy by keeping patients adherent to their therapy. In this example, Technica is moving towards a cloud-based solution that enables all the care teams managing the patient to be informed of the patient's adherence level. In this example, there are five distinguishing value elements that differentiate this particular offering. Table 11.1 shows the value of each of the elements as determined from customer interviews describing the workflow in detail regarding the set-up and monitoring of a patient being set-up.

Each of the above differentiating value elements were assigned values based on the average labor costs of set-up suppliers and the value of incremental adherence. Workflow interviews and quantitative surveys confirmed common workflow steps, labor savings and frequency of necessary communication to improve compliance of non-adherent patients. The fourth value differentiator that references referrals is highly valued by one of the segment clusters that are willing to pay more because of this value differentiator in the offering set.

When conducting research, it is critical to understand points of parity and points of differentiation versus primary competitors in the same marketplace. In some cases, the next best alternative may not be a primary competitor but rather

Table 11.1 Differentiating value driver

<i>Differentiating value driver</i>	<i>Value quantified</i>
1 Cloud solution reduces IT costs at set-up supplier.	5 hours/week labor savings
2 Management by exception for non-compliant patients reduces labor costs and increases revenue by identifying those patients who require attention.	20 hours/week labor savings
3 Larger care team communication reduces costs by set-up supplier.	5 hours/week labor savings
4 Predictive analytic tool that can be used to market with their referral sources.	Brand equity value differentiator
5 Increasing volume of patients by a specified amount based on higher adherence.	Revenue increase based on incremental adherence

an emerging, fast growing competitor. Knowledge of value elements then enables the firm to develop and deploy value calculators with their sales representatives so that a value discussion with the customer occurs in the field versus a focus on price alone. Well-designed value calculators enable the sales person to input customer values into the calculator to customize the probable outcomes that the customer should expect. In the end, the conversation is about what the customer values and not only on price discounts.

Once pricing professionals have quantified their offering elements, a core proposition or base offering can be created so that adding/reducing to the base up or down may expand how many customer groups are covered by the company's portfolio. Your offerings can be created using a menu with the basic elements already valued by your audience. Start with creating a base offering and then layer on the elements that your target values. The core elements may be technology, financing and marketing programs and the variable offerings may include other options from the base along with educational programs and frequency of field visits. You can test your theory in the field pilot. Before going into the field, your segments will be defined by a typing tool (a tool that helps to identify which customers are in which segments, usually based on a discriminant analysis that predicts segment classification from the segmentation database). Ideally the sales force will be given profile characteristics of the major segments under review so you can test your theory of different offerings with different segments. Each offering will have a different price and it is at this point you can establish price "fences" (Nagle & Holden, 2002).

**Lesson 7: Establishing your segment offerings first before determining your price provides the sales force with the knowledge they need for a flexible and profitable negotiation.**

Price fences represent the minimum and maximum pricing parameters for each of your offering elements so that there is no room for interpretation. Knowing what matters to your customers determines how you will price elements in your offering. Your offering set will be determined by whom you want to attract in a particular market. Price fences help to avoid "gray areas" of value overlap illustrated when a sales person throws in an extra service for a customer who is not meant to receive it and now inequities are created within a segment. For example, if you have three target segments who value your offering elements as in Table 11.2, you can establish fences that enable your sales force to effectively negotiate with each of these customer groups. For Segment 1, your sales force will not talk about educational programs but will emphasize the multiple delivery options and field programs that can be estimated as part of their proposal. For Segment 3, your sales force will focus on the value of the educational programs and the breadth and value of their technology offering. All elements will have prices assigned so your sales force can understand what is included in the offering and what is not.

Depending on the structure of your offering and internal company policies, it is often best for some segments to be given à la carte pricing so that you can

Table 11.2 Segment and value offering

<i>Scale 1–5: 1 – Low value, 5 – High value</i>	<i>Segment 1</i>	<i>Segment 2</i>	<i>Segment 3</i>
Educational programs	1 – Low value, has trainer in house	3 – Moderate	5 – High value, has no trainer
Field service programs	5 – High value	2 – Low value	1 – Low value
Technology	2 – Low value	3 – Moderate	5 – High value
Delivery	5 – High value, has small warehouse	3 – Moderate	2 – Low value, has warehouse

subtract or add an element into their contract based on the pricing approach you have established. If you don't have price fences established up front, it is too easy for sales reps to offer what they think is "fair." By doing the work up front and identifying what matters to customers, you are creating price integrity for your established offerings. Fences provide rules for the sales force, ensuring that you are getting an adequate return on the resources applied to each customer.

An example for quantifying value for the above attributes can be done using a conjoint study where scenarios can be presented with different prices so your segments choose how they might conduct a trade-off. As an example, if you hired a firm to conduct a conjoint, you might get results that show Segment 1 is willing to pay more for an offering that emphasizes field service programs. Value calculators can then be developed based on this information so your sales representatives can use a tool that simulates expected value for the customer segment. Another benefit of value calculators is that they assist the sales person with delivering the right messaging on the rationale for the offering to the specific target.

**Lesson 8: Emphasize the importance of adhering to your price fences to avoid adding free extras that increase the cost to serve and dilute the integrity of your price fences.**

Set price fences and offering elements in accordance with your strategy. If you wish to penetrate a particular segment, then you may choose to be more aggressive with that particular group. "True" perceived value is tested in your field pilot where you can approach your targets with these offerings to test their receptivity. Without good discipline and adherence to price fences, your sales force may simply try to "match" a lower price from competition and erode profitability.

**Sales strategy, maximizing profitability**

A segmentation project is only successful if the sales force can execute it effectively in the field. Therefore, when you introduce your segmentation data to your sales organization, be sure to share it in three parts: (1) explain segmentation so they are aware of how it can help them make resource and offering decisions; (2) describe

what your customer data show and how targets were determined; and (3) assist in developing strategic options for specific customers so their field time is optimized with customers expected to grow.

Target segments and sales goals should be chosen by your core team and executive leaders. It is critical to show how your sales leaders can use the segmentation information for developing their sales strategy. To be consistent with a strategic pricing effort, sales leaders decide which current and potential customers to invest, maintain or divest in their area (Table 11.3). Customers within the chosen target group are seen as growth opportunities and should be developed or defended, given that the target group is aligned with segment attractiveness and competencies of the organization. These customers become the ones that deserve your sales force's attention.

In addition to assigning a sales strategy to targets and non-targets, sales can overlay other criteria, such as profitability (low, medium, high), breadth of purchase and/or loyalty to the brand, before setting an exact price within the price band for the targets. If a typing tool exists and your sales organization can discern between your target and other segments, then consider looking at existing data within your firm to assist your sales team in making more informed resource decisions relative to cost-to-serve, thus driving profitability in a positive direction.

**Lesson 9: To execute a value-based segmentation plan, tie it to a tangible sales strategy that distinguishes between profitable and unprofitable customers.**

It should be emphasized with your sales force that they regularly make many daily decisions that affect profitability. When you consider the possible combinations available to a sales representative as shown in Table 11.3, you understand just how important it is to understand what your customers really care about so that your sales representative is not giving too much away in the transaction. In Figure 11.2, there are over 1,080 possible decisions that a sales rep can make at any time with any customer. Thus, the creation of a price policy that sets price by segment for the standard offering will assist your sales organization with the boundaries. A price policy is a more comprehensive document that clearly articulates rules around pricing practices and discounts for specific segments. Rules should be created and followed when it comes to decisions about if and when the sales force can or cannot extend services or price discounts to particular customers. Price fences are

*Table 11.3* Sales strategy

HIGH	Develop selectively	Defend	Develop or Defend
<i>Profit</i>	Use few resources Fewest resources deployed	Defend or Maintain Use few resources	Develop Develop selectively
LOW		<i>Future Growth</i>	HIGH

Types of models/technology available	4 models
Marketing programs	5 programs
Delivery options	3 options <ul style="list-style-type: none"> <li>● Next Day</li> <li>● 2-day air</li> <li>● Standard shipping</li> </ul>
Freight payment	<ul style="list-style-type: none"> <li>● Free shipping</li> <li>● Standard freight charges</li> </ul>
Sales Force frequency	<ul style="list-style-type: none"> <li>● 24/7</li> <li>● Monthly visit</li> <li>● Quarterly visit</li> </ul>
Technical service	<ul style="list-style-type: none"> <li>● No charge</li> <li>● Charge per visit</li> <li>● Charge per phone interaction</li> </ul>

$4 \times 5 \times 3 \times 2 \times 3 \times 3 = 1,080$   
 Possible Decisions

Figure 11.2 Example of a medical device firm

different in that they establish differences between the solution offering elements and what can and cannot be included in a negotiation with an assigned value.

**Lesson 10: An escalation policy is an essential part of the pricing program because it provides flexibility for possible exceptions.**

Now that your sales representative knows who to target, why to target them and understands the need to follow a prescribed price policy, it is also important that an escalation policy or “exception” policy be available as part of your pricing program. For consistent behavior, sales managers should provide a clear escalation policy describing the process that defines what a sales person should do if they want to go outside of the assigned fences or price bands for their customer. As a rule, there should be few exceptions made and escalations should be backed up with a form describing why this customer falls outside of the fence limits. Escalations are usually viewed by an established “price desk” in an organization who has authority to decide “no.”

**Conclusions**

In summary, needs-based (value-based) segmentation is the heart of a pricing plan because you need to identify customer needs first before setting price. The strategic choice to segment your customers before setting price is essential for maximizing profit potential within your firm. Effective price setting is achieved

when you have created offerings that are tailored to your customer segments with clearly established and communicated price fences that inform your sales team about what is included or not included in the offering – all of which can avoid the undisciplined free giveaway. Lastly, segmentation plans are only effective if they can be executed to have impact on sales behavior related to price setting and adherence. Profitability is dependent on the quality of segmentation, sales strategy and how well your sales force adheres to the policies given to them. Clarity of offerings, price fences, value calculators and escalation will ensure a more profitable future.

## **Implications for the pricing field**

Segmentation may not be new; however, when done with careful thought and planning to match a firm's pricing challenge, it can transform the way the firm sells its solutions to its customers. It also forces new behavior from your sales team and establishes integrity of your prices, thereby improving profitability. The ten lessons from this chapter are:

- Lesson 1: *Know exactly why you want to use segmentation and what its expected benefits might be for you.*
- Lesson 2: *When it comes to pricing, segments based on value will be most productive.*
- Lesson 3: *Accept the fact that most value-based segments will not be precisely different, yet they will be sufficiently different to guide pricing decisions.*
- Lesson 4: *Uncover how much the firm is willing to change their behavior if the research findings suggest that they make changes to messaging, field force allocation, resource allocation and solution offering.*
- Lesson 5: *Start with a good segmentation plan to identify customer value before thinking about setting price.*
- Lesson 6: *Conduct a field pilot involving sales management that measures the effectiveness of your segmentation data before rolling-out to the larger sales organization.*
- Lesson 7: *Establishing your segment offerings first before determining your price provides the sales force with the knowledge they need for a flexible and profitable negotiation.*
- Lesson 8: *Emphasize the importance of adhering to your price fences to avoid adding in free extras that increase the cost to serve and dilute the integrity of your price fences.*
- Lesson 9: *To execute a value-based segmentation plan, tie it to a tangible sales strategy that distinguishes between profitable and unprofitable customers.*
- Lesson 10: *An escalation policy is an essential part of the pricing program because it provides flexibility if certain exceptions exist.*

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# 12 The five fundamental value factors

*Ralf Drews*

## Introduction

Just 17 percent of companies apply the value-based pricing model (Liozu et al., 2011), and many of them do so only very late in the stage-gate process of developing a product. An even smaller percentage understand that value is defined by the customer, who not only considers the value of the offering itself but also is consciously or unconsciously driven by other values such as service, product delivery and company brand. Knowing that there exists a wide variety of buying preferences across different customer segments and global cultures makes it even more challenging for companies to set the right price point. A strong company strategy considers all of these variables and defines them well before a voice of the customer (VOC) study is run and a product concept is created that is later to be embedded in the overall go-to-market approach.

In everyday business life, executives often view pricing not strategically but tactically: A value-based price accounts for the value of the product in the context of its use but disregards other value drivers outside the offering as well as the value perception of different customer characteristics. Unless all important value factors are considered, the negative impact can be a hit on the bottom line – if the price is too high, sales stay below expectations; if the price is too low, margin is wasted. In addition, the disconnect between price and strategy can lead to wrong conclusions if corrective actions must be taken to improve a product's financial performance.

This chapter provides a comprehensive overview of all five fundamental value factors in their logical order. Anyone seeking to define the right price for an offering can easily apply this approach to their business.

## The five fundamental value factors

- Value factor 1: Pick the right focus industries
- Value factor 2: Understand the buying influence structure
- Value factor 3: Prioritize other important buying-decision factors outside the offering
- Value factor 4: Define the buying characteristics and the ideal customer profile
- Value factor 5: Apply a voice of the customer (VOC) study at the beginning of the stage-gate process

The following example illustrates the application of the five value factors.

The fictitious company High Pressure Technology (HPT) develops, manufactures and sells high-pressure cleaners. It is headquartered in Switzerland and has a strong brand in Europe. The next-generation product is to be created, and the company’s goal is to gain significant market share in North America where HPT has traditionally been weak. The products are of premium quality and are made for industrial applications. Even though this market has become very competitive, HPT can still differentiate based on three strong value propositions, which set the company apart from other manufacturers:

- outstanding cleaning results without degradation of surfaces due to patented technology;
- low cost of ownership due to premium-quality design;
- productivity enhancements due to reduced cleaning time.

The company’s executive team seeks to leverage those strengths in their go-to-market strategy.

**Value factor 1: Pick the right focus industries**

The most common decision criteria for market selection are market volume, market growth, market profitability and market barriers. Other less-common but very important criteria are related to the strength of the enterprise in the vertical market: market share, brand value, fit with global focus markets and, most importantly, power of the value proposition. A strong *company* value proposition (not *product* value proposition!) is unique, provides true value to customers and is sustainable.

Tables 12.1 and 12.2 show how companies in three different industries select their focus vertical markets; Figure 12.1 depicts the final result.

Table 12.2 indicates the most critical enterprise strengths related to the vertical markets. It is critically important for profitable pricing that the company’s value proposition fits with the buying preferences of the vertical market. Misalignment between company strengths and what the customers appreciate will result in poor product margins.

Table 12.1 Industry attractiveness independent of the company’s strengths

	<i>Weight (1–10)</i>	<i>Chemical industry</i>	<i>Waste water treatment</i>	<i>Ship building</i>
Market size	7	8	7	3
Portfolio fit	9	8	8	5
Profit margin	7	7	7	4
Market growth	9	6	5	5
Competitive intensity	5	3	5	6
<b>RESULT</b>		<b>246</b>	<b>240</b>	<b>169</b>

Table 12.2 Strength of enterprise

	<i>Weight (1–10)</i>	<i>Chemical industry</i>	<i>Waste water treatment</i>	<i>Ship building</i>
Market share	5	2	1	1
Brand value	3	3	2	2
Fit with global focus markets	7	7	7	3
Power of value proposition	10	8	4	5
<b>RESULT</b>		<b>148</b>	<b>100</b>	<b>82</b>

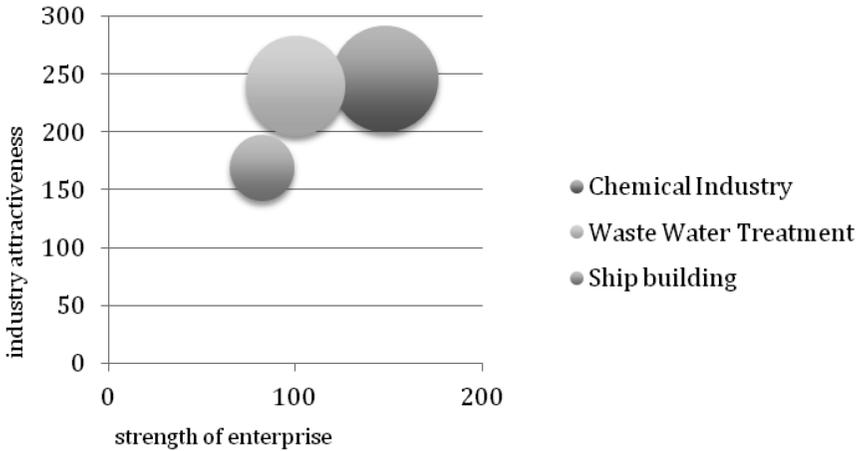


Figure 12.1 Market prioritization

Figure 12.1 illustrates the positioning of the different vertical markets. Based on these results, HPT picks the chemical industry as their focus market because of the strong position shown on the x-axis and the high overall attractiveness (y-axis) in combination with a considerable market volume (bubble size).

Although Figure 12.1 shows that waste water treatment is almost as attractive as the chemical industry, HPT decides to target the latter because it is a much better fit in terms of HPT’s value proposition (8 versus 4) – this is because the chemical industry has a higher degree of cleaner use, and this is where reduced downtime as a result of greater robustness and higher cleaning efficiency make a big difference.

When exploring new marketplaces, the power of the company’s value proposition is a major market-selection criterion!

The next step is to better understand the buying decision-making process associated with this specific industry.

**Value factor 2: Understand the buying influence structure**

Once the focus industry has been defined, the main buying influences and their say in the decision-making process need to be understood. Of course, the distribution of decision power varies slightly from company to company. However, since roles and responsibilities within the target industries are similar, the information in Table 12.3 is sufficiently accurate for a clear product and pricing definition.

The marketing department can identify the buying influences and their decision-making power. In real life, however, sales departments typically understand very well who has the greatest and second-greatest influence when it comes to buying decisions. This information is critical for an effective VOC study since it means prioritizing the requirements of the buying influences in the order of their decision-making power. Meeting the needs of the most-influential decision maker most likely means achieving the best price for one’s offering. In this example, HPT determined the operations manager to have the greatest influence. This means that he will drive the decision based on the value he sees in HPT’s offering. His focus is clearly the process efficiency improvement of 20 percent compared with the next-best competitor:

$$\text{Cost savings} = \text{increased cleaning efficiency} \times \text{cleaning hours per year} \times \text{hour} = \text{value}$$

This equation translates into the following value for the operations manager:

$$20\% \times 600 \text{ hours} \times \$15/\text{hr} = \$1,800 \text{ savings per year per cleaner.}$$

Assuming the average life of a cleaner is 5 years, the customer benefit translates into  $5 \times \$1,800 = \$9,000$ . Based on that analysis, a pricing approach might look like this: HPT charges \$4,500 more than their next-best competitor; in addition,

Table 12.3 Distribution of decision-making influence

<i>Buying influence</i>	<i>Role in the chemical industry</i>	<i>Decision-making influence</i>	<i>Values</i>
Economic buyer	Purchaser	20%	Low costs of purchase
Technical buyer	Operations manager	50%	Low downtime Decreased cleaning time (20% better than competition) Excellent cleaning results
User buyer	Industry worker	30%	Ease of use Excellent cleaning results

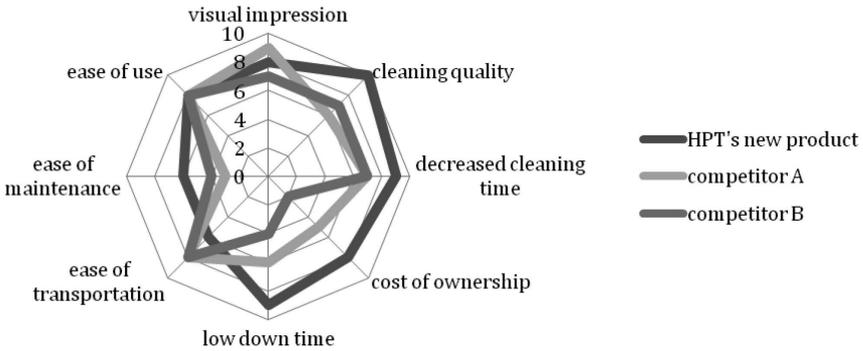


Figure 12.2 Target product value profile reflecting the needs of the most powerful buying influence

they still offer a \$4,500 value advantage, which results in a very attractive ratio of price to performance.

This example shows how important it is to align the decision-making structure in the key vertical market with the company's value proposition.

Once a company thoroughly understands the decision-making process, they can determine the main value drivers of their offering. Figure 12.2 shows that the focus of the product value propositions matches the needs of the most powerful buying influence.

A common tool for identifying the value of product features based on the preferences of buying influences is conjoint analysis, which is explained in more detail later.

### ***Value factor 3: Prioritize other important buying-decision factors outside the offering***

Once the company's value proposition has been defined, the key market selected and the buying-influence structure understood, the next questions are: "What are the six to eight most important buying criteria from the perspective of all buying influences?" and "Which of those buying influences are outside the offering itself, and how does the company's performance in those areas impact the pricing of the offering?"

Companies have to wake up to the fact that they are more than just a product on a shelf. They're behaviour as well.

Robert Hass, Levi Strauss

The key message of Hass's statement is that a buying decision is driven not only by the offering's ratio of price to performance itself but also by other factors like brand (= trust), delivery performance and service. An offering's outstanding price-to-performance ratio can compensate for performance disadvantages of

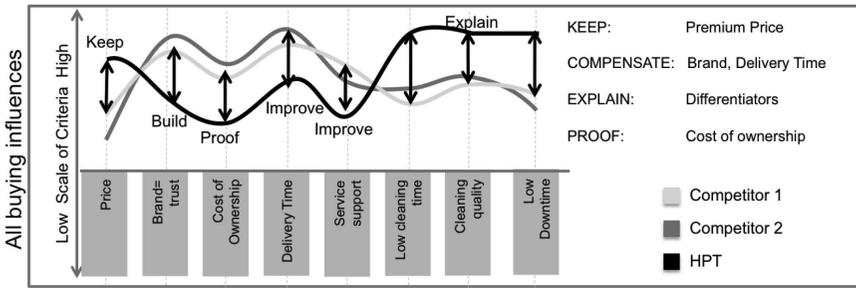


Figure 12.3 HPT’s eight most important buying criteria and its positioning against the competition

other value factors. Thus it is important to define the company’s strategy canvas (Figure 12.3).

This canvas shows how HPT (represented by the black line) is positioned in the marketplace. Although there may be up to 30 buying-decision criteria, the x-axis shows the eight most important criteria (Pareto). Those criteria predominantly drive the buying decision of the three buying influences as described in Value Factor 2. HPT will differentiate itself from its competitors based on its higher cleaning performance at lower costs of ownership. Its challenges are its weak brand, poor delivery and service performance.

Generally, a buying decision considers more than eight buying-decision criteria. So, how are the eight most important buying criteria being defined?

First, as described earlier, it is important that customers in HPT’s target market appreciate the company’s value proposition. For example, if HPT had decided to enter the lower-end performance market in the U.S., the company DNA – producing quality products – could not have been leveraged. Thus the “power of the value proposition” is a key market-selection criterion. Following this logic, four of the eight buying criteria are already defined: little downtime, high cleaning quality, low cost of ownership and high productivity.

Second, in order to understand the importance of value factors outside the offering, one can also apply conjoint analysis since the purpose is very similar – down-selection of buying criteria. Conjoint analysis is mostly used for market segmentation, pricing, and product development. The following simple example explains how conjoint analysis generally works.

It would be important for an automotive manufacturer to determine how significant the factors “brand,” “motor power,” and “color” are with regard to buying decisions. In a conjoint analysis, several options are created (e.g. a red Audi with 170 HP, a gray Mercedes with 170 HP, or a blue BMW with 190 HP) and presented to test persons who rank or rate these different options. By analyzing how they assign preference to these options, the manufacturer can determine the implicit valuation of the individual elements making up the product or service. In this

example, one possible result is that the persons being surveyed are strongly oriented toward a certain manufacturer (most important feature), for example toward BMW (most important characteristics) when it comes to purchasing a new car.

The strategic marketing department should survey the initial definition of all buying criteria. Figure 12.4 shows the result of HPT's conjoint analysis. The key takeaway is that 80 percent of the weight is distributed over the first eight buying criteria; these criteria are reflected in the company's strategy canvas.

As mentioned above, HPT's challenges are its lack of brand value and brand awareness. Since brand equals trust, a well-known brand is sold more easily just because the buyer has a higher degree of confidence that he or she is buying the right product.

The company's delivery time lags behind that of its competitors, as does its service support. The lack of a good service network means that buyers might hesitate to accept the risk of a long downtime in case of a product issue.

These three value issues must be either eliminated or compensated for in the **overall value equation** (Figure 12.5). Since HPT's brand, delivery and service provide negative value compared with the competition, HPT must decide how they want to create the competitive advantage needed to penetrate the U.S. market. It might be viable to lower the price of their offering, assuming this would not affect the company's brand position.

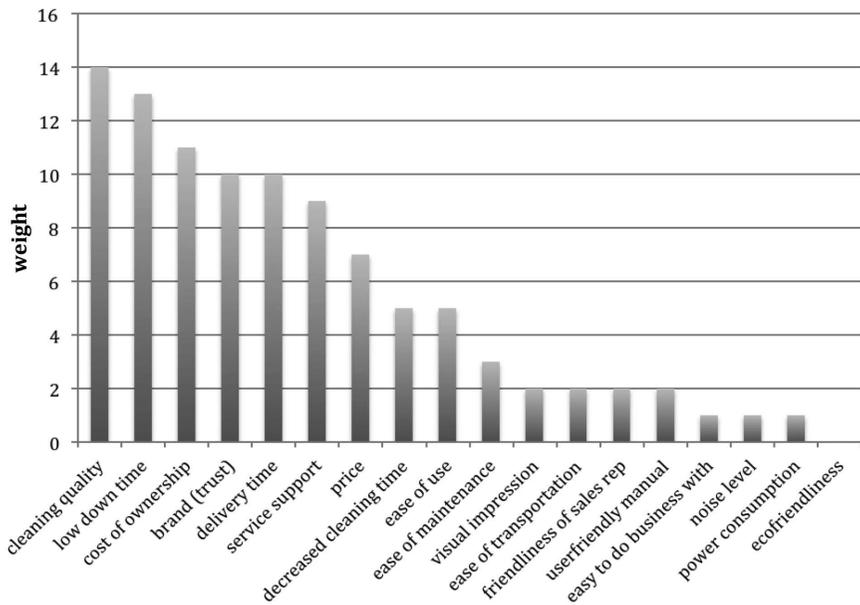


Figure 12.4 Analysis of the eight most important buying criteria by means of conjoint analysis

Competitive Advantage:

$$\begin{array}{l}
 \text{value of the offering} \\
 + \text{ delivery performance} \\
 + \text{ service support} \\
 + \text{ brand trust}
 \end{array}
 \left. \vphantom{\begin{array}{l} \text{value of the offering} \\ + \text{ delivery performance} \\ + \text{ service support} \\ + \text{ brand trust} \end{array}} \right\} - \text{ price} > \text{ best competitor}$$

Figure 12.5 The overall value equation

***Value factor 4: Define the buying characteristics and the ideal customer profile***

Having worked on Value Factors 1 – 3, the focus market is now defined, the influence of the different buyers is revealed and the price position of the offering is determined in the context of the most relevant buying-decision criteria by means of the strategy canvas and the overall value equation (Figure 12.5).

At this point, the strategic homework is nearly done. There is just one step left to ensure that the strategy is effective and the margins are optimized in the selling process: the definition of the ideal customer profile. What is an ideal customer? Mercedes Benz's ideal customer is most likely someone who is wealthy, who likes luxury, who has a solid financial background, who prefers comfortable driving over sporty driving and who is willing to pay for a brand. In this example it seems obvious that Mercedes sales representatives would not spend much time on teenagers since this customer category does not (most likely) comply with the ideal customer's profile. Many companies forget to make this distinction. As a result, their sales force spends time with customers who are unwilling to pay for an offering's extra value. Returning to HPT, if their sales representatives talked to those chemical industry customers who might prioritize initial purchase costs over shorter cleaning time and shorter downtime, the discounts offered would increase, and such a deal would typically result in lower margins. Over time, the brand could be damaged as well. Practical experience shows that management struggles with defining the ideal customer because doing so shrinks the accessible market significantly. However, the Mercedes example shows how ridiculous it would be if Mercedes did not clearly define the ideal customer in the automotive market but sold their product to anyone.

So, what is the ideal customer profile? What are the relevant factors, and how does one describe this customer? Answering that question requires revisiting the strategy canvas (see Figure 12.3).

What could be the **personal win** and the **personal risk** for a buyer choosing an HPT product?

The strategy canvas identifies the following risks: First, there is HPT's weak brand (if something were to go wrong with the HPT cleaner, the buyer might be blamed by his or her superior for having bought a no-name product, and his or her career might suffer). Another risk is the lack of service support. This could lead to long downtimes and loss of productivity. Therefore, HPT's ideal customer is someone who takes risks, who is a global thinker (considers buying a Swiss product) and is open-minded and willing to be different. This person constantly seeks changes to improve his or her business. All these traits describe the customer's emotional side.

What about personal wins? Lower costs of ownership and better cleaning results with less labor could make this buyer a successful change agent in the eyes of his or her superior.

In addition, our ideal customer is someone who truly appreciates the benefits of quality products and is willing to pay for them. All these traits describe the customer's rational side (Figure 12.6).

Summing up, in this case the rational part of the ideal customer is aligned with the differentiators (strengths) presented in the strategy canvas. The emotional part is aligned with the challenges presented in the strategy canvas.

## EMOTIONAL

- Independent character
- Willing to be different
- Change agent
- Open minded
- Global thinker
- Risk taker

## RATIONAL

- Appreciates productivity enhancements
- Driven by fact vs. Emotion
- Receptive to value arguments
- Appreciates TCO benefits
- Company with good service department



Figure 12.6 The ideal customer profile of HPT

The ideal customer profile helps to keep discounts low through a good alignment of product-value propositions and customer-value appreciation in relation to the emotional burdens that the customer must bear.

**Value factor 5: Apply a voice of the customer (VOC) study at the beginning of the stage-gate process**

Now that all important value factors are defined, HPT is ready to run a VOC for the new product development, which is focused on the US market. One of the most efficient and effective ways to do this is to have dedicated in-house resources that specialize in this process. HPT’s VOC team, for example, would most likely be composed of human-interface experts, industrial psychologists and strategic marketing people. The benefit of having an in-house team is that every VOC project significantly increases the company’s market intelligence to an extent and a level of detail that a regular product manager would not reach. One main reason for this is the intense involvement in the customer’s processes by means of customer observations that is required. Another reason is that the skill set and passion of VOC people are different from what a good product manager will most likely bring to the table. The following step-by-step procedure illustrates what a VOC process can look like, how new valuable (high-margin) features can be discovered and how the main features of the new product are selected.

**Step 1: Customer interviews and observations to identify articulated and unarticulated customer needs in the target industry.** This is the most challenging and most critical part because at this point the customer’s unsolved problems can be discovered. If HPT were the first company to solve a newly discovered problem, they could charge the dollar equivalent of the problem’s value without facing any competitive pressure.

Table 12.4 illustrates an example in which a detailed workflow analysis of a drilling machine manufacturer leads to exactly this result. The conclusion of the workflow analysis is that the time required for taking the measurement represents 28 percent of the overall time needed to install a cable duct. The drilling itself takes just 17 percent of the time. So instead of squeezing another 1 or 2 percent out of the drilling time, it makes much more sense to find a way to reduce the measurement time by 50 percent.

This is a good example to illustrate that the customer himself probably would not have discovered this efficiency-improvement potential because he was

Table 12.4 Workflow for the installation of a cable duct

<i>Activity</i>	<i>Time spent</i>	<i>Type of work</i>
Measurement	28%	Manual
Drilling	17%	Machine
Insert wall plug	10%	Manual
Fit holders	24%	Manual
Fit cable ducts	21%	Manual

unaware of this problem. The result of this discovery was the development of a laser gauge that helped to reduce the measurement time by 50 percent.

Another helpful approach to discovering and identifying important product functions is the “day in a life” approach. Unlike in the cable ducts example, this approach observes all interactions between human and machine throughout the day. In the case of HPT, a VOC would analyze storage, sign-out, transportation to the workplace, installation and setup, cleaning, soap refill and cleaner maintenance. This process would be written down and documented in great detail (Figure 12.7).

All interactions, especially those at the interface stages, potentially create additional value for the customer as soon as a problem is discovered.

In Step 1, the most important functions that a product must perform in this specific industry application are identified.

**Step 2: Competitive benchmarking to identify the strength and weaknesses of the company’s target competitors.** In this stage the performance of the competitor’s products are evaluated in terms of the identified functions (Figure 12.8). Independent people using the products in the context of the application perform the evaluation.

**Step 3: Prioritization of functions by HPT’s ideal customer.** In this step, the VOC team creates the target performance profile of the new product development. Before the target profile is created, it is important to understand which functions the ideal customer appreciates the most. Conjoint analysis, as described earlier, is once again applied. The result is shown in Figure 12.9.

The process involves identifying the most important product functions, then assessing the target competitor’s product performance and, last but not least, prioritizing product functions by considering the buying preferences of the ideal customer.

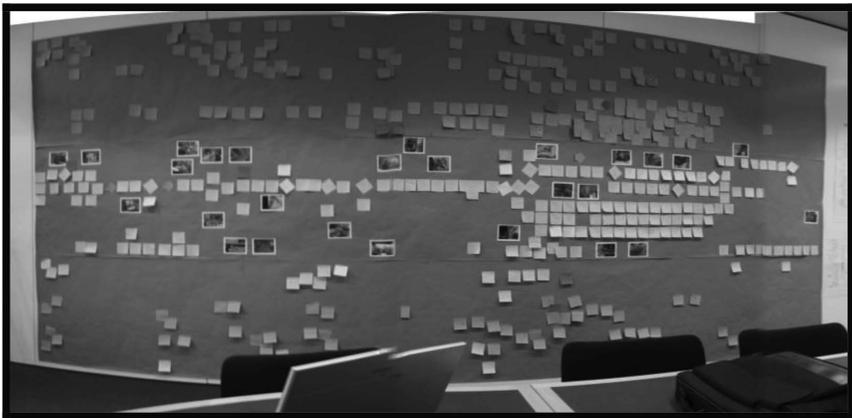


Figure 12.7 Result of the “day in a life” approach

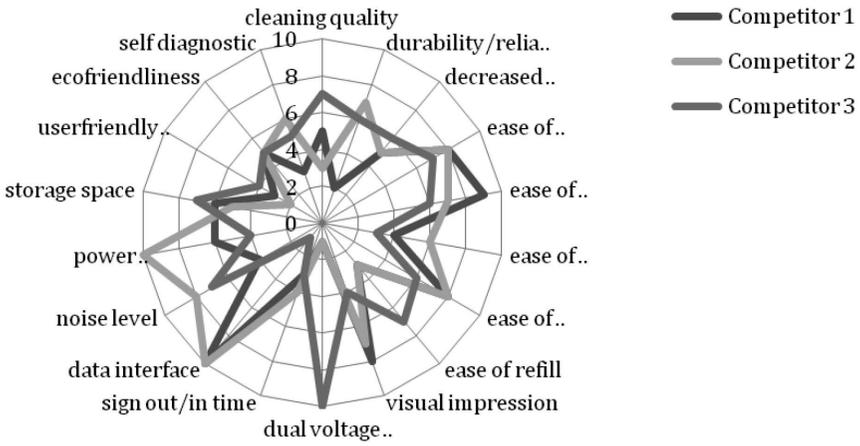


Figure 12.8 Performance of the competitors' products in all relevant functions

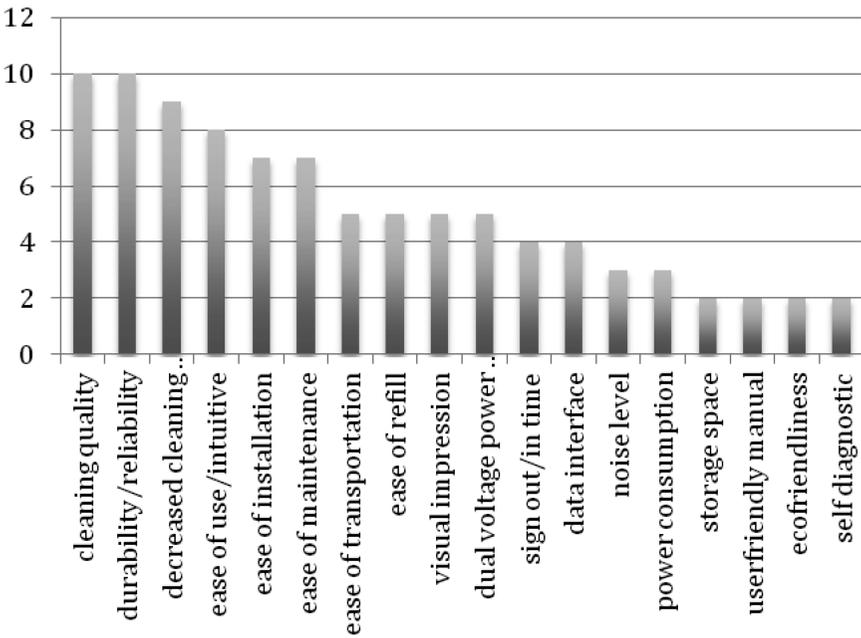


Figure 12.9 Importance of the functions from the ideal customer's point of view

With this result, HPT obtained good verification that their ideal customers truly value the properties as outlined in the strategy canvas (durability=low downtime and low cost of ownership). The final step is to define the target profile of the new product. The relevant factors are the weights of the functions as shown in Figure 12.10 and the costs of realizing those functions. The ideal product would show maximum performance in every function; however, such a product would most likely not be competitive because it would be too expensive.

Once this target profile has been defined, the marketing team will fit the new product into HPT’s strategy canvas and derive the price point from it. This price, combined with the target margin, defines the target production costs for R&D. From a product concept and pricing perspective, the R&D project is ready to be launched.

### Conclusions

In a growing number of publications about pricing, one can read that pricing should become a priority of the CEO and CFO in companies. However, most companies continue to leave pricing to their marketing departments alone.

This chapter explains why product pricing must be embedded in the overall company strategy and why this should be a priority of companies’ senior executives. Strategic elements, like company value proposition, focus markets, buying-influence structure, ideal customer, go-to-market strategies and VOC studies, should not be looked at separately but can be nicely integrated into a powerful overall strategic approach. If this happens all company functions are aligned to support a strong and consistent offering, which optimizes margins and sales.

The five fundamental value factors integrate all the above-mentioned strategic elements and deliver a simple approach for the practitioner.

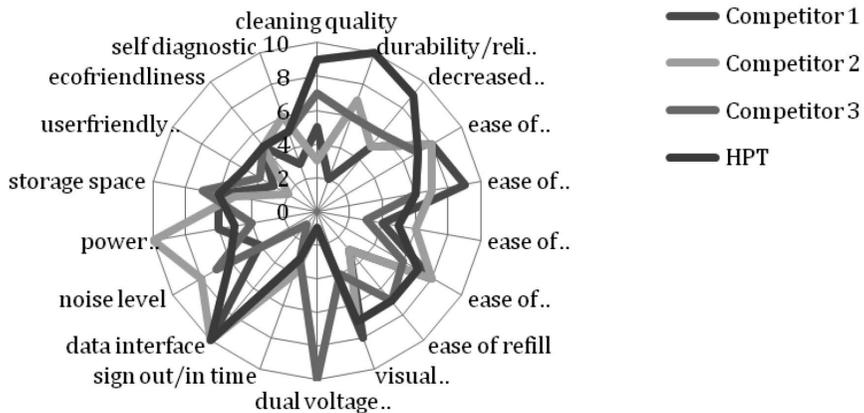


Figure 12.10 Target profile of HPT’s new cleaner

## Implications for the pricing field

Market segmentation has long played an important role in the pricing process. In addition, VOC studies and conjoint analysis have been very useful tools for pricing. The truly innovative thought of the five fundamental value factors is the integration of all important strategic factors, innovation approaches and pricing tools. If this approach is used for pricing, companies will

- discover inconsistencies or gaps in their company and marketing strategy and, more importantly, will now know how to correct them;
- understand better how emotional and unconscious buying criteria influence the go-to-market strategy;
- align the value propositions of products better with non-product-related value factors.

The application of the five value factors leads to stronger strategies, to profitable growth or to deliberate discontinuation in certain marketplaces. In addition, the reader of this chapter will understand why it is critical to link pricing to the VOC process: no R&D dollar should be spent before all relevant value drivers are identified and prices are evaluated.

## Reference

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# 13 Pricing processes in fast-paced business-to-business settings

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## **Introduction**

The concept of pricing capability (Dutta et al., 2002, 2003; Vogel et al., 2002) applies a resource-based perspective on the topic of pricing in order to capture the organizational aspects of pricing. Pricing capability is thus a highly important contribution as it turns the attention towards the organizational processes, routines and resources required to perform pricing activities and thus capture value through pricing. The concept of pricing capability originates from the recognition that 1) pricing activities are not costless (Bergen et al., 2003) and 2) pricing activities are associated with internal and external uncertainties (Dutta et al., 2003; Hinterhuber, 2008b). Pricing capabilities capture the processes, routines and resources that the organization can strive to build in order to improve cost efficiency and manage uncertainty.

However, the process-oriented capability definition applied in Dutta et al. (2003) is based on a single case study where the value creation processes are rather well known in advance of pricing activities. In other settings, the distinction between value creation and pricing is not necessarily as clear. For instance, high levels of customization of products involve iterative, intertwined sales and development activities with customers. Pricing processes are therefore less distinctly divided between internal and vis-à-vis customer processes, as defined by Dutta et al. (2003). This is due to the fact that in such settings the internal pricing processes do not start by a pre-defined value level, as value creation is an ongoing, iterative process. Similarly, the distinction between price orientation and price realization (Hinterhuber & Liozu, 2012) is less apparent in such settings, as prices are more difficult to define *ex ante*.

Furthermore, fast paced innovative settings involve a continuous interaction between product development activities and value assessment of future deliveries. Thus, competitive and value-based pricing approaches will draw on resources for value assessment, which will also be essential for decisions in association with ongoing value creation activities. The processes involved for future value assessment thus also challenge the implicit assumptions in Dutta et al. (2003) that value is defined in advance of the pricing process.

Through theoretical studies and examples from a unit within the semiconductor industry, this chapter shows that for markets involving fast-paced innovation and high levels of customization of products to customer needs, it may be difficult to explicitly isolate pricing processes, and thus pricing capabilities, from value-creation processes. Thus, for certain settings, the chapter illustrates the difficulties of applying the pricing capabilities concept based on pricing processes without taking into consideration the value-creation processes involved. It also suggests that pricing processes should enable proactive pricing activities.

## **Theoretical foundation**

### ***Pricing process as capability and price changes***

Pricing capability evolved as a response to the focus on value creation in association with capabilities. Dutta et al. (2002) illustrate how price setting is a strategic capability that the organization must develop and maintain. Through case studies and empirical examples they argue that pricing, and the ability to price, has a key role in the strategy of the firm. They identify three capitals of pricing – human, systems and social capital – that contribute to the firm's pricing capability. One of the prime reasons to invest in pricing capabilities is for the firm to be able to handle uncertainty in association with pricing. Dutta et al. (2003) provide a few examples of uncertainties related to customers, competitors and the internal organization. Hinterhuber (2008b) describes the uncertainties inherent in value assessment, a key aspect of value-based approaches to pricing.

Of particular importance in association with pricing capability is the ability of the firm to handle price changes and the costs that they incur (Dutta et al., 2002). Bergen et al. (2003) explore this area further by focusing on the internal and external costs of price changes and how to manage price changes. The internal costs may refer to administrative costs but perhaps more importantly to managerial costs involved in pricing (i.e. how much time do managers spend on price changing activities and at what cost). The external costs are related to interaction with customers in order to communicate and gain acceptance for price changes. Dutta et al. (2003) also adhere to the internal and external perspective in association with pricing when they discuss pricing capability from a process perspective. They state that "In setting prices, firms face two issues: appropriating rents and balancing competing internal interests. A pricing capability consists of the systems and processes that a firm develops to address these two issues" (Dutta et al., 2003: 616). Vogel et al. (2002) also view pricing capabilities in relation to price changes and external and internal aspects when they propose that policies and processes are key parts of building a pricing capability.

Based on a study within a business-to-business setting, Dutta et al. (2003) outline two pricing processes: internal and vis-à-vis customers. They state that the firm normally moves between these two processes in iterative cycles or loops, but they also state that a price changing sequence is typically initiated by the internal price setting process. The internal price setting process encompasses the

identification of competitor prices, setting of pricing strategy and transferring pricing strategy to prices. The vis-à-vis customer's process revolves around the bargaining process (with references to Brandenburger & Stuart, 1996) and thus focuses on the convincing of customers of changes in prices and in pricing logic and the negotiation of prices with customers. Thus, a price changing sequence is typically initiated by a stage in which strategy is transferred into generic price levels, in the form of, for instance, list prices. The next stage takes these price levels to the customer level for adaptation and bargaining. Phillips (2005) makes a slightly different distinction, as he is primarily concerned with the tactical level of pricing – between list pricing and customized pricing. Whereas Dutta et al. (2003) focused their study on a business-to-business setting, Phillips discusses list and customized pricing across consumer as well as business-to-business markets. Among the examples of customized pricing, the business-to-business cases are in majority. Customized pricing is characterized, according to Phillips, by the one-to-one quoting of price to each customer. Thus, the seller can quote a different price for each request.

Common for the above descriptions of pricing situations and processes is the assumption of value as created ahead of the pricing process. This is at its clearest in the case of standard, off-the-shelf products or services, which are most clearly associated with list prices. But also in association with what Phillips refers to as customized pricing, the pricing sequence largely assumes that the value level of the product or service can be pre-defined. In the following sections this chapter will illustrate two settings where the pricing process, and thus the value capture process, and the value creation process cannot be as easily distinguished from each other. It is vital to note that although Dutta et al. (2003) is a highly important study as it provides in-depth insights into the character of pricing processes, it is a single case study. As such, it is limited to the character of the empirical pricing setting. This chapter tries to expand our knowledge of pricing processes and capabilities by deliberately studying partly different pricing settings where the pricing processes are likely to have slightly different characteristics. Furthermore, although Dutta et al. (2003) captures several aspects of different pricing approaches, or strategies, it does not explicitly deal with the dimension of intertwinement between value creation, value capture and the role of pricing. This chapter discusses cost, competition and value-based pricing approaches, with a particular focus on the latter and the role and character of these when value creation and capture are intertwined. The next section provides an overview of the main pricing strategies and the main value-based approaches to pricing.

### ***Value-based pricing***

Even though the literature suggests numerous different pricing strategies, there are three main categories that researchers in general are able to agree on: 1) Cost-based pricing, 2) Competition-based pricing and 3) Customer value-based pricing (Hinterhuber, 2008b). The approach of customer value-based pricing can be defined as: “Customer value-based pricing approaches use the value a product or

service deliver to a predefined segment of customers as the main factor for setting prices” (Hinterhuber, 2008a: 42).

Within the value-based pricing approach, two main value definitions can be identified: customer perceived value (e.g. Cannon & Morgan, 1990; Thompson & Coe, 1997) and differentiation value (Forbis & Mehta, 1981). Smith and Nagle (2005) elaborate on the differences between these two main categories and provide an overview of four types of value. They distinguish between: 1) Value in use, i.e. the actual value to the customer of the product or delivery in use (cf. the concept of acquisition utility in Thaler, 1985: 2) value in exchange, i.e. economic value, similar to the prior one, with a focus on differentiation and a referenced commodity value, 3) perceived value, here with a focus on the perceived market value, i.e. it captures how customers perceive value, and more specifically the economic value, and 4) willingness to pay.

Of particular interest in association with a value-based approach is the assessment of value. For instance, in Hinterhuber (2008a), value assessment is ranked as the main obstacle towards implementing value-based pricing. In the review by Hinterhuber (2008b), the above two value definitions, customer perceived value and differentiation value, reappear. But Hinterhuber also stresses the aspect of uncertainty in association with value in business markets due to the future orientation of values. The origin of uncertainty is the interaction between buyer and seller and the process where “two parties exchange resources (e.g. money, goods, services, rights or intellectual property) in the expectation of certain future benefits resulting from consuming these resources” (Hinterhuber, 2008b: 390). This chapter will address the issue of uncertainty of value assessment in two particular settings and further elaborate on its relation to the value-creation process in each case.

Assessing customer value and applying it in association with pricing activities is closely associated with the pricing literature. See for instance the discussion on value-based pricing in Smith and Nagle (2005), Nagle and Hogan (2006) and Bernstein and Macias (2002). However, this explicit part of the pricing process is not dealt with extensively in Dutta et al. (2003). Dutta et al provide one example that shows the importance of the pricing function in leading the assessment of product and reference value, i.e. the value of the competitor product alternative (Nagle & Hogan, 2006). The example also illustrates that the process stretches beyond the traditional pricing or marketing function boundaries. But, limited attention is given to the uncertainty and future orientation inherent in a business-to-business setting.

When viewing value assessment in relation to processes, one issue is whether to associate value assessment with the pricing capability or other capability definitions. It would, for instance, be possible to attribute reference value assessment processes to other capability distinctions, such as outside-in processes (Day, 1996). However, a complete value assessment process is, as the pricing process and capability in Day (1996), a spanning process that links internal and external perspectives. Thus, a value assessment process (if such a process can be isolated and defined) will also be a spanning process. This is apparent in association with

value-based pricing where external information of customer perceived value and competitor reference value must be considered together with internal data on the actual value set of the product or service of the firm in order to set the price. Therefore, from the perspective of capability as process, when working with value-based pricing, the pricing process must include activities that incorporate internal and external perspectives. This is contrasted by a pure cost-based pricing approach where a firm may rely on internal data only.

## **Methods**

In the following sections two pricing settings will be studied. It will be done mainly from a value-based perspective and by considering the pricing processes involved. The settings studied differ from the one studied by Dutta et al. (2003) by their nature of value creation. The two settings are distinguished by having slightly different value creation characteristics but also, as this paper argues, face a slightly different pricing process setting. Each section reviews theoretical descriptions of pricing practices in the particular setting but also utilizes examples from one case firm. Thus, within its business the single firm displays two different types of value creation and, in association with these, two different types of pricing settings.

The studied firm, headquartered in Europe, is one of the major players among a number of semiconductor firms supplying combined hardware and software solutions for consumer electronics OEMs. Most of the firms in this section of the industry have a focus on the design and development of products and are mostly fabless, although they still depend on the characteristics of the industry inherent from semiconductor manufacturing. The studied firm has several development sites and serves customers from all over the world.

The case firm combines two different types of value creation to generate its customer offerings and thus works in two different pricing settings. The first type of value creation is related to generic products in business-to-business. In that sense it does not differ significantly from the settings studied by Dutta et al. (2003). However, the firm acts in a fast-paced industry with substantial, but quickly eroding, innovation premiums. The first price setting therefore considers pricing processes related to the pricing of technologically innovative products with a temporary monopoly character.

The second price setting is characterized by value created by adapting, or customizing, the generic products to customer specific needs and demands. This is thus another, but very different, monopoly pricing setting with barriers of entry that are often created over longer periods of time through long-term customer relationships. Dutta et al. (2003) capture some of these aspects in their study. However, by applying a value creation framework in order to identify different settings in which pricing processes appear, this chapter provides additional detail to the perspective of pricing capability as a process. Although a single firm is studied, the two settings as described above are substantially different in their value creation character that, as will be shown, also influences the pricing processes.

Therefore, although it is a single firm, the empirical part of this study consists of two cases depicting two different pricing settings due to the value creation character.

The differences between the two pricing settings will be outlined through a theoretical review of value creation types and pricing approaches in association with these. Examples and descriptions from the case firm will help to clarify the character of pricing in the settings and the particularities of the processes. This paper is empirically based on a case study. Studies of the firm were done as an observing participant (Alvesson, 1999) over a period of more than two years, which has enabled closeness to the firm (cf. Brundin, 2007). Observing as a participant was made possible through working with a corporate group that provided support to the majority of the firm's business areas in fields such as business planning, pricing and strategic analysis.

## **Findings**

### ***Fast-paced innovation and pricing***

The first pricing setting of this chapter deals with innovative contexts where value perishes rapidly over time. The setting is largely similar to what is described by Dean (1950): a monopoly pricing setting where innovation price premiums are created by the design and introduction of innovative products. However, here the prime focus is on the changes in the products and not whether the products are radically new or not. For instance, the case example in this section comes from an industry where products fulfill the same type of market needs over time but where the main features, due to the fast technological pace, evolve very rapidly from one product generation to the next.

When applying pricing with value-based features in association with innovation, we can distinguish two (non-exclusive) approaches, in accordance with value definitions. The first adheres to the concept of value in use (Smith & Nagle, 2005; and see also acquisition value in Thaler, 1985). The process of new product pricing in association with value in use is described, for instance, in Bernstein and Macias (2002), who through a case study outlines the customer value research involved in such activities. Customer value (value in use) studies are particularly important for new features or new use cases where the price sensitivity of the customer is hard to determine (cf. Nagle & Hogan, 2006).

The second approach is closely intertwined with environments with fast-paced new product introduction (cf. Nagle & Hogan, 2006) and relates to market value and, more specifically, the reference value which forms a basis for distinguishing economic value. Fast paced innovative environments is characterized by players who adopt a semi-structured, rhythmic, time-paced transition process (Brown & Eisenhardt, 1997, 1998). This rhythmic behavior is proposed to be related to three types of internal or external adaptations. The first has to do with the interaction between staff with a focus on future orientation and those focused on current development. Rhythmically paced transitions enable these to interact

in an efficient manner and balance changes with established ways of working. The second is that the rhythm enables work to be paced and thus creates a smooth flow in activities. The third reason is that the rhythm arises in association with external factors. This may, for instance, correspond with market cycles and timing of market windows or the overall pace of the industry. Thus, pacing related to external factors may depend on adaptation to an external technological rhythm, but it might also be related to the rate at which the market can absorb innovation.

One of the prime examples in Brown and Eisenhardt (1998) is how Intel works with time pacing. They discuss how Intel have enabled and adjusted their pace to stay ahead of competition and in line with market demand and absorption of innovation. Intel did this through time-paced innovation of products, time-paced investments in production facilities and alignment of complementor pacing. Time pacing (Brown & Eisenhardt, 1998) requires a proactive approach rather than the reactive alternative of event pacing. The most recent example of Intel product development time pacing is the Tick-Tock model where every other year sees a change in process architecture and process node reduction, respectively. An industry colored by such “pacing” of innovation follows a path that can be predicted with some accuracy. It is important to note that the innovative pace in this example also encompasses continuous (or rather incremental, stepwise) change in existing product lines. Thus, the innovative pace does not necessarily generate new type of products or expands the industry or user targets. Rather, the fast innovative pace is a necessity in order to keep up with continuously increased feature demands from customers or increased feature or technology competition in existing product areas.

Rutherford and Wilhelm (1999) describe how future market prices can be forecasted on fast-paced markets by studying key feature development and price erosion on the notebook market. They propose a three-stage process. The first phase relates computer prices to main features during a time period. Phase 2 quantifies how feature evolution affects market value, and phase 3 applies these findings in order to forecast a competitive selling price with a specific set of features. Applying such a forecast for decision making is, of course, only valid when the industry is not subject to disruptive innovative changes (Christensen, 1997), which may alter the importance of the specific features but follows a pace as described above. However, the approach shows how on a market with a fast but predictable price and feature development the market reference value can be forecasted.

The approach as described by Rutherford and Wilhelm (1999) is associated with new product development or continuous refinement of existing product lines, whereas Bernstein and Macias (2002) include market innovation aspects that require deeper understanding of customer adoption and expected customer value in use. Depending on the situation, key inputs to pricing decisions rely on these value assessment processes. But the value creation process also depends on these value assessment processes as they can provide input to investment decisions. Furthermore, pricing decisions are most often not just taken the moment before introduction but are the result of a long iterative process in which they also must be considered in the light of other products in a portfolio and their timing (cf. the

decision problems in Moorthy & Png, 1992). Thus the value creation and value capture process must be executed in parallel. The distinction between them is also difficult, as they rely on the same key input and the establishment of future market value. Therefore, on highly innovative markets the distinction between value creation and value capture processes is much less obvious.

The role of pricing and future value assessment as a key influencer also on value creation could also be seen in the case study of this chapter. The studied firm is one of the key players within a segment of the semiconductor industry. It incorporates hardware and software design but primarily outsources its production. Customers are typically electronics manufacturers who design and produce high technology consumer goods. Firms in the segment in general have a high ratio of R&D-expense-over-net sales, typically close to one third of net sales. Partly, the segment follows similar industry pacing as the Intel tick-tock example above due to similar semiconductor manufacturing dependence.

During the period in which I studied the firm, an attempt was made at estimating future market value based on feature development and price erosion. This provided a very different picture compared to the cost-based models used previously in the firm. It revealed significant price premiums at the early stages of upgraded feature levels in the market, which then eroded quickly. But it also revealed that products needed to be balanced with regard to feature innovation and cost efficiency. This balance had to be pursued in order to capture the initial premiums but also to survive long enough in the market to reach payback levels. This showed a market that required a different approach to research and development than currently employed. The value studies, as a key part of the pricing planning, were central to revealing this.

This setting also involves a certain level of uncertainty due to future orientation. The uncertainty comes from the fact that the market is changing at a rapid pace. If it was sufficient to assess value at the time of launch, this would not be a problem; but in these settings, value assessment, as well as strategic pricing, must provide guidance long in advance, from an external price changing perspective as well as in the form of guidelines towards value creation processes.

From a pricing capability perspective, this case illustrates the importance of routines related to tracking competitor prices (cf. Dutta et al., 2003), and how competitor products change over time. But as discussed above, in the specific setting these routines also involve forecasting of future market prices in order to estimate future product pricing (cf. Rutherford & Wilhelm, 1999) and revenue levels.

### ***High levels of customization and pricing***

Pricing literature and discussions on value most often relate to products or services that are of a generic and repeatable character. In particular, the product perspective on value dominates the discussion. And for many firms, in relation to pricing, it is highly important that they are able to move towards value-based pricing (as promoted in Hinterhuber, 2004, 2008a, 2008b). However, for firms with a high level of customization in their deliveries, a substantial share of customer

value will be generated by adaptation or design to customer unique demands and requirements. Phillips (2005) has covered this area of pricing to some extent. But his discussion primarily revolves around limited customization of products, which includes a bidding process between competing suppliers, not higher levels of customization depending on longer-term relationships.

Therefore, the second pricing setting that will be considered is the one where value is created in close interaction with customers through iterative customization processes. Such value creation settings can be found in association with professional services, such as consulting services, but also in industrial business-to-business contexts. Descriptions of the character of such a value creation setting can be found, for instance in Stabell and Fjeldstad (1998) where shop logic value creation deals with customization to unique customer problems. In such settings, problem-solving activities drive the allocation of resources. The interaction of the firm with the customer for which to solve a problem is cyclical and spiraling (Stabell & Fjeldstad, 1998), which affects how the capabilities of the organization will evolve.

Whereas industrial organizations most often are associated with the value chain (Stabell & Fjeldstad, 1998), professional service firms are associated with the value shop (Stabell & Fjeldstad, 1998). The value chain is a configuration of activities in a chain-like fashion whereas the value shop consists of an iterative sequence of diagnosis and solving of a customer's problem, and thus the customization of a delivery to a customer's specific needs. A high level of customization is consequently a key characteristic of professional services (Løwendahl, 1997). Industrial organizations, on the other hand, are traditionally associated with their ability to standardize in order to enable economies of scale through repetition. But customization can be an important feature of an industrial organization. In fact, this is not a new phenomenon. Customization has always been significant on industrial markets (Spring & Dalrymple, 2000).

The character of value creation in this setting, and especially the close customer interaction, affects pricing activities. Dawson (2005) emphasizes the importance of customer relationships in relation to value-based pricing as value-based pricing strategies often require a certain level of mutual trust in order to gain insights into the value effects for the customer. In turn, client relation based strategies often rely on individually based long-term interactions (Løwendahl, 1997). The project orientation that can be associated with professional service firms can also be found in industries with a similarly high level of customization. Thus, other firms, such as construction firms, have similar pricing situations.

For further insights into the contrast of pricing depending on a shop value creation model, I will initially turn to professional service firms, such as consulting firms. In consulting industries it is not unusual that pricing utilizes cost plus models based on hourly rates. This enables certain flexibility in problem-solving situations where the exact time required to solve the customer problem may be hard to estimate. Time and cost pricing is a common pricing method for professional services (cf. Dawson, 2005). It is thus a cost-based approach directly related to the prime resources applied in professional service delivery – human resources.

Time based charging is also often the underlying principle of setting price levels for fixed fees or they may appear in combined models together with fixed fees (Dawson, 2005). Dawson (2005) also mentions commission models, retainers and membership fees as common models. Retainers and membership fees are typically applied in order to access information and knowledge services.

What are then the consequences of applying value-based pricing on consulting or other shop logic value creation settings? When viewing the price setting situation from a value-based perspective, it is important to separate between different parts of the value creation process and the value delivered. Interaction between customer and supplier typically starts off by identifying a problem to be solved through a pre-study. After that, a first agreement is made, which includes a compensation target for the supplier for solving the problem. This first phase, which in itself creates customer value (compare consultative services for product selection in Hinterhuber, 2008a), is the one that has the strongest iterative character. The value of this initial process is partly overlooked by, for instance, Weiss (2002). For consultative services associated with product choices (DeVincintis & Rackham, 1998; Hinterhuber, 2008b with references to Corey, 1989), this phase may very well be prominent. The next stage is the execution phase (see approaches to value-based pricing for these processes in Weiss, 2002). This stage also requires close interaction (cf. Løwendahl, 1997) as it revolves around problem solving together with the customer. The iterative character of both of the phases increases the intertwinement between the internal price setting process and the price setting process towards the customer. This tendency becomes especially clear if a value-based pricing approach is applied.

In the case firm of this study, a substantial part of the value created was customer specific, resulting from adaptations and customizations of the generic products to customer and project specific requirements. Such adaptations could be far reaching and encompass hardware as well as software parts of deliveries through unique designs and redesigns. Most often these parts of deliveries involved working very closely with customers, sometimes at the customer site. The firm struggled with the pricing of these efforts and, especially, with making the value of them explicit and pricing them accordingly. In many cases the firm relied on cost-plus models based on the human resources involved, not unlike the setup in many consulting firms. But in several instances, the inability of making value explicit and communicating it to customers lead to the firm not charging for the efforts but giving it away as part of the generic product offering.

From a value-based perspective, this case illustrates a business-to-business setting where uncertainty in value assessment is high due to the iterative and uncertain character of the final delivery. The setting is a prime example of shop logic value creation due to its high levels of customization and the iterative problem solving with customers. This setting makes cost estimation and value estimation difficult. Reference value assessment is especially difficult due to the absence of competitor deliveries for customer unique deliveries (Johansson & Andersson, 2012). Rather, the supplier has to focus on estimating future value in use for the customer. Such exercises will partly be estimates depending on the level of

information available from the customer. They will also be estimates due to the future orientation of value as described by Hinterhuber (2008b).

## **Conclusions**

The concept of pricing capabilities is highly important as it helps clarify the importance of organizational processes and routines of an organization in association with pricing. Thus, the concept also helps us make sense of and address the fact that pricing activities are associated with internal and external costs that need to be managed by the organization.

A common factor which influences the character of the pricing processes for both of the settings discussed in this paper is the reliance on value assessments. If the firm predominantly relies on cost-based pricing, the pricing process may be able to act on data, which to a larger extent is available *ex ante* (this of course depends on the reliability and variation over time of cost estimates). However, if a firm adds a value-based perspective, this influences the character of the pricing process significantly, as the pricing process is intrinsically linked to value assessment (cf. Dutta et al., 2003; Hinterhuber, 2008b).

The two pricing settings discussed in this paper are different from the setting studied by Dutta et al. (2003), and this influences the nature of pricing processes. In the first price setting, the pricing process is largely similar to that as described in Dutta et al. (2003), but it is more difficult to clearly separate the pricing process from the value creation process. In the first case discussed above, it is shown how changes in pricing activities led to clearer establishment of future market value estimates. Thus, pricing activities, processes and routines drive the establishment of future reference value. But such estimates also become crucial for value creation activities as they set the framework also for cost levels, given that a certain level of profitability is pursued. Therefore, the pricing process, with future reference value assessment as a core capability, is of generating a key input to the value-creation process. This is a matter that is not explicitly dealt with in Dutta et al. (2003).

In Dutta et al. we see how the process of establishing reference value and customer value is driven by the pricing function. These activities extend into sales, engineering and product development functions in order to collect and evaluate data. Thus, defining value levels is indeed driven by the pricing process and, thus, a part of the pricing capability. But, as the first case shows, in fast-paced industries this capability will continuously set the framework for value creation processes. Value creation does not take place ahead of value definition. But rather, these two interact iteratively and pricing processes provide vital input to value creation decisions.

In the second pricing setting where the value creation process is iterative, the pricing process is also increasingly iterative and intertwined with the value creation process. Price setting authority is also more local due to the close relationships required for value assessment and creation. Thus, although Dutta et al. mention the iterative interaction between the internal and *vis-à-vis* customer processes,

they also mention that the internal process precedes the vis-à-vis customer process in a price change sequence. In the second described pricing setting, the two processes as proposed by Dutta et al. are very closely interrelated due to the focus being mainly on customer-specific value creation and not on customer-generic value creation. Thus, there is limited input to the pricing process *ex ante* (except for some cost bases, such as labor costs for consulting services). This is particularly the case for value estimates.

Practitioners should recognize that pricing should play a leading role in these settings. The pricing process must not only certify that the right price is set, but also that value assessment provides the correct basis for value creation processes. Independent of whether value assessment is seen as part of the pricing process or not, pricing is likely (as shown in the above examples and the literature) to drive the development of value assessment. Still, it is not just value assessment that provides a framework for value creation efforts. Rather, several other aspects of the pricing process must be involved, such as the overall pricing strategy and pricing policies, in order to establish the revenue potential and, thus, the direction of value creation (see the emphasis on market strategy and tactics in association with value-based pricing practice in Anderson et al., 2010). Therefore, a pricing process depending on value-based pricing efforts must be initiated in advance of or closely interact with the value creation process from its beginning. It will, in these settings, have to be pro-active vis-à-vis value creation in order to manage uncertainties related to value assessment.

### **Implications for the pricing field**

Both of the pricing settings discussed in this paper require pricing processes that enable working proactively with pricing as well as in interaction with value creation processes. Thus, in the discussed pricing settings we need to challenge clear distinctions between value creation and value appropriation (cf. the distinction in Mizik & Jacobsson, 2003), here with a particular focus on pricing. Furthermore, the concept of pricing capabilities as proposed by Dutta et al. (2002, 2003) is important in order to put focus on the processes, routines and systems that the organization depends on for its pricing activities. However, it is also important to view pricing processes in relation to value creation processes in order to uncover various types of processes and to identify their interdependencies and interaction. For instance, in one of the pricing settings discussed, the internally and customer-oriented pricing processes were closely intertwined due to the single customer, high-level customization value creation character.

The findings in this study should be recognized by academics as an opportunity for future research. Future research should continue to study pricing processes from a capability perspective in various value creation settings in order to increase our understanding 1) of how pricing processes diverge between various settings and 2) what pricing process aspects can be considered as generic and contribute to creating a more consistent basis for the definition of pricing capabilities. Further research should also consider the explicit role of value assessment from a capabilities perspective (cf. Johansson et al., 2015).

## Implications for innovation in pricing

This chapter illustrates the vital role of pricing processes in the organization. It shows how pricing processes must be proactive versus value creation and actively drive the incorporation of external and internal perspectives as a spanning process (cf. Day, 1996). Thus, this chapter emphasizes the strategic importance of a firm's pricing capability.

Practitioners should therefore recognize the need to build processes and routines that support a proactive role of pricing. As illustrated, this is crucial in fast-paced industries in order to estimate future market value and establish pricing guidelines for future products (or updated products), and thus lay the foundations for future revenue estimates. It is also fundamental for firms that provide highly customized solutions in order to provide continuous assessment of value in use. Capabilities should be built so that pricing functions and activities are enabled to play a more active role in order to support value creation activities. This means that pricing must take a long-term view. Organizations should focus on the ability to assess future value and provide pricing guidelines at an early stage in relation to value creation activities and on the ability to interact with ongoing value creation activities.

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# 14 Pricing due diligence in the mergers and acquisition process

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and Vernon Lennon*

## **The case for change**

Historically, the Mergers and Acquisition (M&A) process is undertaken primarily to grow inorganically or to achieve investment returns. A financial valuation of the target acquisition is completed by the acquiring business in order to determine an acceptable purchase price for the entity. The process used to develop the business valuation is meant to bring clarity and visibility into the expected financial synergies and strategic advantages of the new entity. However, failure to achieve the investment returns expected at the original acquisition event according to the financial valuation occurs frequently (Straub, 2007; Pautler, 2001). To make matters worse, a combination of incomplete, insufficient or incorrect assessments of the target business will increase the likelihood of missing investment expectations. Due to the frequent limits on time and data access during the due diligence process, along with the high level nature of the valuation, many acquiring firms miss their chance to investigate a potential arbitrage generated from a more detailed understanding of the target business' strategic pricing practices and organization. A more rigorous assessment of a target company's pricing capabilities and the associated improvement opportunities can substantially sharpen the enterprise valuation and the subsequent value capture from M&A.

Just as with company-to-customer transaction pricing, the M&A process positions buyers and sellers at opposite sides of the negotiating table. Successful deals are accomplished when common ground is found between buyer and seller and both parties leave the process satisfied. Harnessing improved "purchase price" information about the target company in an M&A process through a comprehensive understanding of pricing capabilities provides the seller an improved position in the valuation discussions. The buyer, on the other hand, can achieve faster acquisition synergy realization using a comprehensive pricing improvement program.

Little research has been published on the assessment of a business' strategic pricing capabilities during the M&A due diligence process, and there is subsequently no detailed guidance on how the evaluation of a company's pricing capabilities should inform the financial valuation of the business. This chapter will directly address both of these gaps with a clear and concrete pricing capabilities assessment process that effectively measures a company's strategic pricing

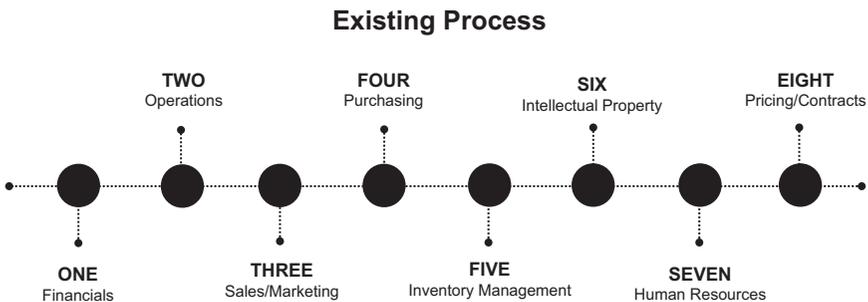
capabilities and specifies how the results of the assessment affect the enterprise valuation of the entity. A brief review of the traditional M&A process will highlight specific information and process arbitrage opportunities. Then a detailed approach for pricing will be elaborated, including how the results of the assessment alter traditional cash flow entity valuations.

### Typical M&A due diligence process

While specific due diligence does not occur until late in the acquisition process, it is arguably the most important part of the “deal.” The due diligence process begins immediately following a Letter of Intent (LOI) and usually includes a large information and data request. The large information request tends to extend the due diligence beyond the typical LOI 60-day timeline, but an unprepared seller can also produce data and reporting examples that are insufficient for the buyer.

The detailed analysis of the financial and operating levers of a target business leads to a valuation by both the acquiring company and the acquired company. In order for a deal to consummate, these two valuations need to be reconciled at the negotiating table. Buyers use their due diligence to produce an internally acceptable valuation for negotiations. Sellers build their valuation through their detailed understanding of the “day-to-day” business. The “day-to-day” operations, such as manufacturing, distribution, sales, marketing and, most notably in this discussion, pricing, can collectively provide tremendous insights for both buyers and sellers into operational efficiency and future earnings. The quick turnaround time in an M&A process and the usual desire for rapid closure, often leave real information gaps in the buyer’s analysis of the target’s “day-to-day” operations. This produces a potential arbitrage event in which the seller understands more about operational competencies than the buyer, but the arbitrage can be closed by the buyer if pricing capabilities are accurately assessed.

The major areas analyzed during the traditional due diligence process are shown in Figure 14.1.



*Figure 14.1* Due diligence – existing process

Several of the traditional due diligence areas yield potential questions to address for their impact on pricing strategy and realization.

- **Financials.** The perennial trio of financial statements (balance sheet, income statement and cash flow statement) and a detailed review of accounting practices are the first pieces of information passed between seller and potential buyer. Questions to address:
  - Is the financial data aggregated at too high of a level for pricing analysis? *E.g. Information captured at the ship-to level by SKU level allows for significantly more modeling and opportunity to capture pricing improvements.*
  - Can underlying drivers of financial performance be clearly identified? *E.g. Tracking mechanisms, financial reason coding and underlying detail to substantiate assumptions.*
- **Operations.** Considered the next most important area, operations covers all of the major manufacturing and distribution processes of the target entity. Questions to address:
  - Is the operational information available, detailed, include a statistically significant length of history captured and easily assessable? *E.g. What information is captured, what information is missing, how can it be obtained and quantified.*
  - Are the right operational metrics being monitored to understand the profit impact of manufacturing and distribution decisions? *E.g. Are the metrics, as currently measured, being utilized to improve the overall go-to-market processes.*
- **Sales and Marketing.** An in depth understanding of the size and quality of the commercial team, along with Marketing's ability to campaign appropriately, is necessary to predict future channel competencies. Questions to address:
  - Are sales and marketing performance metrics being tracked at granular levels of individual offerings, sales personnel and customers?
  - Is the information utilized to impact future performance plans?
- **Intellectual Property.** IP is critical to assessing competitive advantage and value extraction for an organization. It is also important to align IP with market value perceptions. Questions to address:
  - How does the existing and pipeline IP reflect future customer needs? *E.g. Is the forecasted IP competitive advantage used in creating customer value models?*
  - Does the existing and pipeline IP focus on specific function and service needs that customers are willing to pay?

- **Contracts and Pricing.** Price is the quantified and captured perception of value in the marketplace; price capture goes far beyond just price setting. Questions to address:
  - How many FTEs in the organization are dedicated to contract management, price setting, price deployment and have price influence? *E.g. Where are the pricing functions held within the company and are they solely dedicated to pricing or is the function merely a checkbox?*
  - How does this compare to the number of dedicated purchasing resources?

From the answers to the above questions, pockets of missed opportunity and limited information clarity often arise regarding pricing capability and pricing performance within the major areas of due diligence. Undertaking a due diligence approach more focused on pricing capabilities generates potential value arbitrage and enhanced synergy realization.

### Revised M&A due diligence process

Recommended adjustments for each due diligence area and the addition of a strategic pathway to excellence area together can collectively enhance the overall valuation of a business (Figure 14.2).

- *Financials.* While a significant amount of time during due diligence is spent analyzing the financial information of a potential acquisition, often the level of granularity is not sufficient to truly reflect how well the company is operating. Hidden within the lower levels of product and customer specific activity, buyers will often find information suggesting that large amounts of capital (dollar, human, operational) are often spent chasing transactions providing negative or little return. With the proper analysis, such as the use of price waterfalls and profit leakage reporting, a buyer can understand where the “bad” business is occurring, where proper resources are being used on

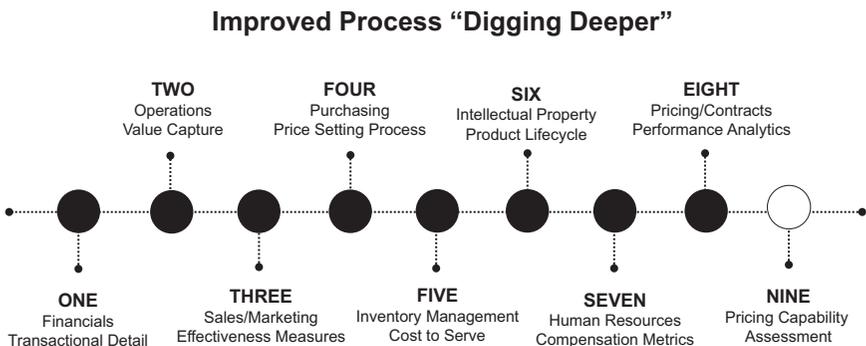


Figure 14.2 Due diligence – improved process “Digging deeper”

“good” business and plan for a product and customer rationalization process to begin shortly after deal closure. Doing so will not only enhance the future value of the acquisition but will also lead towards a better understanding of pricing captured during the product lifecycle and the impact of customer turnover.

- *Operations.* It is not enough for an investigating business to digest the portfolio of products or services, embrace new products in the pipeline or fully understand the channels utilized in customer fulfillment. A true picture of the targeted “go to market” approach is necessary in order to ensure that the right decisions are being made about “what” to sell to “whom” and “when.” Buyers need to drive toward a full understanding of operational value capture and ensure that offer pricing is matched to the value within each situation. “Churn” analysis is a great way to interpolate the influences of customer retention and price/volume into the reporting hierarchy as a means to better understand operational efficiency.
- *Sales and marketing.* A key driver often missed in the due diligence dissection of the commercial team is sales force effectiveness.
  - Usually blunt performance measures, such as revenue dollars and gross margin percent, are the primary yardstick for comparing regions, territories and salesperson competency. While these are solid metrics to start the dissection process, they do not tell the buyer enough about the competency of the commercial team to truly affect the final valuation. First, no real measure of effective discounting is analyzed to fully understand how relative behavior is impacting top and bottom line results. Secondly, no profitability metric is measured that allows for a proper comparative analysis. Without this, regional pressures, product mix and competitive disadvantages can be lost in looking at the higher-level metrics alone.
  - There is, however, a single metric that encapsulates both differential profitability and discounting behavior, although it is infrequently used by buyers in the due diligence process. “Price realization” is the measurement of a settled price compared to the initial target price for each particular pricing event. When strategic pricing is embodied by an organization, this metric can be used to derive an “apples to apples” comparison across products, geographies and even salespeople, resulting in a true assessment of commercial competency. Of course, price realization measurement is highly dependent upon an effective net price setting process.
- *Purchasing and vendors.* Given that the “buy side” of margin plays as critical a role as the “sell side,” understanding the Product Management team’s approach to the pricing process can tell a purchasing organization much about the transfer of value within a prospective target. This understanding coupled with how supplier-pricing practices are paired with internal-pricing practices provides a picture into future margin gaps and opportunities. Often lost in the due diligence process is an understanding of how product managers set price.

Recognizing where different price methods are used (cost plus, market based, value based), along with understanding how they are managing the pricing of their full product spectrum, has a large impact on top and bottom line results.

- *Inventory management.* Transactional “Cost to Serve” and “Contribution Margin” are two key metrics that can enhance the dissection of inventory management practices at a potential target firm. Ascertaining initially if, and then to what degree, these two concepts are being employed can impact valuations by offering further insight into operational effectiveness.
- *Intellectual property.* Current and future intellectual property pricing is another area where a purchasing organization can find arbitrage in the due diligence process. The proper use of product lifecycle management along with competitive normalization (how to compare one product to competing offerings) reflects a firm’s value management protocols. When done well, the higher margins early in the product lifecycle of one product can be replaced as newer and more advanced products come online. The management of this cycle not only maintains margin consistency, but also strengthens customer value perceptions and their “willingness to pay.”
- *Human resources.* The key valuation area within Human Resources is the compensation criteria for all of the different operating areas of the firm. Variable compensation metrics that are based upon revenues and margins alone neglect the focus on profitability that is needed for all levels of the organization. Furthermore, these same profitability measures are often only enabled at the highest levels of a target firm and also tend to be aggregated. Offering these same drivers to lower levels of the organization and reflecting them through concepts such as “target price” and “price realization” measurement will influence all levels of an organization to focus on profit management.
- *Contracts and pricing.* Understanding a target firm’s approach to price management at a tactical level is another way to influence valuations and find potential arbitrage. Analyzing whether price changes have been made in broad sweeping cuts, based upon vendor cost increases only or if a more strategic and tactical approach has been taken, once again offers insight into true value extraction. While the analysis here is of great value in the due diligence process, it is often neglected due to time constraints and resources required.

Sufficient data is needed to effectively complete a detailed pricing analysis and derive a proper understanding of price competency. Unfortunately, the due diligence process does not always allow for the time necessary to complete these protocols, and target firms do not always have the proper data prepared. A process for pricing that generates quantifiable insight into a target firm’s pricing competency while not overburdening the due diligence process is described next. This approach reduces the time necessary to complete the transactional analysis, while simultaneously providing a tool with a high degree of correlation for prediction and understanding of a seller’s capabilities.

## Strategic pathway to excellence – introduction

Practitioners undertaking a capability assessment during due diligence must conduct the assessment with limited data access and the time constraints previously referenced. As a result, the diagnostic techniques for use during M&A due diligence and elaborated below are intended to be objective, unequivocal and based on an arms-length perspective of an enterprise's full pricing function and strategy.

A more data-intensive capability assessment is certainly recommended after a potential entity has been acquired. Although the outcome of an assessment for an owned business is primarily the same – to identify, validate and quantify the pricing improvement potential for a business – the specificity of the outcome will increase when presented with full access to customer, offering and transaction detail. Pricing improvement opportunities for an owned-business will become customer-, market- and offering-specific, while those for an acquisition target after due diligence are usually concrete but not as individualized.

The five components of the process for pricing in the due diligence process are: (Figure 14.3)

- 1 Overall Strategic Clarity
- 2 Market Pricing Intelligence
- 3 Transactional Pricing Management
- 4 Price Performance Measurement
- 5 Pricing Organizational Alignment

Upon completion, the capability assessment included in this process will highlight significant areas of improvement opportunity for the target and, more importantly, inform a better valuation of the enterprise.

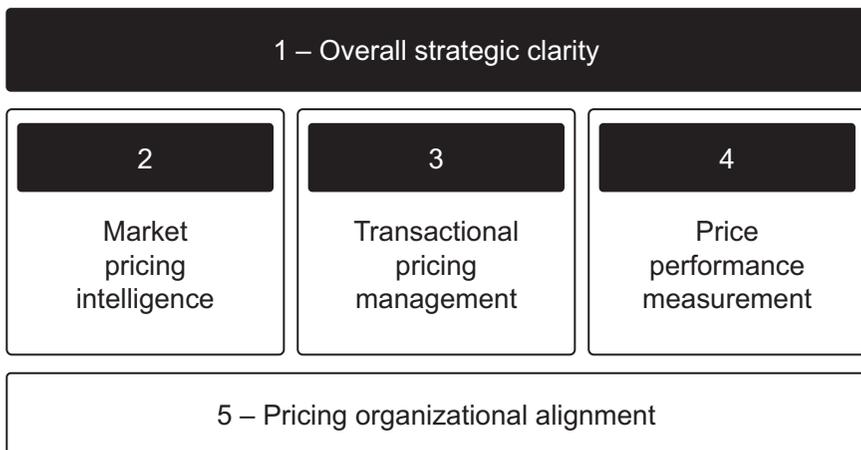


Figure 14.3 Strategic pathway to excellence for pricing

**(1) Overall strategic clarity**

The first component of the process is an evaluation of how well the business knows its own overall pricing strategy and how clearly it can articulate that strategy across the markets, customers, products and services it sells. This is an important foundation to strategic pricing execution because it sets the general direction for the business to follow for a wide range of areas, including product development, sales force compensation, key performance indicators, account lifecycle management and customer communications.

General pricing strategy occurs typically in only three broad varieties – premium pricing, lowest price position or competitive parity. However, similar to other aspects of pricing execution, the tactical implementation of each flavor has a wide variability. A premium price provider, for instance, may at times need to be the lowest price provider to enter a different geography or industry segment. A lowest price provider may actually price a new technology or new service offering at a premium price level in order to specifically protect the value of its intellectual property or first-mover advantage. Best practice pricing does not require an unflinching single price position. On the contrary, best practice reveals that pricing strategy can be quite malleable in the presence of compelling market-based reasons to change. For example, wide and intended variation in the market price positions can be seen in the products from GE Healthcare, a typical price leader, across its developing markets. Also, targeted price promotions, used to fill expected low yield periods, can be seen from usual high price providers, like Disney Resorts and many luxury cruise lines.

The assessment of a target's Strategic Clarity during due diligence does not, therefore, evaluate whether the business has selected the “correct” flavor of pricing strategy. Instead, the assessment is how accurately a business can describe its pricing strategy. A company's leadership should always be able to explain, document and demonstrate the company's pricing strategy in total and the variation of that strategy by commercial segment. And once management provides a pricing strategy, it should match the offer positioning and commercial actions of the business under review.

For each component of the process, a series of diagnostic questions will be suggested. In addition, a recommended approach to conducting the assessment of each component will be offered.

*Diagnostic questions for strategic pricing clarity*

- 1 What is the overall pricing strategy of the business? *E.g. Cost plus, competitive match, market reactive, value-based pricing.*
- 2 How does the description of the pricing strategy vary across the senior team? *E.g. Is the entire executive team aligned on the strategic vision for pricing?*
- 3 Is the pricing strategy specifically documented in the company's strategic plan?

- 4 Is the price-position well defined for every offering by segment relative to competition?
- 5 How does this strategy vary across markets, products and services?
- 6 How is the pricing strategy reflected in the company's external literature?

*Assessment process for strategic pricing clarity*

- 1 This component of the assessment is best undertaken in person with the target company senior leaders. The diagnostic questions should be posed and the answers documented during a meeting with the business. Ideally, this meeting includes the company's sales leader, the marketing or product management leader, the CFO (or equivalent), the CEO (or equivalent) and the COO (or equivalent).
- 2 A review of the company's external collateral should also be completed. This would include marketing brochures, company website collateral, company online social media postings, company press releases and any other published materials from the business.

An assessment of a company's Strategic Clarity during due diligence highlights improvement opportunities when there is ambiguity or inconsistency in the pricing strategy. In these cases, the commercial side of the organization lacks a coherent pricing position and will consequently price products and services inconsistently. The scatter plot of a company's net price versus volume that often shows pricing "all over the map" is one important symptom of a business with little Strategic Clarity. Articulated pricing strategy that is inconsistent from a strategic plan to the opinion of a senior leader to the printed collateral of business is another sure sign of limited Strategic Clarity.

Best practice for a company is to have a well-documented pricing strategy that is consistent in both its internal and external communication materials. For example, a premium pricing strategy should be reinforced by internal company documents that specify higher new product launch prices, more aggressive annual price realization targets and explicit competitive responses. A premium pricing strategy should also be reinforced by external collateral that highlights a company's high-end service reputation, its unrivalled financial returns for customers and the wide breadth of its offer selection.

Companies that are judged to have a high degree of Strategic Clarity in their pricing will not have any substantive improvement opportunities in this area, and there will be no impact from this assessment component on their valuation. Conversely, companies that are evaluated with little or no Strategic Clarity in their pricing should have their future enterprise value adjusted. Future value will be higher by an annualized +1 percent improvement to sales if the Strategic Clarity can be improved. If there is no expectation to improve the Strategic Clarity for a business with a low assessment, then the future enterprise value should be discounted by -1 percent overall. The application of a valuation discount is particularly important for a business where the overall market historical average unit pricing trend has been negative.

## **(2) Market pricing intelligence**

The second component of the process investigates how much data about the company's market is collected, analyzed and utilized to make pricing strategy and tactical decisions. "Market" here is defined as all of the factions external to the business that actively participates in the marketplace where the business manufactures and delivers its offerings. This wide definition of external parties encompasses end-use customers, resellers, competitors, suppliers and channel partners, such as distributors. There is a wealth of information available from these assorted players that can materially impact pricing strategy and execution. A business that effectively manages the collection and processing of the information from these sources and then proactively uses the insights to drive company pricing behavior is a business poised for pricing success.

There is more often too much market information surrounding a business than too little. Even though perfect market price information is rarely found – competitor pricing exactly aligned by the business' own SKU numbers or end user willingness to pay by transaction type – rich sources of customer, competitor and vendor pricing inputs abound. For instance, most companies have details embedded in their sales pipeline tracking systems, customer satisfaction surveys, quarterly account reviews and industry trade reports. Moreover, the collective institutional wisdom of the commercial teams is usually a rich source of information that is often not systematically mined. The amount of information is therefore not the metric to assess. Rather, the sophistication with which a company collects, categorizes and then informs pricing decisions is the intended metric of merit during the due diligence capability assessment.

This component therefore focuses on the cataloging and use of market intelligence data. It assesses an acquisition target's ability to strategically and thoughtfully weaves the various market information sources into a coherent perspective on the pricing landscape.

### *Diagnostic questions for market pricing intelligence*

- 1 Does the business collect, store and analyze competitor pricing behaviors in a central electronic repository?
- 2 Are the reasons for won and lost deals/proposals collected and analyzed? *E.g. Complete quote capture with reason codes: lost based on price, lost based on delivery time, lost based on terms, etc.*
- 3 Is quantitative end-user feedback about benefit and price perceptions used as an input to set prices? *E.g. Are value models created, at an attribute level to show value realized versus prices paid?*
- 4 Is there a quantitative assessment of the value provided by the business' products/services versus the next best alternative(s)? *E.g. ROI analysis.*
- 5 Are commercial segments defined using customer buying behavior distinctions?
- 6 Are suppliers regularly interviewed to identify early market trends?

- 7 Are raw material price changes a key component of price actions and are these changes made as feedstock spot markets move?
- 8 Does the business use pricing tests and pilots to validate opportunities?

*Assessment process for market pricing intelligence*

- 1 Similar to the Strategic Clarity component, the assessment of Market Intelligence is best undertaken in person with the target company's senior leaders. This meeting includes the same participants as the Strategic Clarity discussion.
- 2 A review of the company's win/loss data should be completed. If available, a review of the company's customer-facing ROI analysis or value analysis.

Pricing improvements are available when a company does not collect and analyze their market data in a systematic way. A more effective use of Market Intelligence can lead to increased win rates, higher price realization in targeted segments and product development more suited to end-user customer needs.

The diagnostic questions from this assessment component are intentionally categorical so that they can be answered directly during due diligence. An overall improvement opportunity can be calculated based on the number of "YES" answers provided to the seven diagnostic questions.

- 0–2 YES Answers = Significant improvement opportunities exist
- 3–5 YES Answers = Moderate improvement opportunities exist
- 6–8 YES Answers = Little improvement opportunities exist

Where significant improvement opportunities exist, the company's enterprise valuation should be adjusted higher by an annualized +0.5 percent improvement to sales. Where moderate improvement opportunities exist, the company's enterprise valuation should be adjusted higher by an annualized +0.25 percent improvement to sales. No adjustment should be made to the target company's valuation in the event that little improvement opportunities are identified by the Market Intelligence assessment.

***(3) Transactional pricing management***

The third component of the process examines how well the individual pricing and value variability of each customer and offering combination is executed within the company. Knowing exactly how much price is being realized by every transaction is paramount to knowing where the company can align pricing and ultimately improve profit. An evaluation of a target company's pricing capability during due diligence must include this component.

Transaction-level profitability is defined here as the return from the delivery of a specific product or service to a specific customer at a specific time. While the definition of returns will certainly vary – from simple gross margin to contribution

margin to EBITDA – the concept of capturing the complete revenues and costs-to-serve for a defined product/service and customer combination is robust across segments, industry and geography. It holds for product- and service-based businesses and also applies to both healthcare and information and business service sectors. From individual transactions, a business can determine the profitability for a particular product or service, a particular customer or larger aggregations like segments, product lines or locations.

The ultimate goal is to understand all transactional components and appropriate the costs and margin components correctly to each transaction. The appearance of high margins is often hidden by “below the line” costs or the misappropriation of invoice-level items. Furthermore, contracts with limited compliance discipline are often standard operating procedure for a business and customers can choose when to adhere to guidelines. This further dilutes margin management. This component of the capability assessment therefore focuses on the cataloging, analysis and use of transactional data. It assesses an acquisition target’s ability to build introspective analysis and achieve a clear perspective on their true margins. Without this diagnostic, true margins can be easily blurred and normal KPI’s can be skewed and increase overall acquisition cost.

#### *Diagnostic questions for transaction management*

- 1 Are all direct and indirect costs associated by customer site (and customer master) tracked? *E.g. Cost to serve models based upon layered contribution margin methods: direct, indirect and allocation basis.*
- 2 Do standard reporting tools offer the ability to drill down and track granular changes as a result of price-related functions? *E.g. Transaction P&L, waterfall analysis.*
- 3 Are customer discounts analyzed in comparison to customer performance?
- 4 Are the total costs of support (call center, technical, number of site visits, etc.) of each customer allocated to customer site?
- 5 Is the customer compared on a cohort basis for transactional costs?
- 6 Are salespeople, customers and products measured on price performance?
- 7 Are specific pricing analytics used to evaluate new sales opportunities? *E.g. Comparison to recommendation, comparison to average.*

#### *Assessment process transaction management*

- 1 The assessment of Transaction Management is best undertaken in person with the target company’s Sales leadership, Finance leadership and the IT management team.
- 2 A review of the company’s cost-to-serve approach and reporting examples, if available, should occur.

An overall improvement opportunity can be calculated based on the number of “YES” answers provided to the seven diagnostic questions asked during the due diligence process.

- 0–2 YES Answers = Significant improvement opportunities exist
- 3–5 YES Answers = Moderate improvement opportunities exist
- 6–7 YES Answers = Little improvement opportunities exist

Where significant improvement opportunities exist, the company's enterprise valuation should be adjusted higher by an annualized +1.5 percent improvement to sales. Where moderate improvement opportunities exist, the company's enterprise valuation should be adjusted higher by an annualized +0.75 percent improvement to sales. No adjustment should be made to the target company's valuation in the event that little improvement opportunities are identified by the Transaction Management assessment.

#### ***(4) Price performance measurement***

The fourth component of the process is an evaluation of how well the business measures price performance, reports on the impact of price and reacts to the available tracking measures. The ability to accurately and granularly measure a business' pricing performance is essential to more sophisticated and strategic pricing actions. Assessing a company's price performance measurement proficiency is an important part of the due diligence discovery, since having a detailed understanding of price capture is necessary for a business to make effective and enduring pricing adjustments.

A sound metric to measure pricing performance, such as price realization, is necessary to a business for several reasons. Businesses rarely pay attention to or improve on the things they do not measure. Pricing performance measurement through a small set of pricing metrics also allows for easier identification of improvement opportunities and required midcourse corrections. Finally, a good pricing performance metric can be a powerful organizing force for a business' value delivery. The voice of the customer can be heard in the improvement or deterioration of this quotient as a reflection of their value perception for the goods and services they procure.

#### *Diagnostic questions for price performance measurement*

- 1 Are pricing performance metrics utilized in standard business reporting? *E.g. Price realization (price suggested versus price accepted).*
- 2 Is commentary on pricing performance regularly included in the standard business reporting package?
- 3 Is the impact of price on margin changes readily apparent in financial reports?
- 4 Are price performance metrics and reports distributed to pricing decision-makers? *E.g. sales managers, product managers, contract approvers.*
- 5 Is pricing variability regularly measured? *E.g. price scatters, clouds, price bands.*
- 6 Are pricing performance metrics, forecasts and corrective actions regularly reviewed between finance, sales and marketing teams?
- 7 Is there a quantified pricing improvement metric included in the business' annual budget or operating plan?

*Assessment process for price performance measurement*

- 1 The assessment of Price Performance Measurement is best undertaken in person with the target company's Finance and Sales personnel. This meeting includes the same participants as the Transaction Management and Market Intelligence discussions.
- 2 A review of the price-related reports (customer, product, geography, churn) should be completed.

Accurate price performance measurement helps a business highlight the fundamental drivers of its profitability. Isolating controllable price changes from turbulent mix changes is essential to focus appropriate attention on the company's effectiveness in selling value, negotiating price changes and positioning against competition. For the Price Performance Measurement component, the number of "YES" answers provided to the diagnostic questions during the due diligence process identifies the improvement opportunity.

- 0–2 YES Answers = Significant improvement opportunities exist
- 3–5 YES Answers = Moderate improvement opportunities exist
- 6–7 YES Answers = Little improvement opportunities exist

Where significant improvement opportunities exist, the company's enterprise valuation should be adjusted higher by an annualized +1 percent improvement to sales. Where moderate improvement opportunities exist, the company's enterprise valuation should be adjusted higher by an annualized +0.5 percent improvement to sales. If there is no expectation to improve the Price Performance Measurement for a business with a low assessment, then the future enterprise value should be *discounted* by -0.5 percent overall. This capability is particularly important in high price and long sales cycle businesses where managing the customer lifecycle is of high importance.

***(5) Pricing organizational alignment***

The final component to process appraises the degree to which pricing is cemented in the business as a way of life. The most effective pricing companies make pricing part of their DNA – pricing is explicitly reflected in the commercial team training programs, the incentive structure, the financial reporting regimen and the product development process. The pricing literature supports the importance of organizational alignment to the success of any sustained pricing improvement initiative (Baker et al., 2010; Dolan & Simon, 1996). This last component determines to what degree price performance is an organizing force for the business as well as how advanced its pricing organization currently is by raising a series of questions during the due diligence process.

Well-executed pricing requires the delicate coordination across separate functions of a business. To align the sales, marketing, finance, manufacturing, customer

service and R&D functions in the pursuit of pricing realization, a company must have a top-to-bottom commitment to effective pricing performance. There are simply too many places for pricing implementation to fail, too many systemic biases standing in the way of good pricing performance and too many sources of profit leakage. A company must be properly aligned for its full price potential to be initially realized and then sustained.

Substantive pricing transformation at a company requires sustained management attention to the business' pricing strategy, execution and organization over time (Liozu et al., 2011). As businesses move through the stages of pricing transformation, their pricing function matures and becomes increasingly sophisticated (Hunt & Saunders, 2008). Since the transformation stage and maturity state of the business are critical to pricing performance, the overall pricing improvement opportunity identified during due diligence is sensitive to the organizational starting point of the business. The assessment of the current level of sophistication for a business' pricing organization is therefore a vital factor in determining how much pricing may affect the company valuation.

#### *Diagnostic questions for pricing organizational alignment*

- 1 Is there a defined pricing function in the organization?
- 2 Are pricing responsibilities not assigned to the pricing function clearly documented and assigned to specific individuals in the business?
- 3 Is there a pricing or margin component to sales compensation plans?
- 4 Is there an escalating approval process for net prices based on margin or price realization?
- 5 Is pricing included in sales training, both on-boarding and continuing education?
- 6 Is pricing included in product management training?
- 7 Is there a defined pipeline of pricing improvement initiatives categorized separated into short- and long-term opportunities?
- 8 Is there regular communication to the organization on the business' pricing performance?

#### *Assessment process for pricing organizational alignment*

- 1 The assessment of Organizational Alignment is best undertaken in person with the target company's senior leaders. This meeting includes the same participants as the Strategic Clarity and Market Intelligence discussion.
- 2 A review of the documentation about the pricing function including organizational charts, roles and responsibilities should be completed.

Pricing improvement opportunities will be limited without the presence of strong organizational alignment assessed during the M&A due diligence process. For this component, the number of "YES" answers provided to the diagnostic questions listed provides insight into both the company's current pricing function and

its ability to execute sizable improvement initiatives in the future. The measure of current organizational alignment along with the receptivity to future improvements together will drive the overall pricing improvement opportunity estimate.

- 0–3 YES Answers = Significant improvement opportunities exist
- 4–6 YES Answers = Moderate improvement opportunities exist
- 7–8 YES Answers = Little improvement opportunities exist

Where significant improvement opportunities exist, the company's enterprise valuation should be adjusted higher by an annualized +1 percent improvement to sales. Where moderate improvement opportunities exist, the company's enterprise valuation should be adjusted higher by an annualized +0.5 percent improvement to sales. No adjustment should be made to the target company's valuation in the event that little improvement opportunities are identified by the Organizational Alignment assessment.

### **Aggregating the components**

The five components of the process each generate potential adjustments to the overall enterprise valuation. At the conclusion of the assessment, the practitioner needs to total each individual adjustment to achieve an overall price premium.

The price premium, in turn, is calculated as the sum of the individual component adjustments to the traditional enterprise valuation. This also includes the range of potential valuation adjustments associated with each component of the capability assessment. At the end of the assessment, a significant change to the target business sales trajectory and overall enterprise valuation can result.

	<i>LOW</i>	<i>HIGH</i>
Overall Strategic Clarity Adjust	-1.0%	+1.0%
Market Pricing Intelligence Adjust	0.0%	+0.5%
Transactional Pricing Management Adjust	0.0%	+1.5%
Price Performance Measurement Adjust	-0.5%	+1.0%
Pricing Organizational Alignment Adjust	0.0%	+1.0%

A +5 percent potential price premium for a business can produce material profitability increase, while a -1.5 percent potential price premium can generate significant underperformance.

### **Use of the results during M&A negotiation**

There are two different perspectives to apply to the target company enterprise valuation after it has been adjusted based on the completed process. The first perspective is that of the potential buyer, and the second perspective is that of the seller.

The buyer's team leads the M&A discovery process, and so the adjusted valuation will result from that team's direct financial discounted cash flow analysis. Based on the total pricing opportunity adjustments, the buyer's view of the enterprise value may be as much as 5 percent higher than a valuation conducted using traditional techniques. With a valuation that is adjusted higher as a result of the pricing opportunity assessment, the buyer has several new degrees of freedom to employ in the M&A process.

The buyer could simply include the higher valuation as the initial offer price to the seller. In effect, this approach presumes that other potential suitors have not conducted the same level of pricing opportunity assessment, and therefore the buyer's valuation would surpass that of the other suitors in the first pricing wave. This "first offer high" approach is suggested when the buyer believes that there are no strategically preferred buyers in the process according to the seller. In other words, if the buyer is on equal footing with other buyers and the expectation is that the target sale will go to the highest bidder, then the price-adjusted valuation should be included in the first pricing wave.

Another option for the buyer is to withhold the price premium, calculated as the difference between the price-adjusted valuation and the traditional valuation, during the buying process. In this circumstance, the price premium would serve as expected internal upside to the target purchase. The premium could be used to sell the acquisition internally to the buyer's stakeholders, but then not included in the offer price. This "keep private" approach is suggested when the buyer believes that they are already one of the preferred buyers in the process and their traditional valuation is within the range expected by the seller.

A third option for the buyer is to use the price premium to measure the sensitivity of the expected returns from the traditional valuation and then only offer the price premium if the initial offer value needs to be increased. The sensitivity can be measured by comparing the key financial return metrics (ROI, IRR or NPV) with and without the price premium. The premium can then be added to the offer price for the acquisition target only if needed. This "use if needed" approach is suggested when multiple auction or proposal rounds are expected. This third option will most often occur, so it will be most likely that some portion of the price premium will end up included in the eventual target company valuation.

From the buyer's perspective, a potential 5 percent premium provides more negotiating room for the buyer to reach an accord with the seller. The salient characteristic of the enterprise valuation price premium is that it does not appear in the financial history or output of the target company. As a result, the price premium is not reflected in traditional valuation methodologies. It therefore provides real leverage to the buyer when calculated following due diligence because the seller and other suitors that follow the traditional valuation approach will not have the same insights about future profit improvement potential.

The second perspective on the adjusted valuation is that of the potential seller. A savvy seller of a business unit or portfolio company will conduct the same analysis that is suggested for the buyer. But the seller will complete this effort before putting the target business up for sale. In this case, the seller calculates an internal

price premium for its business. The seller can then direct the discussions during management presentations to the potential pricing opportunity. The seller can also stand firmer on its asking price with the knowledge of this valuation adjustment.

A more impactful approach for the seller would be to include the price improvement potential in their financial forecasts. In this case, the seller would incorporate specific pricing improvements into the revenue and profitability projections for the business' future revenue and profitability performance. These projections would be based on the internal capability assessment and subsequent opportunity identification. The seller should include specific commentary on the expected actions and impact from pricing improvements in the management forecasts.

The seller's position is not nearly as strong as that of the buyer regarding the price premium on the valuation. The buyer identifies the price opportunity as a future potential while the seller's assessment is more accurately described as an opportunity lost – a revenue and profit improvement lever that has not yet been implemented. The analysis is nevertheless recommended for the seller to reduce the potential information inequality that might exist if the buyer conducts the assessment and the seller does not.

In summary, the adjusted target company enterprise valuation generated by completing a robust pricing analysis provides the participants of an M&A deal process with a range of options for using the discovered value. As noted, since the valuation price premium does not appear on the company historical financial statements and rarely will appear on the management sales and profitability projections, the adjustment is not unlike an intangible asset of the company. And like other intangible assets, such as brand names or market reputations, the price premium will be subject to widely diverse interpretations. The preceding assessment approach is intended to reduce the diversity of opinion on the quantifiable impact of pricing improvement. However, participants in the M&A process who leverage the price premium for their enterprise valuation must be prepared to defend their valuation with the detailed findings.

### **Implications for innovation in pricing**

In the final analysis, the Mergers & Acquisition process includes elements of both art and science. Final deal settlement prices are often predicated as much on the seller's ability to sell the concept of value in future returns as it is on the buyer's ability to dilute those claims with the information uncovered and analyzed in the due diligence process. However, the very quality and quantity of information, or lack thereof, often plays more of a role in predicting future synergies and derived competitive advantages than any other part of the due diligence process.

Several areas within the current due diligence process that can be improved through enhanced information capture about the company's pricing capabilities have been highlighted. Recommendations were provided for what specific information to review and which specific questions to ask in order to uncover areas of arbitrage in the target company valuation. Using the assessment during the M&A due diligence process will improve company valuation and provide more specific

pricing improvement areas to validate after the acquisition is complete. The assessment is not intended to replace a more comprehensive and transaction-specific opportunity diagnostic after the company has been acquired. Rather, the recommended pricing addendum to the traditional due diligence process is designed to effectively evaluate the pricing opportunity environment for a specific business from the arms-length distance of due diligence and thereby inform the final company valuation.

The framework developed here fills an important gap in the pricing literature and provides a directly applicable solution for M&A practitioners to employ in their due diligence process. When embedded within the overall M&A framework, the Pathway to Excellence will not only provide a more thorough perspective of a company's pricing competency, but it will also produce greater clarity about the expected synergies and competitive advantages realized in the future cash flows of the acquired entity.

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# 15 Busting the four fatal myths in pricing

*Nelson Hyde*

## **Myth busters: four fatal pricing traps**

If a firm lowers its price, will it sell more?

For years, Economics 101 has taught us that if a firm lowers its price, more people will buy and sales will increase. Yet much of the time, this is simply not true.

Although individual products have price elasticity, at many stages of its life cycle a product is not highly price elastic. At these stages, lowering prices generates little new demand – and it can trigger a price war. Failure to understand clearly when and when not to lower price, or to factor in how competitors will respond, is at the heart of two of the pricing traps this chapter addresses:

- “If we lower our price, we will gain share.”
- “We should drop our price to win this deal.”

The price pressure in mature, commoditized industries can be excruciating. The antidote to price pressure is demonstrating real, solid financial value to the customer – showing how one’s product’s or service’s differentiators will materially improve the customer’s bottom line. This means going beyond describing features and benefits to demonstrating operational impacts and financial results. It is one thing to say that a product is more reliable (a benefit) because it is made of higher grade material (a feature), but it is another to show how the increased uptime from reliability (impact) adds \$80,000 to the customer’s bottom line (financial results). Using price rather than value to close deals is at the heart of the other two pricing traps this chapter addresses:

- “At the end of the day, customers only buy on price.”
- “We have to set our prices at the market price.”

In over 25 years, I have heard each of these statements at multiple Fortune 1000 companies in many different industries. I have heard them stated by sales VPs and CEOs, at conferences and in meetings. These statements have become a part of conventional wisdom. But each statement is true only in very narrow circumstances, a nuance that does not usually make it into the conversation. As a result, these statements are routinely misapplied.

These four traps are not so much about pricing strategy or tactics as they are about execution in the field. They are about competitive pricing dynamics at the most crucial moment that determines a firm's pricing success and margins – in other words, what the salesperson does next when the customer is banging on the table demanding a lower price.

It's been said that the definition of insanity is doing the same thing over and over again and expecting different results. Innovation in pricing means breaking the traditional mindset and knowing when *not* to keep following the old rules.

Through principles and examples, this chapter shows how generalizing the four statements above to situations for which they were not intended only invite potentially fatal consequences. It identifies under which conditions these principles do and do not apply and what to do as an alternative. It demonstrates what executives can do to break through the traps and seize a competitive advantage through innovation in pricing practices.

### ***Trap number 1: "If we lower our price, we will gain share"***

Can a firm price its way to greater market share? Conventional wisdom says yes, but history does not agree.

Consider the wild ride of General Motors since this century began. The last year of the 20th century was a good one for the North American light-vehicle market – the industry made \$7 billion in profit in 1999. But signs of what was to come were already emerging. Despite the fact that more vehicles than ever were sold in 2000, the North American market lost money, and as a group that year the Big Three automakers – GM, Ford and Chrysler – saw their market share drop for the seventh year in a row.

To protect their share, in 2001 the Big Three offered rebates averaging \$2,300 per vehicle. Seven years later, rebates were even bigger. By 2008, Ford's average rebate had crept past \$4,000. Despite this, however, the industry's unit sales had not yet returned to their 2000 levels.

The North American car market had turned into a brutal fight for market share. In 2003, GM began an internal campaign to capture and retain a 29 percent market share; executives were seen famously sporting "GM 29" lapel pins. Yet from 2001 to 2008, the Big Three's market shares continued to slide, averaging a loss of more than 2 points a year. And they lost more than share, they lost money, too – a staggering \$75 billion over that period (see Figure 15.1).

In 2007, desperate, GM completely reversed its course. It began to emphasize profitability over market share and quality over quantity. It cut its low-profit fleet sales and reduced rebates.

Although these efforts were too late to prevent the bailout that was to come, GM's new price strategy is paying off in spades now. In the fourth quarter of 2011, GM reported its eighth straight quarter of profitability and predicted that it might reach \$10 billion profit in 2012. Earlier in 2011, GM attributed fully half of its margin improvement to pricing, and it announced its third price increase of the year.

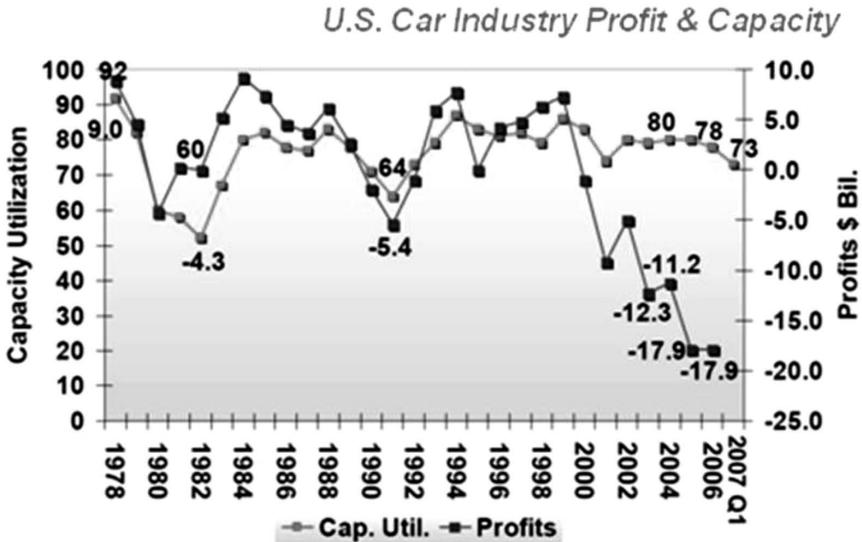


Figure 15.1 U.S. car industry profit and capacity

Source: Center for automotive research.

Why didn't the carmakers' price incentives increase overall demand, especially given that demand for cars remained somewhat positively elastic?

Rebates did increase demand a little because they made cars more attractive for first-time buyers. But in this mature market, *most* of the market for new car buyers – the real engine that fuels growth and demand – had already been tapped. There were fewer first-time buyers. Most purchases were replacement purchases, and demand was not growing nearly as fast as before.

This shows how price elasticity changes over the course of a product's life cycle (see Figure 15.2). In a product's mature and declining stages, the market is mostly a replacement market, and demand is generated less by price than by other factors. For example, in health care demand is driven much more by demographics, such as the growth in number of people over 50, than by price. If the price of an X-ray machine is reduced, it does not follow that more people will go out and break their arms. But if the number of people over the age of 70 increases, and if people in this age group are more likely to injure themselves in falls, there will be greater need for X-rays.

In a product's early-growth introduction phase, first-time buyers are not very price-sensitive because as early adopters they value the product for reasons other than its price – its new technology, for example, or the status it bestows on the buyer. Of the four stages of a product's life cycle, only the growth stage is truly elastic; it is during this phase that lowering price can generate significant incremental growth in demand and rapidly increase the number of first-time buyers.

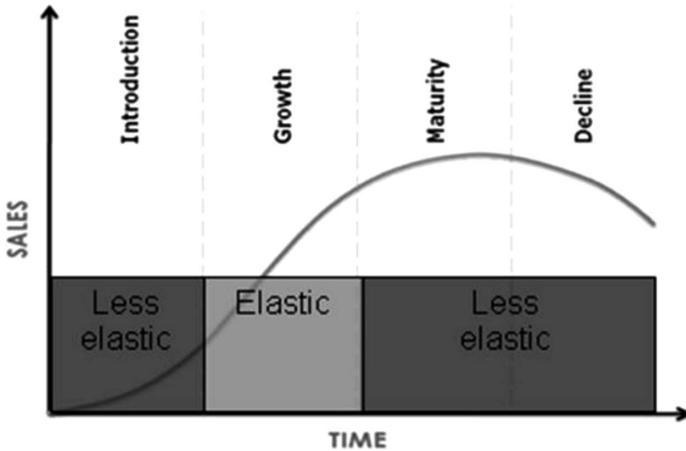


Figure 15.2 Price elasticity in the product life cycle

Demand aside, why didn't GM's strategy of lowering prices at least boost its market share? To be fair, lowering prices actually did influence its share – but only momentarily. The higher rebates boosted traffic to the dealerships and improved sales. But that lasted only as long as it took Ford and Chrysler to follow suit. After that, their respective market shares returned to the status quo; only now, the car-makers were earning less profit on each car.

It is tempting to lower prices to win a sale. And it *can* win the sale: every salesperson can tell stories about the deal won by beating the competitor's price. The problem is what happens next. Competitors will not roll over and play dead – they will match the price drops.

Taking a strategic view of market pricing means looking at the deal not in isolation but as one move of many in a chess game. If I make this price move now, what will my competitors do? What will happen then? Is that good or bad? Will I be better off, or worse off? If each of the Big Three had been thinking several moves ahead, there would never have been a price war, and Detroit probably would not have needed the bailouts.

My own company tried to increase its share in 2011. It succeeded. Now it is dealing with the significant fallout from missing its profitability targets. In situations like this the message needs to change from “any share is good share” to “grow profitably.”

### ***Trap number 2: “At the end of the day, customers only buy on price”***

If customers always bought on price, we would all be driving a Yugo. While most of us are concerned about price, we will also often pay more to get greater value. We will pay more *not* to get the Yugo.

FedEx figured this out early in its history. In 1981, FedEx began an advertising program with the tagline “Federal Express: When it absolutely, positively has to be there overnight.” Its differentiator was a guarantee of reliability, not price. Unlike GM in the 2000s, FedEx’s strategy was to maximize profit and *not* be the low-price provider. When UPS entered the express delivery market, it offered prices half those of FedEx’s – but it could not provide the same level of reliability or service, and it struggled.

FedEx recognized that not all shipments are equal – that even though many shipments are urgent, some of those shipments really, really do need to get there by a certain time, such as parts that could otherwise hold up a production line, anything with a drop-dead deadline. By assuming more of the risk, FedEx was able to charge more.

In other words, FedEx differentiated between those customers who buy based on price and those who are willing to pay more for greater value. One of the critical success factors for effective pricing is being able to tell which group one’s customer is in. Trying to sell a jet to a customer who can only afford a propeller plane will result in one of two outcomes: either the supplier will sell the jet at a steep discount and devalue the jet for the rest of the market, or it will lose the sale because the discount isn’t high enough.

Some customers are true pure price buyers – they cannot afford anything else, and they are relieved when a supplier can offer them a price that fits within their budget. But not all customers buy based on price alone, especially if they are niche and premium players who are not themselves trying to be the low-price provider. They are selling value and differentiation, and they rightly charge for this. As a result, studies show, they place a higher value on vendors who can provide a higher quality product, technical know-how or service. They are more willing to invest time and money in their vendors in exchange for customized product advantages not available to their competitors. It’s not the case that they will pay any price; price is a factor, but it is not the main factor. They are relationship buyers.

It can be tough to tell which customer is a true price buyer and which is not, partly because of what Reed Holden of Holden Advisors calls “poker players.” Poker players pretend to be concerned only about price, but they are in fact quite willing to pay more. They know that if they put up a fight, they can often pay a lower price for the same purchase they would have made anyway. So they bluff.

Companies with strong pricing offer products and services to price buyers that are different from those they offer to other buyers. Having a complete range of products in the portfolio – both the jet *and* the propeller plane – allows a seller to force clearer price-versus-value trade-offs. If a customer truly demands a lower price, the supplier can provide its lower-priced product. If the customer then complains that the prop plane is missing some important features, the supplier can offer a line of jets with the desired features at a higher price.

Companies with strong pricing have also figured out how to tell which kind of customer they are talking to. There are usually some telltale signs; the key is to identify those that are specific to one’s industry. For example, a freight transporter

wanted to know which customers were bluffing on price demands and which customers really wouldn't pay more. This company shipped packages that were then amalgamated to fill a truck that goes to a specific destination. The business was highly commoditized, and price pressure was intense. However, some customers had a greater need for reliability or guarantees than others.

A salesman for the company was able to put his finger on the telltale sign: "Just go down and look at their docks." I thought – look at their docks? What is that going to tell you? But the salesman went on:

If the docks are really clean and orderly, everything is in its place with a clear logic to the operations – that's a just-in-time inventory shop, and even if they pretend to scream and yell about price, they'll pay for guaranteed on-time delivery. If the docks are a mess, they usually won't pay as much – those are your price buyers.

### ***Trap number 3: "We have to set our prices at the market price"***

Once upon a time, offering Internet connectivity was a selling point for hotels. Now, it's a staple. And customers expect it to be fast, free, and not just in the lobby.

Once upon a time, power-operated windows were a novelty in cars. When was the last time any of us hand-cranked a car window?

The evil twin of innovation is commoditization. As new innovations occur, good ideas get copied, and we move on to the next innovation. Gordon Moore captured this effect for technology industries in what became known as Moore's Law: the number of transistors in an integrated circuit doubles every two years.

What's the pricing corollary to Moore's Law for technology? Let's look at microprocessors. Over the five-year period ending in 1999, microprocessor chip prices fell at the rate of 60 percent a year. For every \$100 worth of microprocessors sold in 1994, the price five years later was less than \$8.

Companies must be able to anticipate this kind of headwind. However, once they do measure it, anticipate it, and build it into their plans, it starts to become conventional wisdom. And then it's a slippery slope to believing that "That's just the way things are; there's nothing we can do about it." "You can't fight it." "It's what the market does." This is when "conventional wisdom" starts to become a self-fulfilling prophecy.

But that bogeyman we call "the market" is really individual companies making a series of individual decisions. Push, shove, action, reaction. We saw above how carmakers' failure to anticipate competitors' reactions to price moves led to a destructive downward price spiral. But at each step, there was a decision point. Other than just blindly following your competitors, who in turn are probably blindly following you, what are the options?

The answer lies in "pricing power" (see Figure 15.3). Pricing power allows a company to withstand the forces of commoditization and the pressure of other companies' prices. Pricing power is created when a product or service (a) has

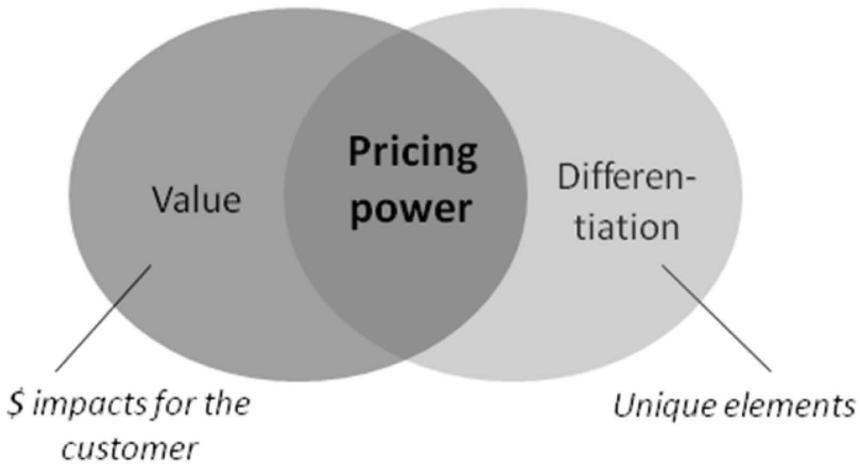


Figure 15.3 Pricing power defined

differentiators and (b) that customers value and will pay for. Even against the 60 percent price drops for microprocessors, for example, specialty processors for mobile phones and gaming were able to command much higher prices and experienced less price erosion.

For pricing power to be successful, however, a company needs more than differentiation that customers care about. It also must be able to tell a convincing story about its added value. This means moving beyond talking with customers about features and benefits to talking about impacts – what impact the product has on the customer’s own strategy, differentiators and bottom line.

Without pricing power, or without a good way to convey it, a company will truly be buffeted by the “market.” It will typically be forced to follow the market price, unless it has a cost advantage over its competitors and has room to undercut the competition.

Companies don’t always have to be held hostage by “the market.” Their costs plus a margin help set the floor price; their pricing power helps set their ceiling price. That leaves much greater latitude for setting price than what one’s competitors charge.

***Trap number 4: “We should drop our price to win this deal”***

Recently, my company was competing for a significant deal for large diagnostic-imaging equipment in Japan. Our Japan-based competitor was also trying to win the deal, and it offered a much lower price. So we did what a lot of companies would do. We lowered our price.

However, our competitor’s equipment offered nowhere near the functionality or value that ours did. Theirs was a much lower-end version of a highly complex

and innovative diagnostic machine. Yet when our competitor played the price card, we followed suit. We had pricing power, but we didn't leverage it. We let the competitor dictate the rules of engagement.

If that customer's budget could reasonably afford our more valuable equipment, then we should have been able to find a way to communicate that extra value and justify our price. If the equipment was too rich for the hospital's ability to pay, then why were we talking to them?

Effective targeting and good customer segmentation are central to strong pricing. This is where many companies' efforts to grow market share run into trouble. Growing market share often means selling to new customers who are further "down-market." Yet the products we are selling haven't changed, and those products may be too rich for the new target audience. So we increase the discounts to close the sale.

Those heavier discounts effectively reset the market price even for those customers who would gladly pay more to get more. Customers absolutely do talk to each other about what they've paid for something, and word gets around fast. In the diagnostic medical equipment industry, it's even worse: customers report what they paid to a third-party firm, who gladly publishes the results.

The statement "We have to lower our price to win this deal" is often true. But that doesn't mean you always should. What are the alternatives?

Simple deal qualification can go a long way toward protecting price. And once a supplier knows that it's talking to the right audience, it still has to find compelling ways to tell its value story and highlight its differentiators. For this reason, many companies develop tools to quantify exactly how their offerings will impact the customer's bottom line.

But even that may not be enough. Customers need to believe they are getting a fair price. They are more convinced if they can negotiate the price down. Many purchasing agents earn commissions based on how much they save their companies – in other words, on how well they negotiate. They also take classes in how to wring the lowest prices from their vendors, and they study disingenuous but effective techniques:

- "You're close." (And then, when the vendor lowers the price, "You're getting closer." And then, "You're getting warm . . .")
- "We go way back. Is this how you treat your most loyal customers?"
- "We're a leader in this industry. Your customers do business with you because I do business with you."
- "You should be paying me a commission for all the work I've given you."

Effectively countering this is both an art and a science. When a customer says, "I need a lower price," the next words out of the salesperson's mouth are going to determine whether the company is about to improve or erode its margins. If the salesperson says, "Let me check with my manager," expect margin erosion. But there's a fighting chance if the salesperson is trained to ask for something in return, to negotiate some kind of give-get: "Sure, absolutely. I can make that

happen. We can make that happen if you \_\_\_\_\_”: fill in the blank. Maybe the customer needs to buy a service contract to get the lower price, give the company a larger share of its business or award the company the contract on a higher margin product.

Alternatively, the salesperson can remove something from the bid, reducing the product’s costs and improving margin. Either way, the best salespeople anticipate the question and work out their response ahead of time in agreement with sales management to avoid being taken by surprise.

## Pricing in the field

It is common to lower prices in order to grow revenue and market share. However, lowering prices can be a dangerous game because it instantly lowers margins. Any gains in volume must be sufficient to compensate for the resulting margin gap. We have seen here examples in which neither additional volume nor margin materialized.

Sales is usually the keeper of volume and revenue; pricing and finance are often focused on profit. This chapter identified ways that *sales* can engage with customers to protect *price*.

The resulting price and margin improvements can be significant, as they were for GM. And the impacts are not limited to profitability. They can also include revenue growth. One high-tech company increased its quarterly margins by 37 percent while growing its revenues by 17 percent. Similarly, a software firm’s 40 percent revenue growth over 18 months was accompanied by margin growth of almost 200 percent. It’s time to change the way we think about the conventional wisdom. It’s time to change how we apply accepted pricing principles.

## Implications for innovation in pricing

This chapter identified ways in which commonly accepted pricing principles are misapplied, resulting in profit erosion, share loss and even bankruptcy. We have an opportunity to innovate in our pricing by clearly identifying when business-to-business (B2B) pricing principles do *and do not* work, and where they need to be replaced by new, alternative principles.

Specifically, this chapter identified the pricing traps that result from applying four commonly accepted pricing principles to situations where they were not appropriate. It identified alternative practices that can be used in real time in the field, and the conditions under which they apply.

By taking into account two critical variables – how competitors will react to price changes and how to shift the main value proposition from “look how good this price is” to “this is the value the product creates for you the customer” – this chapter presented new ways to use four conventional pricing principles:

- “If we lower our price, we will gain share.”
- “We should drop our price to win this deal.”
- “At the end of the day, customers only buy on price.”
- “We have to set our prices at the market price.”

Table 15.1 Capacity utilization and profitability in the U.S. car industry

<i>Pricing principle</i>	<i>Applies . . .</i>	<i>Does not apply when . . .</i>	<i>Practical application</i>
If we lower our price, we will gain share	During growth phase of the product life cycle When competitors choose not to respond	During early growth, mature, and declining phases of the product life cycle When competitors respond by lowering their price	Quantify the financial value to the customer of one's differentiators Price to capture a portion of the value one creates for the customer
We should drop our price to win this deal	When dropping price increases one's economic return over the life of the customer When one can extract something of value from the customer in exchange (e.g. greater volume)	When customer is buying on the basis of one's value-add When customer is a poker player who is only pretending to be a price buyer in order to get a lower price	Extract something of value from the customer in exchange Link pricing to one's segmentation scheme Create multiple price/product combinations with different value for the customer to choose from
At the end of the day, customers only buy on price	When customer is a true price buyer (cannot and will not pay the higher price)	When customer is buying on the basis of one's value-add When customer is a poker player who is only pretending to be a price buyer to get a lower price	Identify telltale characteristics of true price buyers Have different products for price buyers than for those who want added value
We have to set our prices at the market price	When one has no differentiators that produce economic value for the customer	When one does have differentiators that create economic value for the customer	Quantify the financial value to the customer of one's differentiators Price to capture a portion of the value one creates for the customer

Table 15.1 summarizes the opportunities to innovate on what have been commonly accepted but often misapplied pricing principles. It identifies four of those pricing principles, situations where they apply, conditions under which they will fail and what to do if conditions ripe for failure exist.

These new distinctions can empower salespeople to take new responsibility for margin by improving price capture. Companies that have deployed these distinctions have not only improved margins, sometimes dramatically, but in some cases have also been able to do so while impressively growing their volume and revenue.

# 16 Creating, calculating and communicating customer value

How companies can set premium prices that customers are willing and able to pay

*Todd Snelgrove*

## Introduction

How does one get paid for value created? Every high quality player in every market around the world has asked this question. If a supplier creates value, and if that value requires investments, then it must find a way to obtain an equitable return on that investment or the wheels of innovation will stop.

Successful companies allocate money to develop people, processes and cultures and have the right people focused on finding innovation and on bringing that value to the market. The companies that are best in class in value-selling realize a 60 percent higher customer-retention rate, a 17.9 percent difference in year-over-year growth in company gross profits and larger deal sizes (Aberdeen, 2011).

So why is it that so many companies still adopt a make it up in volume, market-share or cost-driven strategy rather than value-based pricing? Companies that employ a good value-based pricing strategy (by value-based it means create value, communicate value and deliver value so you can price for value) are 20 percent more profitable than those with weak execution on value pricing and 35 percent better off than those that follow a cost- or share-driven strategy (Monitor Group, 2011).

Since the financial benefits of value creation and pricing are well known, why do so many companies fail to achieve the results they seek after they have done the work to create something that is of value?

Either they do not truly create customer value, and therefore cannot value-price for it, or they have not allocated the necessary resources to convert the value created into something that a customer is able and willing to pay for. Companies that choose a low-priced, commodity approach to their offerings will always be at the mercy of the next competitor to offer an “almost as good product at a lower unit price.” For those that do invest and create customer value, it is time to do the work to get paid for that value.

We will delve into a case study of an industrial firm in a tough market. This firm has found a way to convert the value of its better performance products and technical knowledge and to communicate it to customers so that they are willing and able to pay for it.

### **Current approach: total cost of ownership (TCO)**

When a company is able to understand where value is created throughout the asset or service life cycle, it can price for part of the incremental value created. But first it must understand what costs and values are incurred and generated and where, when and by whom. In general, the concept of *total cost of ownership* (TCO) has been the best model to use to find these factors.

The existing literature and market consensus is that TCO is the “sum of purchase price plus all expenses incurred during the productive lifecycle of a product, minus its salvage or resale price” (Anderson & Narus, 2004). TCO is exclusively concerned with the cost side of customer value and thus neglects the value of customer-specific benefits (Anderson & Narus, 2004; Piscopo et al., 2008).

### **Future approach: total profit added quantifying customer value along all relevant dimensions**

The limitations with current TCO are that it solely looks at the “cost” side of the equation but never at the upside or value side. To have a more detailed analysis, The Gartner Group attempts to do this with a TCO variation called *total value of ownership*; however, the word “value” here refers to soft benefits, such as ease of use, comfort level or “happiness of a user.” Although these soft values should be considered, a whole area of value creation has been missed – the revenue side. A true detailed analysis should explore all dimensions that affect the customer’s net profit. Therefore, a wider explanation of TCO – one that looks at the difference between the next best alternative of an option and that takes into account all increased or decreased revenue minus all increased and decreased costs over the life of an asset – allows one to determine which decisions are the most profitable. I am calling this the best measurement of value, and by value I mean profit impact, so Total Profit Added.

Thus, suppliers that are able to help their customers increase revenue, expand margins, enter new markets, sell an “upgrade option” and/or enter into longer customer relations create a benefit for the revenue side of their customer’s balance sheet that needs to be measured. A few real-life examples of the expanded view of Total Profit Added or TPA follow.

The first example involves increased margin or sales for an original equipment manufacturer (OEM), not by substituting a lower priced similar part. When a supplier is able to help an OEM make a better piece of equipment, it can use that differentiated value either to sell more than its competitors or to value-price for it. However, if the supplier cannot help the OEM show its customer the value created, that value becomes “lost in translation” between the supplier’s, the OEM’s and the product’s final customer. In such cases it is incumbent upon the supplier to work with the OEM’s product management on the Front End Engineering and Design (FEED), sales and marketing teams to help them not only make a better application but also be able to sell that value to their customers.

A global OEM, after being pushed by field sales, decided that it needed to make a product that offered some customer features and benefits that were different than its competitors’ rather than trying to make a good-enough, cheap product

that everyone in the market was focusing on. The OEM worked with an established partner and added not only high-quality branded components but also a solution that lengthened their application's maintenance intervals relative to their competitors' because the bearings did not have to be greased. In this case, the value created for the OEM was the increased net margin they were able to obtain in the marketplace by having a differentiated product that they could show customers that would have a lower operating cost, would require less maintenance and less lubricant and would cost less to dispose of. In taking a TPA approach, the OEM was able to realize higher profits by creating and selling value. If it had taken the existing TCO approach, it would have viewed the price premium for these greased-for-life bearings as a "cost increase" and not taken into account the increased price premium for which its application could be sold in the marketplace. To do this the OEM was shown the value via TPA improvement in operating cost and performance that its customers would obtain and given the sales, marketing, tools and training to be able to articulate that to its customers.

A second example is the well-known "Intel Inside" designation. Let's assume that the Intel chip is better. Does it help the PC maker? Not really. It's the person who buys and uses the computer – who now has a machine that uses less energy, is faster or crashes less – who benefits. That value would have been lost inside the machine if Intel did not find a way to either pull customer demand or support their computer manufacturers with "Intel Inside" market communication to push this "value." The marketing term *ingredient co-branding* describes this situation.

Let's consider another example, in which a firm helps a user operate a piece of equipment that is more reliable, that runs at higher production speeds or that generates less scrap waste. In the existing TCO analysis, no value is taken into account for the profitability that is generated by the better running machine. In one case, a company was able to increase the throughput of its process by 1.5 percent, which yielded a net profit of over \$18,745,000 annually. The investment was justified only because the increased-profit side of the TPA model was included in the analysis.

### **What do customers really care about: total profit added or lowest unit price?**

Before devoting the necessary time and investments to calculating the full TPA for a new product or customer, a supplier must first ask, "Do any of our customers still even care about value? Or in today's world, is it always about the lowest price?" Sales teams continue to send market reports back indicating that they've lost deals because the supplier's price was too high and that the value it offers customers is not appreciated, so customers won't pay for it. In too many instances, people transpose the terms "cost" and "price." These are two completely different concepts. What customers want is the most sustainable Total Profit Added to their business. However, if a company is unable to measure the value that it creates and how these either help increase revenue or reduce other costs, its customer will

focus on lowest unit price instead of best value as they become conflated in the customer's mind.

Customers and procurement professionals do seek value as measured by TPA. Respondents to a 2008 *Purchasing Magazine* survey reported a continued decline in the importance of purchase price, whereas the importance of TCO remained flat. Not surprisingly, a 2007 study sponsored by the International Association of Commercial and Contract Management (IACCM) found that customers rank TCO as being nearly two times as important as unit price (Strategic Account Management Association and International Association of Commercial and Contract Management, 2007). Procurement professionals and management teams are realizing that unit price is only a subcomponent of best value and that those price savings usually do not find their way to the company's bottom line. Advanced procurement is also looking at how it adds innovation to its business, reduces risk, capital employed, increases revenue and reduces waste – areas not covered under existing TCO analysis but accounted for using TPA.

### **Where costs and benefits exist in the four stages of an asset life cycle**

It is essential that a supplier know where the value and costs exist within the life cycle of the asset that it is involved with – to know who obtains which benefit, and who is asked to make which investment. Sometimes an investment occurs in one stage and the benefit emerges elsewhere.

It all starts with the *design phase*. For example, an OEM works with its component suppliers and aggregates these components into a functioning asset that has utility. Here is where decisions about operating and disposal costs for the user are made, such as what material to use, what tolerances the machine should be made to, how long the product will last, how expensive it will be to operate and so forth. These operating attributes are intended to be trade-offs between what the customer wants and what they will pay. This phase is where miscommunication sometimes occurs. The constant reports from the field that customers don't want something better or that they do not value something lead product designers to reduce costs, usually by substituting *similar products* that have a lower unit price. People become confused about whether the customer seeks the lowest price or the lowest cost. As the aforementioned research shows, they seek the lowest costs. Thus the supplier must ensure that it can demonstrate how the performance of its product(s) will reduce customer costs and/or increase revenue. If it is unable to demonstrate this, then the term *lowest price* becomes the discussion point.

The operating costs incurred by and benefits to the user who buys this product from the OEM can be broken down into the following three stages.

The approach starts with a close look at the *acquisition process*, including receiving costs, payment terms, holding inventory and unit price. When asked whether they measure TCO, some procurement professionals will say yes. A follow-up question usually reveals that these are the indicators being measured.



Figure 16.1 The priceberg

These are, of course, important measurements; however, in most cases they are just the tip of “The Priceberg” (Figure 16.1).

Next is the installation, *operation, and maintenance phase*, during which the buyer uses what has been purchased, and in which the sometimes less visible costs below the water line come into play. Included here are factors such as how long the item lasts, how much energy it uses and whether it can increase the throughput of what it is helping to produce, affect scrap rates, be easier and predictable to repair and so forth.

Finally, the buyer needs to *dispose* of what has been purchased. Disposal can range from being almost free to very costly; the item may even have a residual value. For example, the cost to dispose of lubricants after their use can be as much as 2.5 times more than the cost to acquire them.

The breakdown of these costs into the different categories can vary as a result of many factors, but numerous studies show that the initial purchase price of an industrial application (such as a pump, fan or gearbox) is 12 percent of its total cost (Accenture, 2001) – even less when you analyze its TPA. Simply put, should you focus on reducing the acquisition price of an asset when it is only 12 percent of its TCO or on buying a better asset that has the lowest operating and disposal costs that covers 88 percent of its TCO? The better asset that is more “expensive” up front might just drive more profit.

Let’s take, for example, an industrial asset, such as a pump, that follows the Accenture Study and 12 percent of its cost is the acquisition price while 88 percent is its operating and disposal costs. These pumps could have the same ISO specification. It should be noted that ISO is a conformance measurement, and all things

that have the same ISO specifications do not have the same performance. We will assume two options exist: a \$1,200 initial purchase price pump with \$8,800 in operating and disposal costs, or a TCO of \$10,000; versus a better pump that costs \$1,500 to buy but uses \$350 less energy, \$250 less lubricant, enables you to predict its failure (meaning it can be repaired for \$235 less), saves one event of unplanned downtime that equates to *1 hour lost production at \$7,500*, and *the pump lasts 20 percent longer*. Its TCO is purchase price \$1,500 + alternative operating costs of \$8,800 – costs saved of ( $\$350 + 250 + 235 = \$835$ ) + *revenue increased* ( $\$7,500 \times 10\%$  operating margin = \$750) *plus the \$1,500 pump has a 20 percent longer life meaning it has to be replaced less often, saving 20 percent of its initial purchase price* ( $20\% \times \$1,500 = \$300$ ). By getting the supplier to help calculate the TPAO, the low price product costs the company \$10,000 and the better product doesn't cost the \$1,500 + \$8,800 costs that are assumed or \$10,300, it actually costs almost \$1,900 less:  $\$1,500 + (\$8,800 - \$835 - \$750 - \$300) = \$8,415$  or a \$1,585 saving. In this case, like most, the 25 percent more “expensive” pump actually ends up costing almost 16 percent less (Figure 16.2).

Looking at a far simpler example, what does the average person consider to be important when purchasing a car? Intuitively, once the specifications are chosen, such as a four-door family sedan with automatic transmission, air conditioning and a certain size engine, then one could assume the choice is made based on a unit-price comparison of the options that meet those criteria. However, the costs



Figure 16.2 Price versus TCO

of owning a car do not end with the initial purchase. The operating costs, such as fuel consumption, average cost to repair or service, financing, insurance, depreciation rates and numerous other costs, live well beyond the acquisition of the car. With this data, one might find that the car that initially appears to be more expensive will actually provide the largest Total Profit Added and is therefore a better deal. In some cases the costs to insure different cars having the same features and specifications are very different. Since insurance is a mandatory cost, the cost differences should be included in a TPA analysis. Edmunds, a website for car buyers, has created their own TCO acronym, “true costs to own,” which allows customers to calculate the differences between cars ([www.edmunds.com/car-buying/true-cost-to-own-tco.html](http://www.edmunds.com/car-buying/true-cost-to-own-tco.html)). The Accenture (2001) report shows that for light-duty trucks, the initial purchase price is only 12 percent of its TCO, whereas for commercial aircraft it is 8 percent and for Class 8 vehicles (large tractor trailers) it is 11 percent.

Because of the wealth of data that exists in the marketplace today, the ability to apply the concept to everyday purchases is now more feasible in the B2B and B2C worlds.

### **The key steps for successful value pricing and value selling**

The first step is to determine what is of value to one’s customers, creating products and services that deliver that value, quantifying that value, pricing for the value created and then communicating that value so that customers are willing to pay for it.

Sales and marketing should spend their time understanding where they affect a customer’s profitability rather than arguing with their own management that their products are priced too high or finding numerous creative ways to discount in the marketplace.

#### ***Creating the right products and services in order to price for value***

The journey must begin with creating products and services that have customer value. This value needs to be compared with the customer’s next best alternative. A company’s customers always have a choice, whether it is to do nothing, to insure, to buy someone else’s (different) option or to buy your offering. Value is not realized in the mind of the engineer who creates a product; it is realized only when the customer uses that product and obtains something they value. By “value” we mean something the customer is willing to pay for. Numerous tools exist for helping companies in this area, from voice-of-the-customer analysis to value mapping to simple surveys and the like. Simply put, customers are not in the business of buying products or services; they are in the business of making money. A company’s offer had better help them accomplish this in some way.

#### ***Quantifying that value***

Once a company has a solution that offers the customer a benefit, it must quantify the benefit that the user or users will receive versus the investment it is asking

them to make. The more accurate term *investment* is used to denote the price differential between an option and the next best alternative. The term “premium” should not be used, as the perception in most markets is that you’re paying more for a logo or nothing of tangible benefits; actually a synonym for “premium” is surcharge. Do not think you want to be seen as the surcharge brand. If the company’s marketing uses buzzwords such as longer, more, less, faster, quicker, better or a list of hundreds of more generic benefit statements, then these need to be quantified. How many companies will allow their employees to buy something they want? A business case needs to be created. The question is, by whom? Is it the job of the supplier or the person wanting to buy the solution? Presumably the company knows more about how its solution creates value and has an interest in supporting the buyer in justifying the investment in its solution. A recent study shows that 90 percent of buyers require a business case to change what they are doing and that 81 percent of them expect the supplier to deliver it (Alinean, 2011).

A tool that allows the sales force to sit down with a customer and run the expected business case is what is needed. The tool should not just guess at some “maybe” benefits. Best-in-class tools have the following characteristics (see Figure 16.3).



Figure 16.3 Documenting customer value

- All inputs are changeable.
- Proof points are supported by references and technical reasoning.
- Ranges of expected numbers that help focus the discussion based on reference points.
- Database that shows where other users have obtained benefits and what the impact was.
- Clearly understandable calculations. The goal is not to confuse one's customer into buying something. The logic and calculations should be obvious.

Now that the customer has a realistic business case, with the reasoning behind the case, references for the reasoning, support documentation and an understanding of how the business cases were developed, a business discussion can occur. The premium value pricing can be seen as an investment. However, if the customer believes that the supplier is engaging in a value-pricing exercise (the more value he agrees to, the higher the price the supplier will charge), the supplier will encounter resistance. This exercise should be used to justify the supplier's price. We will later discuss how this value quantification helps in the initial pricing process.

All the customer can question now is whether the supplier will guarantee such performance, the probability that this will occur, whether the value created is aligned with the customer's goals and the political question "Does the person investing in the solution belong to the department that will reap the benefit?" The supplier needs to have programs and answers for these reasonable questions.

At a 2010 Winning with Procurement conference, hosted by Huthwaite International in the U.K., Paula Gildert, the head of R&D procurement at AstraZeneca, offered an interesting summation:

Suppliers often don't come to us with a business case. But it's what we want. Sell your value in our numbers to get our attention. But if you can't quantify your value – don't be surprised at the failure of procurement to do so.

### ***Pricing for the value created***

Once a supplier has created value and has quantified that value in terms of a comparison with the next best alternative, it is time to price so that the supplier and the customer each gain an equitable return for the investments that will be made or have been made.

Since different customers, different segments and different groups within the value chain all have different value created for them, it is important to start with who obtains what value and where in the asset life cycle. After a supplier runs numerous simulations, based on best available data, industry benchmarks it knows and assumptions on improvements based on its test data, it can begin to obtain ranges of impacts for different customer segments. Whether it can support many different price points will then depend on its channels to markets and the type of product or service it is selling. For simplicity's sake, a supplier would

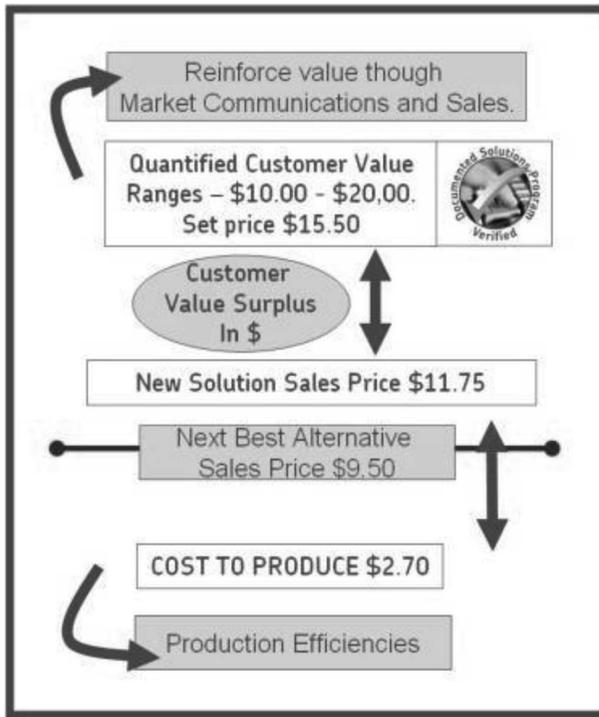


Figure 16.4 Quantifying customer value

choose a price for its new offering based on the average incremental value created versus the next best alternative, where the value surplus that the buyer receives is enough incentive for them to try the new offering. This ratio will change based on the hardness of the value created and the time frame. If the value is immediately recognizable and very hard in measurement terms, the supplier can charge a higher proportion of this value. However, if the payback is longer term, the hardness of the value less visible and the certainty less, the supplier would and should retain less of the value surplus.

When the value is created through the OEM, the supplier must calculate the incremental value that the user of the products received and then work backward to value-price. For example, if a supplier's offering helps an OEM create a machine that lasts longer, uses less energy and is less expensive to repair, the supplier would need to calculate how much value it creates for the user of the machine and then price for that and help the OEM explain that value to their customers.

**The process**

- Calculate ranges of customer value (Figure 16.4).
- Determine production cost.

- Determine whether there is enough profit to move forward. If not, STOP.
- Determine a sales price that maximizes one's profitability, with enough incentive for customer to move versus next best alternative.
- Sales and marketing must work on increasing the understood customer value.
- Engineering, quality and processes focus on production efficiencies.

One option is pay for performance agreements, where suppliers are paid on their ability to increase the measurable value created versus the existing situation. Vitasek shows that companies engaging and rewarding their supply base around value created are more profitable than other companies (Vitasek et al., 2010).

Although value pricing is the usual and most visible way of getting paid for value, other options, such as increased share of customer wallet, less discounting of overall business, longer customer agreements and even a consulting fee for finding the cost-savings ideas, might be more palatable and easier for the customer than a price premium alone.

**Communicating your value.** The supplier may have found value that its customer cares about, may have created it, measured its financial impact and priced appropriately for it, but if it cannot communicate that value in a way that the customer understands and appreciates, the whole exercise is likely to fail to yield the desired results. Let's discuss two main points: the use of the word *value* and what the customer hears and the use of industry and technical jargon-laden communication pieces.

"Value" has begun to acquire a negative connotation in the marketplace. First, the word is constantly overused. However, and more important, "value" has come to be associated with low-priced offerings. Think of the advertisements one hears about store brands, low-frills airlines and low-priced knockoffs – they all offer VALUE. The underlying message is that the only thing that creates value is a low acquisition price, that no other attribute creates a measurable or meaningful value. Even though that might be true for some of these product categories, it is not what I mean by value.

The word has also been used to encompass all the soft things we "enjoy" in a relationship. A value supplier is responsive, listens to its customers and offers things it does not charge for. Basically, it creates *soft value*.

"When we know something, it is difficult for us to imagine not knowing it or to understand why others also don't know it. As a result, we often find it hard to communicate and collaborate effectively with others" (Bertini, 2016). In technical industries, we see communication material covered in industry language because we feel we are customizing our message. Even if a supplier's audience is a technical buyer, the supplier will need the commercial buyer's involvement. The supplier should not make the mistake of relying on the customer to translate its marketing message of longer, better, faster, more reliable, harder or safer into a business case for their company.



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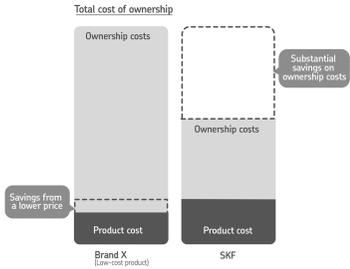
**But what about non-critical applications?** Is it good business to purchase lower cost, lower quality products for non-critical plant productivity equipment? And wouldn't SKF products have to help that equipment run far beyond its anticipated MTBF in order to justify choosing them?

Actually, no. Even less critical equipment benefits from SKF knowledge. The minor savings from lower cost, lower quality products is overwhelmed by TCO savings. In fact, only a minor MTBF/R improvement supports your choice of SKF. It may sound hard to believe, but by plugging the numbers into SKF Documented Solutions software, we can prove it.

**The bottom line?** For even the most non-critical applications, and even when SKF products cost three times more than the competition, a facility would only need those applications to run about three weeks longer to justify the additional investment.

See how we prove it with the SKF Documented Solutions example on the reverse side of this sheet.

**Total cost of ownership**



The chart shows two bars representing Total Cost of Ownership (TCO). The left bar is for 'Brand X (Low-cost product)' and the right bar is for 'SKF'. Both bars are composed of a dark grey 'Product cost' base and a lighter grey 'Ownership costs' top. Brand X's product cost is lower than SKF's, but its ownership costs are significantly higher, resulting in a taller total bar. SKF's product cost is higher, but its ownership costs are much lower, resulting in a shorter total bar. A dashed line indicates the difference in ownership costs, labeled 'Substantial savings on ownership costs'. A small box points to the lower product cost of Brand X, labeled 'Savings from a lower price'.



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Figure 16.5 Price versus value

So let's not throw the word "value" around unless we are willing to quantify it. It is more appropriate to speak of the financial impact that is created for the customer; and that impact must be expressed in dollars and cents, euros, etc. (see Figure 16.5).

### Implications for innovation in pricing

As has been suggested before, the pricing discussion must be part of the whole new-market development process, and it should provide that sober second thought that challenges the wild assumptions of engineers and product developers. Suppliers must keep asking, "If value is really created versus the next best alternative, what can be charged for it?"

This discussion requires a true understanding of the TPA, including all profitability factors, all costs and all revenues that have been created for each party

along the value chain. If a supplier is trying to persuade an OEM to pay for value that will be realized by someone else in the value chain, then it must be able and willing to help the OEM communicate and capture part of that value. The theory of willingness to pay needs to be updated to a newer version – Ability To Pay (originally used in investing and taxes – someone’s ability to pay) – that will be based on the soundness of the supplier’s business case. At the extreme, a customer’s willingness to pay will be based on their ability to pay. If it’s a guarantee of performance and benefit, the buyer should be able to take the supplier’s business case to their bank and use it as collateral to secure the investment needed to buy the supplier’s solution. Willingness to pay increases as benefits are converted into hard, measurable currency, and ability to pay changes as the value created becomes a “currency” that can be traded internally for more funding or with a local bank.

Pricing professionals may need to offer customers many different ways to pay for the value created. A price premium supported by a business case that one’s sales force customizes and can clearly articulate is only one way. Pay-for-performance relationships, in which a premium is paid as value is created, is the next evolution for some capital goods that can have clear measurement impacts.

A supplier that invests to create better products or services must ensure that it can get paid for part of the value created. It must equip its sales teams with the necessary tools, knowledge and skills to present and market communication collateral so that they can explain why its price increase is an investment.

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# 17 Pricing strategies for recessionary times

*Fernando Resende*

## **The challenge**

How to be profitable in a competitive market with limited opportunities where the contractors push for the lowest price and competitors' strategy is to win the deal, no matter what they need to do in terms of pricing.

## **The strategy**

If the strategy of the company is to participate in these types of opportunities, you can't play the "game" of low prices. You need to define a strategy to get the deal with a sustainable margin using smart pricing. You need to define a strategy that drops down the initial investment from the customer (CAPEX) and think about how you can get additional revenues mid- to long-term. The main question in this situation is how to decrease the initial prices, not the margin, and maintain a healthy business.

The first and very important initial step is to make sure that your scope of supply of your proposal is what the customer needs and requested in the technical specifications. Below you can see some topics you need to consider during proposal elaboration and negotiation.

## ***Scope optimization***

One of the main problems I faced working in the pre-sales/pricing area is that sometimes the prices itself are not the responsible for your proposal to be higher than the competitor's. The real problem could be the scope of supply you are considering in your offer. I already saw some cases where the price difference between your offer and the lowest could be reduced by only aligning the scope with the customer (or even with internal meetings reviews). If you don't realize a scope optimization in some cases and you decide to go ahead with only price discounts, you could win a deal with a smaller margin than you could have realizing it.

When an RFP (Request for Proposal) is released, the scope and technical specifications are normally not so clear and sometimes the documents don't bring

enough details for you to build your solution. In these cases, what I normally recommend is to schedule a meeting with the customer, if possible and allowed, to understand their needs. If the customer doesn't accept meetings during the RFP process, I recommend to

- Ask official and intelligent questions during the period allowed by the customer. Think about what you can ask in your favor. Don't ask questions if the response could be to your disadvantage. Example: Don't ask if the customer wants a specific feature you don't have. Ask if the customer wants a feature that your competitor doesn't have.
- Make a clear schedule that reserves a good amount of time for scope review. Normally the timing that the customer gives you to prepare the proposal is short, so plan all the activities from the beginning and convince all involved of the importance to follow the schedule.
- Exclude anything extra from your scope. Make sure that the scope you're considering in your proposal is clearly requested by the customer. If it's not clear, consider it as optional, present prices separately from the main scope and inform the customer that it's not included in the basic offer.
- The best technical solution is rarely the most competitive commercial offer. There is no need to present the "state of the art" technical solution unless you're sure that the customer intends to pay extra money for that.
- What is not in the specifications or customer request, assume to your favor. Sometimes the customer mentions a technology or extra functionality only to know about the benefits of your solution, but they are not asking you to include this extra scope into your proposal. So if these types of extra scope are not clearly defined as mandatory, don't include them in your basic pricing.
- Utilize a roadmap to fully maximize cost efficiency. Consider the roadmap of your products and the customer schedule to build an optimized offer. Sometimes during the proposal elaboration you don't have the better-cost solution, but you can have it ready when the project will be implemented.
- If you are offering configurable equipment, utilize the minimum recommended hardware that meets the specifications and exclude redundancies, unless requested.
- In case of software, offer only the basic software and necessary additional software when required. Try not to price optional software/features. You can price it higher later once you have signed the contract.
- If services are part of the scope, offer only the requested scope of work. If the specifications are unclear, state clearly in your proposal what is part of the scope and what is not. Make sure that the seniority level of the resources you're considering are appropriate to the service the customer has requested. For example, don't consider a Senior Engineer when a Technician is enough to execute the service and meet the customer request. Often you have an overqualified team for the proposed service.
- Carefully analyze the service resources dimensioning: travel and living expenses, tools, cars, phones, etc. This can be a high cost.

- Regarding pricing of third part components – if the costs are relevant compared to total project costs, list the price of these components separately. Offer the customer the option to purchase these components directly from the third party.

Considering all that is mentioned above, we can have an attractive commercial offer with the scope aligned with customer expectations. All extra scope can be priced separately with a comfortable margin that could bring you additional revenues in the medium to long term.

### ***Recovery killers***

Once you are comfortable that the scope of your proposal is optimized, you need to be careful with some points that I used to call “Recovery Killers.” They are points that can destroy the margin of the project if you don’t analyze them carefully during the proposal elaboration.

- Be careful about discount applied to a unitary price level before the final negotiation. Instead, it is preferable to offer a special discount for the package or special discount for the project. Adjusting the scope can be done during the negotiation phase, and if you define a unitary price list with a discount before the final scope definition, you can discount items that have quantities different than forecasted in the RFP and have direct impact in your final margin.
- Do not commit to price erosion. It’s very dangerous to commit to future discounts if you don’t have a clear visibility of your costs in future years. It is preferable to agree to a new negotiation with the customer after a period or if there is a huge change in the demand or quantity.
- Avoid extraordinary business models, such as pay-as-you-grow, revenue sharing or price per user/subscriber, unless you carefully analyze the impacts. If you decide to go with one of these business models, agree on clear rules with the customer that they need to meet for the pricing to be valid.
- Avoid special discounts, such as percentage of sales, unless you have a clear commitment for the total scope/volume from the customer.

### ***Checklist for smart pricing***

There are also some basic rules that I like to follow during the pricing definition and the negotiation phase with the customer. These can help you to define a pricing value for your products/solution instead of only price based on the cost-plus margin.

- Always consider the previous prices that the customer had.
- Do not give a discount without reason.
- Check if the customer has some link to another company (mother company, subsidiary) and align the prices.

- Think about where the scope of the project will grow in the following years and price accordingly. Price expansible items higher than one-off items.
- Price components that competitors don't have and the customer wants with a higher price.
- Check out the market price level for similar deals or customers.
- Do not present prices for items customers don't ask for. You can price them higher later if you get the contract.
- Understand how the customer will negotiate the deal and how many "rounds" of negotiation there will be. If there is more than one round at list price, never offer your best price at the beginning.

The main idea of the process above is to reduce the initial price as much as you can for the customer to make the project viable from an investment point of view, avoid any extra discount that is not necessary and maximize the gains for the medium to long term.

### **The results**

The usage of scope optimization and smart pricing could reduce the costs and prices significantly, depending on the case, and increase the commercial margin. Instead of giving discounts to the customers, you could optimize the initial scope, drop down the prices and keep the margins at a healthy level. Of course, there are some cases where you need to drop your entry margin anyway to win the business. But if you did a good job on scope optimization and smart unitary price lists, you can see your margin recover at the first expansion you have.

### **The unexpected findings**

If you did a very good job with scope optimization and if you presented an aggressive price after the first bid, the customer can use your price and give it as a budget to the competitors. This may force you to give additional discounts in the next rounds of negotiation.

### **Key lessons**

As part of a pricing team you're normally not in Sales, Finance, Engineering or directly reporting to these structures. Be close to these groups; they will be crucial to you to define a good strategy and ensure the scope is optimized. Also try to be close to your customers wherever possible, asking the sales team to bring you to customer meetings to understand their needs and objectives. Be a part of the pricing negotiations.

### ***Compliance moment: competition law***

Rule to remember: Do not enter into any agreement with competitors that deprive customers of the benefits of competition.

- Do not propose or enter into any agreement with any competitor about any aspect of competition between your company and a competitor, including agreements on pricing, bidding, deal terms or market share.
- Do not propose or enter into any agreement with any other party regarding whether or how to bid. Only submit bids if the purpose is to compete for and win a particular piece of business.
- Avoid contacts of any kind with competitors that could create the appearance of improper agreements or understandings.
- Do not provide, receive or exchange any of the following types of information with a competitor or its representative, whether in person, electronically or at an industry meeting:
  - Prices
  - Customers, suppliers, sales territories or product lines
  - Terms or conditions of sale
  - Production, sales capacity or volume
  - Costs, profits or margins
  - Market share
  - Sales, marketing or development strategies for products or services
  - Distribution methods



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## **Part IV**

# **Innovation in pricing tactics**



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# 18 Using economic value communication to bend business-to-business buyers' value perceptions

*Christopher D. Provines*

## Introduction

Communicating value is a crucial element in making value-based pricing work. Even the best offering, with a well-thought-out value-based pricing strategy, will underperform its potential if the value communication strategy is not well designed and executed. In business-to-business markets, economic value communication is becoming more important as economic buyers play an increasingly influential role in the buying process and decision. Seller firms face margin erosion, pricing pressure and missed revenue opportunities if they cannot effectively deal with economic buyers who are unwilling or unable to acknowledge value.

There are a number of environmental and organizational forces causing the rise of the economic buyer in business-to-business markets. First, the great recession of 2008–2009 has put pressure on businesses to take costs out and be more competitive. Next, there has been a strong move by many businesses to upgrade their procurement capability and become smarter buyers of goods and services. Finally, globalization has meant new competitors and broader transparency of prices across geographies and channels. Taken together, these drivers have significant implications for sellers and their pricing.

In response to these trends, many sellers have moved from selling a simple product or service to selling solutions. These solutions are generally more complex and require a different level of marketing communication and buyer involvement. Likewise, these complex offerings are usually more difficult to understand from an economic value perspective. So, sellers' own moves to differentiate offerings are creating the need to be more effective at economic value communications.

The focus of this chapter is on economic value communication to the economic buyer in business-to-business markets. There are numerous people in the buying organization who influence supplier selection and purchase decisions in the business-to-business purchasing process. These people have differing roles, which can include the user buyers, technical buyers and economic buyers. Each of these buyer types can represent either individuals or groups of people (Miller & Heiman, 1986). The primary focus of the economic buyers, as is used here, is on evaluating the economic consequences of selecting one supply alternative over another. These buyers are interested in the bottom line. They care about things

like cost reduction, revenue growth, productivity improvements and return on investment. Usually these buyers are interested in not just price, but also getting good value for money.

One may assume that economic buyers are highly sophisticated in the application of analytical techniques to understand the bottom line impact of one solution as it compares to another. Surprisingly, research reveals that a large percentage of economic buyers lack the insights necessary to perform more sophisticated analysis of economic value – that is quantifying, in monetary terms, the differentiated benefits provided by alternative supply solutions (Ferrin & Plank, 2002). Thus, there is an opportunity for sellers to “bend” or shape the economic buyers’ value perception by educating them through effective economic value communication.

Value communication is also generally an underappreciated area in many seller firms. For many firms and pricing practitioners, this author has observed that much of the focus of value-based pricing is on setting the price and managing transactional prices. Much less relative focus is on developing a comprehensive, integrated economic value communication strategy and plan.

This chapter is intended to help practitioners develop effective economic value communication strategies and tactics to bend buyers’ value perceptions by answering the following questions:

- What are the types of economic value communication tools and tactics business-to-business firms use?
- How might the use of these tactics and tools vary based on different buying situations?
- How could a firm strategically assess a given buying situation and choose among the alternative economic value communication tools and tactics available?
- How can firms use economic value communication tools as part of a comprehensive economic value communication strategy and plan?

## **Background and theoretical foundation**

### ***Value in business-to-business markets***

What is value? There is a diversity of opinion and a variety of definitions on what constitutes value (Day & Crask, 2000). So, as a starting point, it may be helpful to define value. This paper proposes a slight adaptation of a commonly accepted definition from Anderson et al. (1993) of value in business-to-business markets. Value, as used in this chapter, means the perceived worth in monetary terms of the economic, technical and psychological benefits received by a customer firm in exchange for the price paid for a product offering, taking into consideration competing alternatives and prices (Anderson et al., 1993). This definition brings together a number of important points:

- Value is perceived, thus implying the seller can influence the buyer’s perception of value through effective communication.

- Value is expressed in monetary terms and is what the buyer firm receives in exchange for the price paid. This means that raising or lowering the price of the offering does not change its value. Changing the price only changes the buyer's incentive to purchase (Anderson et al., 2000).
- At a given price, all things being equal, a seller who excels at value communication could potentially sell more compared with a seller who does a poor job of value communication.
- Finally, value is relative to competing alternatives and prices. For buyer firms, this could include make versus buy decisions for manufacturers, and it could involve status quo versus making a change.

This definition of value assumes there are three types of benefits: economic benefits, psychological benefits and technical benefits. Economic benefits are measurable, differentiated benefits such as cost reduction, productivity improvements, revenue growth and rate of return (Nagle & Hogan, 2006). As an example, a manufacturer of an x-ray machine used in the physician office setting may have a significant advantage compared with competitive x-ray machines in terms of routine user maintenance. This difference in user maintenance time can easily be quantified and translated into monetary terms for the buyer. This is an example of an economic benefit.

Another type of benefit is psychological. As used here in a business-to-business context, psychological benefits include things like trust, relationship, service and brand. These benefits do not directly translate objectively into economic value, but depend on each buyer's subjective assessment of value (Nagle & Hogan, 2006). In business-to-business purchasing, the elements of risk and career consequences come together as an important driver of psychological benefits. The old saying "nobody ever got fired for buying IBM" is an example of this psychological benefit. Buying IBM was considered a safe bet and, therefore, had a psychological benefit.

Finally, technical benefits include user friendliness, ease of use, quality levels and technical specifications. The assumption used here is that any technical benefit that can be objectively translated into an economic benefit is captured and communicated as an economic benefit. The previous x-ray machine example showed how a technical benefit – less routine maintenance – could be translated into an economic benefit. There may be other technical benefits remaining that are more perceptual, difficult to quantify or dependent on a subjective buyer assessment.

The focus of this chapter is on economic benefit communications to economic buyers in business-to-business markets. Business-to-business consists of all organizations that acquire goods and services used in production of goods and services (Kotler, 2003). For the purposes of this chapter, this includes government organizations as well. The ability of sellers to bring convincing economic messages, tools and evidence is critical to influence buyers' value perception and willingness to pay. This does not mean that psychological and technical benefits are not important. Rather, the intent is to use economic benefits communication as the foundation for value communication in business-to-business markets. This assumes, of course, that the seller has a distinct advantage and some objective differentiated economic benefits.

### ***Communication strategy***

A well thought out communication strategy should include choices such as the objectives of the communication, the target audience, the key messages, communication tools to use, communication frequency, communication intensity and the economics of the proposed communication strategy. In business-to-business markets, there are a number of marketing communication channels that firms can use to reach target audiences such as advertising, sales promotions, public relations and publicity, direct marketing and personal selling (Kotler, 2003). Marketing communication mix – that is the tools firms use to communicate benefits and value – often vary based on industry norms, industry structure and other factors. For example, in healthcare markets, clinical trial data, scientific publications and health technology assessment studies play a key part in communicating value to various stakeholders.

In communicating value in business-to-business markets, the marketer will need to decide what element of value to communicate and which audience to target. In a buyer organization, there are different stakeholders involved in the purchase and supplier selection decision. These include the user buyer, the technical buyer and the economic buyer (Miller & Heiman, 1986). Each member of the group has a set of individual preferences and a range of influence on the buying decision (Perdue & Summers, 1991).

Figure 18.1 provides a summary of the intersection of the target audiences and the benefits communicated.

The focus of this chapter is on the lower right-hand corner – communicating economic benefits or value to the economic buyer. This does not imply that communicating other benefits to the economic buyer is not worthwhile. On the other hand, this does not presume that communicating economic benefits to the other buyer types should be ignored. Rather, this assumes there is an opportunity for seller firms to get better at communicating economic benefits to economic buyers.

### ***Rise of the economic buyer***

Webster and Wind (1972) defined a buying center as the decision-making unit of a buyer organization. Organizational buying is often a complex process and involves multiple groups of people, differing goals and conflicting decision criteria. It is also a process that is influenced by other variables, such as environmental, organizational, individual and social factors (Webster & Wind, 1972). In recent times, two of these variables have had a significant impact on the role of the economic buyer in buying decisions. These two variables, which will be discussed in detail, are environmental and organizational factors.

Environmental variables, as described by Webster and Wind (1972), include political, economic, legal, cultural and technological factors that influence the buying decisions. A key environmental factor is economics. Economic factors include the general state of the economy and business conditions. The great recession of 2008–2009 was a period of severe economic decline and uncertainty. One of the results of this period of economic decline was an increased focus on cost reduction and cost containment that seems to have carried on since the recession.

<b>Benefit Communicated</b>	<b>Psychological</b>			
	<b>Technical/ Functional</b>			
	<b>Economic</b>			
		<b>User Buyer</b>	<b>Technical Buyer</b>	<b>Economic Buyer</b>
		<b>Type of Buyer</b>		

Figure 18.1 Intersection of benefits communicated and buyer type

This resulted in businesses turning to their supplier network to extract cost savings. Many suppliers felt the brunt of this cost reduction as pricing pressure.

The other key variable influencing buying that has changed recently are organizational related variables. Organizational variables include the organization of the buying center and the purchasing function, technology relevant for purchasing and the buying tasks (Webster & Wind, 1972). Many businesses have invested in improving and transforming their purchasing function and processes in recent times. There has been a growing recognition of the role procurement can play in generating value for businesses. A survey of chief financial officers (CFOs) revealed that 73 percent of CFOs believed that the procurement function has grown more strategic and nearly a fifth of chief procurement officers (CPO) now report to the president or CEO of their company (Aberdeen Group, 2007).

Procurement has traditionally played a role in managing the buying process in many businesses. This included identifying vendors, creating specifications, initiating and managing requests for proposal and negotiating with suppliers. In recent times, partly as a result of the economic environment, many businesses have used the purchasing or procurement function not just as an organization to initiate and manage the supplier selection process, but also as a lever to deliver significant business results. This means that procurement has evolved in many businesses from the task of just managing the buying process to actually being a key economic buyer in the supplier selection process.

***The challenge with economic buyers***

There is a problem with economic buyers, particularly procurement as an economic buyer. In general, purchasing managers are more knowledgeable about price but usually much less knowledgeable about value. There is also the issue of value ambiguity. This simply means that procurement either cannot translate different benefits into economic value or is uncertain about the reality of achieving the economic benefits.

This is a real life problem. From an economic value perspective, procurement traditionally thinks of economic value as total cost of ownership. This is the total cost to acquire, use, maintain and dispose of the supply item. Studies show that even the best procurement organizations do not consistently use total cost of ownership analysis when making purchasing decisions (All, 2007). One study of purchasing managers showed that less than one third of respondents rated their company as good/excellent in even being able to identify cost drivers (Ferrin & Plank, 2002). In using total cost of ownership in supply decisions, the following have been identified as key barriers for procurement organizations (Ellram & Siferd, 1998):

- complexity: time consuming, difficult to understand, overall complexity
- cultural/organization issues
- proper use and relevance
- data availability.

In experiments with purchasing managers, one study found that purchasing managers usually chose a lower-value, lower-priced product over a higher-priced, higher-value product even if the two are monetarily equivalent to the reference. In general, there was a bias towards lower purchase price (Anderson et al., 2000). There are a number of logical explanations for this behavior. It could be due to the rewards and goals of procurement. Most purchasing managers are rewarded for reducing supply costs. Alternatively, it could be due to economic value ambiguity. This means the certainty of achieving the economic value.

Finally, the purchasing managers' behavior in this experiment could also be due to the type of supply item being purchased. In the experiment mentioned above, the item being purchased was a simple 10-hp replacement motor. This is a rather routine, non-strategic supply item. More sophisticated procurement organizations usually go through a process of segmenting supply items and suppliers into categories. The result looks something like what is illustrated in Figure 18.2 (Bueler, 2006). It could be that the purchasing managers viewed the item as standard and saw no reason to pay more for the item even if it offered more monetary value.

This leads to an important point. Professional purchasers in buyer firms get paid to drive business results. A big focus for professional purchasers is on taking costs out of the business. In the absence of compelling data, the professional purchasers will naturally use purchase price as a key benchmark and will work towards getting the lowest price possible, all things being equal. So, it is up to the seller to educate, provide compelling evidence and to convince the buyer of the economic benefits. Otherwise, it becomes a price game.

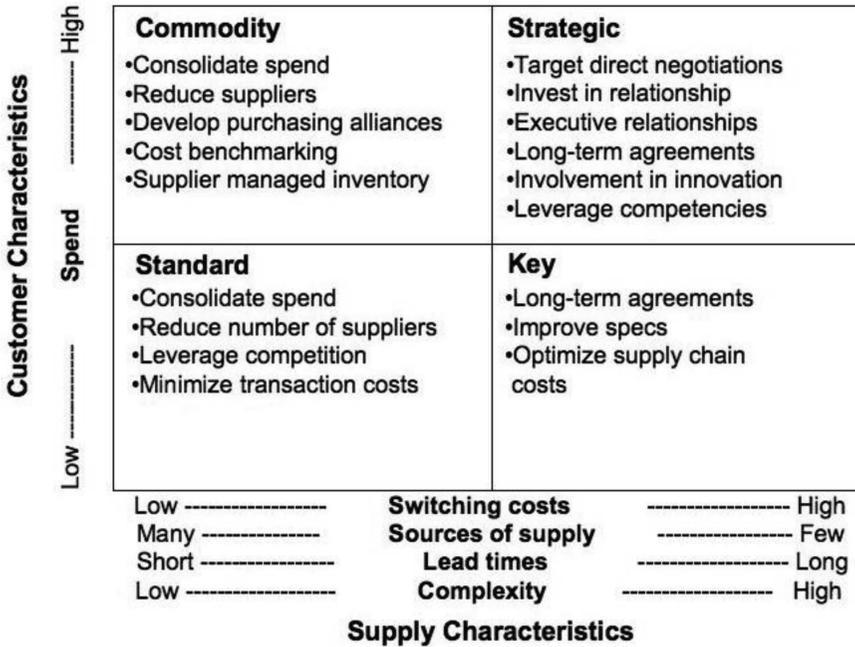


Figure 18.2 Supplier segmentation and procurement tactics

***Evolving nature of procurement as an economic buyer***

The modern procurement organization is under increasing pressure to deliver value from the supplier network in a number of ways. While reducing purchase price or costs have been the big area of focus of many procurement organizations, there are other areas that certainly cannot go neglected. For well-run procurement organizations, balancing a number of key objectives is critical.

Table 18.1 below presents a summary of the key objectives for the modern procurement organization. The degree of emphasis on each focus area will depend on the firm’s industry, operating characteristics, business situation and procurement maturity.

The reality is that while saving money is one of the key goals of procurement, particularly in tough economic times, most CPOs are also very concerned about supply continuity, quality or a supplier causing damage to the company’s brand or image. A survey of top performing CPOs revealed that reducing supply risk scored almost as high as reducing costs, even in the midst of the worst recession in decades (Martindale, 2009). For suppliers, this comes back to the idea of educating customers. Procurement organizations are rational and are interested in driving value in many different ways for their business. At the same time, these professional purchasers often lack the information and insights to make the best supply decisions. It is up to the supplier to educate these buyers and help them drive value.

Table 18.1 Focus areas and objectives for procurement

<i>Focus area</i>	<i>Objectives</i>
<b>Supply costs</b>	Reduce the purchase price as well as the total cost of ownership of supply items.
<b>Supply chain risk</b>	Reduce risk of supply disruption or supplier issues that may reflect poorly on company.
<b>Innovation</b>	Use supplier network to source product, process or business model innovation ideas and solutions to help grow and reduce costs.
<b>Non-value added work</b>	Eliminate non-value added work across the firm in supplier selection and management.

## Findings and practical applications

### *Economic value communication tools*

Given the rising importance of the economic buyer in the purchasing process, sellers will need to decide what economic benefits to communicate and how to communicate those benefits. There are a range of tools and tactics available to communicate economic benefits. These vary from relatively simple to highly complex tools and tactics. Often sellers use a variety of these tools in combination to target buyers along the consumer response stages. These stages include awareness, interest, evaluation, trial and adoption (Rodgers, 1995).

There is no standard definition for the types of economic benefit communication tools in use today. Depending on the industry, various terms are used to describe these tools. Based on the author's experience and an evaluation of case examples, definitions were developed. For the purposes of this chapter, three categories of economic benefit communication tools will be defined. These include economic benefit claims, decision analytic models and workflow/business model studies. Each of these will be discussed in detail.

### *Economic benefit claims*

First, there are economic benefit claims. Economic benefit claims are statements, messages and marketing collateral based on some evidence or data regarding the economic benefit of using the supplier's solution. These benefit communications can be delivered through numerous communication channels, including websites, personal selling and advertising. These tools include customer self-reported data, observational studies and prospective studies.

A benefit claim is used to present facts and data and is a non-interactive form of communication. Essentially, it is a one-way communication from the seller to the buyer and is usually intended to establish evidence and credibility regarding the economic impact of the supplier's solution. In choosing this type of communication tool, the seller will need to consider factors such as industry norms, the amount and type of evidence required to positively influence buyers and the investment required to generate the claims.

As an example, consider eXmark, a manufacturer of lawnmowers. eXmark sells lawnmowers primarily to commercial landscapers. On its website, eXmark states “our customers report a 20 percent improvement in productivity” ([www.eXmark.com](http://www.eXmark.com)). The company also provides information about the economics and costs of running a commercial landscape business. This helps to put the 20 percent productivity improvement into perspective for the landscape contractor. The economic claims are essentially based on customer self-reported data.

In some industries, such as medical device and pharmaceuticals, large-scale prospective economic studies are used to develop economic benefit communications. Consider the case of Cordis, the company that launched the first drug-eluting stent in the world. Drug-eluting stents are tiny metal scaffolds that are inserted into the patient’s coronary artery to prop open a blocked artery. The metal scaffolds are coated with a drug that improves the effectiveness of the device. Cordis invested in economic studies across a large number of patients to collect and compare costs of treatment across hundreds of hospitals (Ryan & Cohen, 2006). These types of studies measure the costs and benefits of using the new medical device in a controlled clinical trial, and study results are usually published in peer review journals.

The final category of economic benefit claims is observational studies. These represent studies based on the supplier observing the impact of its solution on one or more customers in order to understand the costs and benefits. These studies are often referred to as value-in-use studies. Consider the case of Camfil Farr, a manufacturer of air filtration supplies. This company has completed numerous value-in-use case studies comparing the economic benefits of using its air filters to competitive alternatives. In one comparison in a single hospital study, the company reports a 400 percent improvement in filter life and saving the customer \$1,000 per air filter change-out per air handling unit ([www.green-air-filters.com](http://www.green-air-filters.com)).

### ***Decision analytical models***

The next category of economic benefit communication tools is decision analytic models. The definition for these tools has been adapted from one that is used in the healthcare market. For the purposes of this paper, a decision analytic model will be defined as a logical mathematical framework that combines inputs, assumptions and data to help inform buyer decision makers (Weinstein et al., 2003). The value of the model lies not only in the results it produces, but also in revealing the causal logic between inputs and outputs (Weinstein et al., 2003). From a seller’s perspective, the intent is to not only educate and inform, but also to persuade the buyer. Unlike economic benefit claims, these tools allow for an interactive exchange. Usually the tools allow the buyer to input operational variables and assumptions in order to understand the range of potential economic benefits.

In practice, across a variety of industries, these decision analytic models are often called varying names. There are no standard definitions or clear standards as to how to construct these models. The models range from simple web-based analytical frameworks to spreadsheets to other software. Table 18.2 below presents an attempt to define the variety of decision analytic models used.

Table 18.2 Summary of decision analytic models and examples

<i>Tool</i>	<i>Definition</i>
Interactive web-based economic benefit calculator	Website tool that allows potential customers to enter data and calculate economic benefits.
ROI tool	A spreadsheet or other software-based tool that is used to calculate a return on investment (ROI). ROI is typically used when there is some kind of upfront capital investment required by the buyer. These tools often rely on user input and assumptions as well as pre-defined algorithms to calculate economic benefits.
Value calculator	A spreadsheet or other software-based tool that is used to communicate economic benefits. These can include comparative analysis against next best alternative. These tools can range from simple to very complex.

### ***Workflow/business model studies***

The final category of economic benefit communication tools is workflow and business model studies. These are before and after studies that are performed by the seller in collaboration with the buyer. These typically occur when the seller is marketing a complete solution or a significant change in how the buyer will operate a major business process. It could also involve a major change to the business model of the buyer firm. In this case, it is difficult for the buyer to independently evaluate and understand the economic benefits of the seller's solution. Therefore, the seller needs to work collaboratively with the buyer to prepare a clear before and after picture of the economic benefits of making a change.

One example is studies that are completed in order to sell hospital laboratory automation solutions. Many hospitals are moving to automating their laboratories for routine blood testing. In the past, hospitals operated numerous different types of instruments that perform blood tests with separate processes. Many of these instruments required hospital personnel to load and remove patient samples. With the advent of laboratory automation, robotics and automation technology is used to eliminate many manual processes, such as loading, storing and moving patient samples. Automation results in lower labor costs but also improved quality and timelier test results. This often requires a complete redesign of the hospital laboratory. Manufacturers such as Ortho Clinical Diagnostics sell automation equipment along with the service to redesign laboratory processes through lean six sigma ([www.orthoclinical.com](http://www.orthoclinical.com)).

Another example is Xerox. Rather than sell just copiers or multifunction devices, Xerox is also selling managed document services. Presumably this is being done to avoid commoditization or to capitalize on a strategic advantage. In 2009, Xerox was awarded a \$100 million, five-year contract to manage Procter & Gamble's worldwide print operations, including print shops, offices and home-based work settings. The goal was to reduce P&G's document management costs by 20–25 percent (Collett, 2010).

As firms look to take costs out and become more focused, more and more they turn to suppliers who can help change the business model or completely reengineer major processes to improve costs, time and quality. This means that sellers will need to have the resources and skills to help these potential buyers understand the before and after picture as well as the risks associated with change. Many firms have already begun to outsource, reengineer or change major processes, including business processes such as customer service, human resource processes, payroll and accounts payable.

Figure 18.3 provides a summary of the various economic benefit communication tools available to the seller. These tools are stratified by the complexity of the tool and the type of communication. The communication can be one way from seller to buyer, such as through a brochure. Alternatively, the communication can be two ways. An example would be a sales representative presenting a value calculator to a customer. The next section will discuss how to select the right tools for a given buyer situation.

**Economic value communication strategy**

In order to help facilitate selecting the right communication tool and tactics, a conceptual framework was developed. The framework proposes two factors that

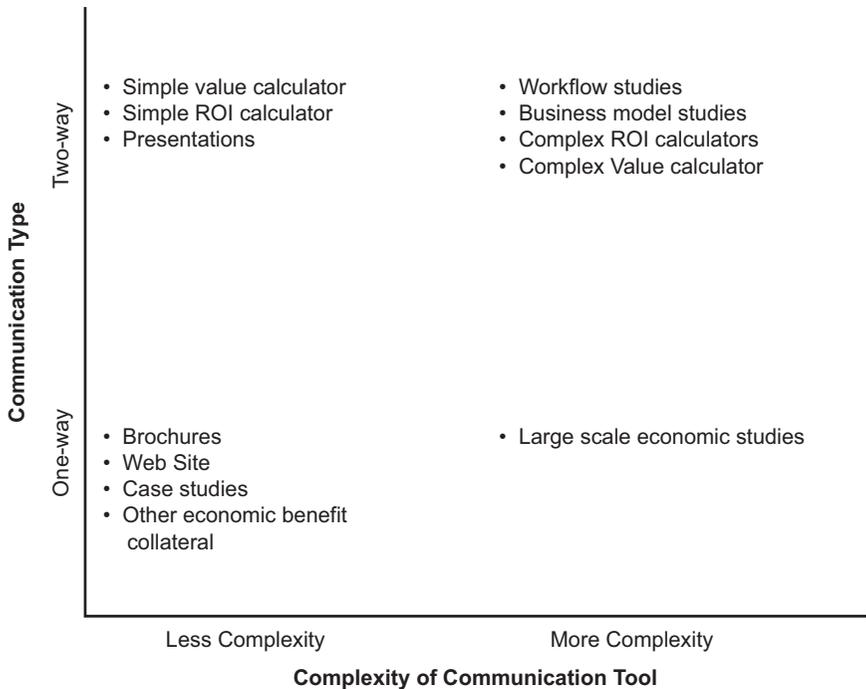


Figure 18.3 Summary of economic benefit communication tools

should influence the choice of economic benefit communication strategy and communication mix. The first factor is the complexity of the offering. The other factor is the buyer's perceived outcome risk.

From a definitional perspective, an offering was considered to be highly complex if it was a customized, integrative combination of goods, services and/or software to meet the customer's needs (Galbraith, 2002). Often, complete solutions from sellers are viewed as highly complex solutions. The Xerox managed document services solution is an example. Complexity of an offering can also be driven by factors such as technical complexity, ease of installation and existence of after sales service (McCabe, 1987).

Using complexity of the offering as a factor in determining the type of communication channel, tools and tactics is relatively straightforward. The more complex an offering is, the more difficult it is for the buyer to assess and understand value. Complexity of the product has also been associated with how buyer firms make the buying decision (McCabe, 1987). In turn, this means that the seller needs to deploy different tactics to help educate the buyer in understanding the economic value. This concept is also consistent with findings from diffusion of innovations research. As the complexity of an innovation increases, it becomes harder to understand and the rate of adoption decreases (Rodgers, 1995).

The notion of complexity as a driver is also aligned with the way economic buyers segment supply items (Kraljic, 1983). Additionally, complexity is cited as a barrier in procurement organizations' ability to adopt total cost of ownership for purchasing decisions (Ellram & Siferd, 1998). Consider the example of Xerox discussed earlier. The economic value messages and the communication tactics change significantly as Xerox moves from selling a product (copier) to a highly complex solution (outsourcing global print services).

The other factor that influences the communication strategy is the outcome risk perceived by the buyer. For the purposes of this framework, outcome risk is composed of four variables. The variables are potential business impact, trialability of the solution, observability of the benefits and compatibility with the buyer's business. The combination of these variables impacts the buyer's perceived outcome risk. This, in turn, should drive the seller's choice of the economic benefit communication strategy and communication mix.

Potential business impact is a fairly straightforward concept and an example may help illustrate. A manufacturer of analytical testing equipment would likely face more business risk in the decision of selecting a key raw material supplier than it would in selecting an office supplies vendor. A problem with the raw material vendor would have a much greater impact than a problem with office supplies. This concept also aligns with the way procurement views the supplier network from a supplier segmentation and purchasing strategy perspective (Bueler, 2006; Kraljic, 1983).

The other variables impacting perceived outcome risk are adapted from diffusion of innovation research. Rodgers (1995) determined that there are attributes of an innovation that drive the rate of adoption. In addition to complexity that was mentioned previously, additional attributes include trialability, observability and

compatibility. In the context of perceived outcome risk for economic value communication, Rodgers' original definitions were adapted as follows:

- **Trialability** is the degree to which the buyers can trial the offering on a limited basis and measure economic benefits. The buyer will perceive more risk in offerings that cannot be trialed.
- **Observability** is the degree to which the outcomes are observable. The more transparent or observable the outcome, the less perceived risk by the buyer.
- **Compatibility** is the degree to which the seller's offering is seen as consistent with the buyer's existing systems, processes, organization, beliefs and behaviors. As the offering become less compatible, the buyer's perceived risk increases.

Combining the ideas of complexity of solution and the buyer's perceived outcome risk as two key factors that influence economic benefit communication leads to Figure 18.4, which provides a segmentation and categorization of communication tactics and tools based on the author's experience as well as a review of case examples. As outcome risk increases, there is an increase in the investment in economic communication required. Likewise, as the complexity of the offering increases, there is a need for a change in tactics to be sure that communication is effective. Regardless of the quadrant, there is a need for the supplier to "teach" the customer new insights about the economics of the customer's business and show how the supplier's solution creates improved economic benefits relative to other alternatives.

The notion of teaching customers is consistent with recent research. Recent research on sales teams shows that the most successful sales representatives are those who challenge the customer and teach the customer something new about their business. The point of Figure 18.4 is that there are a variety of economic benefit communication tools available to the seller. In order to be successful, sellers will need to strategically assess the type of buying situation and choose the tool or combination of tools to best influence buyers. Each buying situation will be discussed in detail with an example.

### ***Quadrant 1: Low complexity/high outcome risk***

This is a quadrant where many new high-cost technologies fall. Economic buyers are particularly concerned about investing in expensive new technologies and not receiving the benefit in return. Successful economic value communication tactics include large-scale economic studies, case or pilot examples, sophisticated value calculators and sometimes guarantees. Take the example of Genomics Health (GHDX). GHDX is a California-based, innovative diagnostics company. Oncotype DX Breast Cancer Assay is a multigene expression test, developed and marketed by GHDX, that physicians currently use to predict the likelihood of chemotherapy benefit and recurrence risk for patients with early-stage, estrogen receptor positive breast cancer. Prior to this test being available, doctors relied on treatment guidelines that took into account inputs like the size and type of cancer tumor to decide who should receive chemotherapy.

		Relative complexity of offering	
		Lower complexity offerings	Higher complexity offerings
Degree of outcome risk	Higher risk	<p><b>Quadrant 1: Economic value communication tactics</b></p> <ul style="list-style-type: none"> <li>• Value calculators</li> <li>• ROI calculators</li> <li>• Large scale economic studies</li> <li>• Case studies</li> <li>• Risk sharing or guarantees</li> </ul>	<p><b>Quadrant 2: Economic value communication tactics</b></p> <ul style="list-style-type: none"> <li>• Workflow studies</li> <li>• Business model studies</li> <li>• ROI calculators</li> <li>• Case studies</li> <li>• Risk sharing or guarantees</li> </ul>
	Lower risk	<p><b>Quadrant 3: Economic value communication tactics</b></p> <ul style="list-style-type: none"> <li>• Simple value calculators</li> <li>• Value selling collateral</li> <li>• Case studies</li> </ul>	<p><b>Quadrant 4: Economic value communication tactics</b></p> <ul style="list-style-type: none"> <li>• Case studies</li> <li>• Value calculators</li> <li>• Supplier scorecards</li> </ul>

Figure 18.4 Economic value communication strategy framework

In the traditional diagnostics testing industry, where a \$50 test is considered expensive, GHDX set the price of its new diagnostic test at approximately \$3,500. The value proposition to payers (government and private insurers) was simple. Based on existing treatment guidelines, some percentage of patients were receiving expensive chemotherapy (approximately \$15,000) that the GHDX test suggested was not necessary. In order to persuade payers that the test was good value for money, GHDX developed economic studies and value models to prove that if physicians used insights from the new test, the test would be a fair value at \$3,500.

However, for some payers, the evidence was not enough. A common challenge in the diagnostics industry is to prove not only that a test provides new clinical insights, but also that physicians would use insights from the test to change clinical practice. From a payer perspective, the payer is worse off if it pays for an expensive diagnostic test and the women and doctors do not follow the test results. So GHDX went a step further. They entered into risk sharing arrangements where they tracked, along with a payer, whether the test was having the intended impact on clinical practice. If the number of patients receiving chemotherapy exceeded an agreed upon threshold, even if the test suggested that the patients would not benefit, the insurer received a pre-negotiated lower price. In this example, the supplier used multiple tools/tactics to create an integrated economic communication strategy including large-scale economic studies, value calculators and guarantees.

**Quadrant 2: High complexity/high outcome risk**

In this quadrant, there is not only high outcome risk for the buyer, but the offering is very complex. This makes economic value communication a challenge.

Consider the example of suppliers who sell hospital laboratory automation equipment and services. Since each automation solution is customized for a given customer based on the customer's unique operating characteristics and needs, vendors develop different approaches to communicate economic value. Often the automation solution includes products, services and software. In this case, there is typically a detailed workflow study that is performed to develop a picture of the current state of the customer's operations.

Much like the Xerox example discussed previously, laboratory automation vendors try to identify operating improvements, which could include revenue growth, efficiencies and cost reduction opportunities. By teaching the customer about their current operating issues, the workflow studies open up the opportunity for the suppliers to highlight how their solutions could help drive improved economic value. In these complex selling situations, teaching the customer and highlighting economic opportunities is critical and requires a customized consulting-like approach.

### ***Quadrant 3: Low complexity/low outcome risk***

In this quadrant, the solution should be relatively easy to understand and the outcome risk is low. An example is a manufacturer of air filters that has a superior filter, which requires less frequent changing. The filter is also more efficient because it causes fan motors to work less and has a lower loss of air pressure. Thus, it requires less electricity to operate. The air filter supplier communicates economic benefits around reduced labor for changing air filters and reduced energy costs. In order for the customer to achieve the outcomes promised by the air filter vendor, it simply needs to switch to the new filter.

In this example, the supplier uses simple economic value collateral to communicate the economic benefits. Since the filters fit the existing system (compatibility), can be used on a limited basis (triability) and results measured (observability), economic value communication should be relatively simple. In this quadrant, typical communication tactics/tools include economic claims in the form of value-in-use studies and simple value calculators.

### ***Quadrant 4: High complexity/low outcome risk***

In this quadrant, the buying situation includes an offering that is relatively complex but has lower perceived outcome risk. This could be due to the nature of the solution being purchased. An example of a relatively complex offering that has low outcome risk would be call center outsourcing. Call center outsourcing is not a new phenomenon. Business process outsource firms have been doing this for some time. Additionally, outsourcing could potentially be done on a pilot or limited basis to 'trial' the outsourcing solution. Economic benefit communication tools for this quadrant would include case studies, ROI calculators and value calculators.

The conceptual framework presented in Figure 18.4 is meant to guide practitioners in thinking about an economic benefit communication strategy. Ideally, the economic benefit communication strategy should be an integrated strategy, which includes multiple communication channels, multiple tools and key messages to

communicate. The communication objectives, investment required and the business case should be a starting point for the communication strategy. With this as a starting point, the seller will need to strategically assess the buying situation and choose the right mix of benefit communication tools and tactics to successfully influence economic buyers.

## **Conclusions**

In business-to-business markets, value is perceived. It represents a combination of the economic, technical and psychological benefits received in exchange for the price paid, relative to alternative solutions. This means that sellers have the opportunity to shape or 'bend' buyers' value perceptions. Many buyers, even sophisticated ones, lack the tools and insights necessary to assess the economic benefits of suppliers' solutions. So, what do they know?

Being rational buyers, business-to-business economic buyers at least know and can evaluate one dimension of the offering. This, of course, is the price of the offering compared to other alternatives. In the absence of clear and convincing economic benefit communication, the seller risks a buyer who is focused primarily on price. This can lead to price competition and erosion.

One way to combat this price competition and erosion is to develop an integrated economic value communication strategy. This is not about simply developing a value calculator and handing it to the sales force. It is about developing a comprehensive communication strategy.

The complexity of the offering and the perceived outcome risk of the buyer are two key factors that should influence how sellers think about an integrated communication strategy. The greater the complexity of the offering, the higher is the need to communicate economic benefits. Similarly, the higher the perceived outcome risk, the more the seller will have to do to convince the buyer of the economic benefit of the solution.

## **Implications for the pricing field**

- Much has been written about how to assess economic value and set prices based on economic value in business-to-business markets.
- However, a firm's investments in assessing value and setting value-based prices will ultimately prove fruitless if economic benefit communication does not succeed.
- A company's economic benefit communication strategy is proposed to be dependent on two factors: (1) the complexity of the offering and (2) the buyer's perceived outcome risk.
- Different value communication tools and tactics should be used depending on the complexity of the offering and the perceived outcome risk. These communication tools and tactics should come together in an integrated economic benefit communication strategy.

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# 19 Value

## Distilling the essence

*Harry Macdivitt*

### Introduction

Most businesses today are confronted with rapid technological change, intensive competition from existing competitors and new entrants, and ever decreasing life cycles. These conditions have resulted, in many industries, in premature commoditization. To preserve their market share, companies often reduce their prices either voluntarily or because of insistence by customers exercising their buyer power. The result is declining revenue, margin erosion and business failure. Nevertheless, some companies manage to thrive. These companies identify and use customer value as a strategic tool.

What often present as pricing problems are really failures to come to grips with the underlying value issues. A deep understanding of customer value helps us to make much better business decisions. In one sense, every price accepted by a customer is a value-based price. If there were no value, there would be no sale! But we can achieve much better prices by delivering much better value or by making customers aware of the real value we deliver to them. This is true whether we are pricing on cost or competition or deploying value-based pricing. George Orwell famously wrote, in *1984*, “All animals are equal, but some are more equal than others!” Something similar can be said about customers – and this takes us to the tricky and complex topic of market segmentation. Segmenting our markets on value, and identifying the most attractive personae, is a significant challenge in implementing value-based pricing effectively. We have a few suggestions to help the pricer a bit later in the chapter.

Value is tricky to define and conceptualize (Liozu et al., 2012) and, for this reason, can create difficulties both inside organizations and in communications with customers. Failure to identify the value created, and to present this compellingly to customers, reinforces commodity perceptions and fuels demands for further and deeper discounts (Hinterhuber, 2008). It is a vicious circle. Effective practical solutions are elusive.

Businesses must learn how to define the value they offer in terms meaningful to customers and to craft distinctive propositions that present this value compellingly and convincingly. This requires new and different thinking in which the focus of attention is moved away from product technology and specification to

how products and services impact customers at economic and emotional levels. Our experience shows that when businesses make this transition, margins increase and market shares are protected.

In this chapter, we present an innovative approach to defining and quantifying value. The model we describe, the value triad (Macdivitt & Wilkinson, 2011), is a simple but powerful tool to help business managers focus on the value they offer. We describe two case studies in which the model has been applied.

## **The value triad in practice**

### *Typical customer challenges*

*“All products in this market are the same – including yours. . .”*

(Automotive components manager in discussion with product manager)

*“Banks today are all merely suppliers of poor quality, commoditized services . . .”* (raised with wealth management sales executive by a lawyer advising a very wealthy family)

*“You’ll have to drop your prices if you want to keep our business . . .”*

(asserted by purchasing executive in a U.K. hospital to a medical device sales manager)

*“Your technology is irrelevant. We can get the same functionality as part of an integrated bundle from other suppliers – and at a tiny fraction of your price . . .”* (opening gambit by chief buyer in a Tier 1 telco to a supplier of advanced aerial components).

Every one of these assertions was made over the last 2–3 years in the context of a sales interview. Every assertion was made directly to sales people and product managers. Sales people promptly passed the problem “upstairs” to product managers. Product managers had no answers and nowhere to hide! In every case the supplier’s market share exceeded 50 percent. And in every case, managers were almost completely at a loss to know how to deal with the situation.

Academic studies have shown the impact of competitive intensity of pricing performance for new products (Ingenbleek et al., 2010). Continuing economic uncertainty has engendered a perception that the only solution to a pricing problem is to yield to customers’ increasingly unrealistic demands, drop price and hope for the best. Because managers and sales people do not know how to respond and lack critically needed confidence in pricing (Liozu et al., 2011), the only solutions are either to walk away or to discount – usually deeply. Deep discounts make things worse, not better, and sets up the discounter for more of the same. Walking away creates an opportunity loss.

There are alternatives. The above companies were not, and are still not, commodity suppliers. Each is still a leader in its segment with a market share between three and five times what one would expect in a genuinely commoditized situation. But their customers hoodwinked their salespeople into believing that their

prices were too high, that their products were commodities and not worth the prices being charged and that they would lose out if they didn't drop their prices *right now!* Because these companies learned how to identify and use value, their customers are still buying, often at higher prices than before (Hill et al., 1998).

Most businesses today are seeking to protect the revenue, profits or share that they already have achieved. Developing a value argument for them is a strategy to reverse margin erosion. To achieve this, they must persuade their customers of their differential value (Hinterhuber, 2004; Nagle & Holden, 2002). These companies employ value as a means of fighting back against the torrent of demands for discounting.

### ***The value triad***

Value can be quite “slippery” to define as it can have many tangible and intangible dimensions. A simplistic definition cannot capture this completely. The value triad (Figure 19.1) is a practical tool that helps managers capture as much as they can of the richness and variety of meaning encountered in value. By building a real focus on customer value into product development processes and service delivery, companies can have a solid basis for creating differentiation – doing something different in a manner that really matters to the customer. By clearly focusing on customers' needs and pain points, novel ways of serving can be uncovered (MacMillan & McGrath, 1997). Value triad analysis should lie at the heart of sales, marketing, product management and pricing decisions. It is a unifying concept and can bring these important functions together (Macdivitt & Wilkinson, 2011).

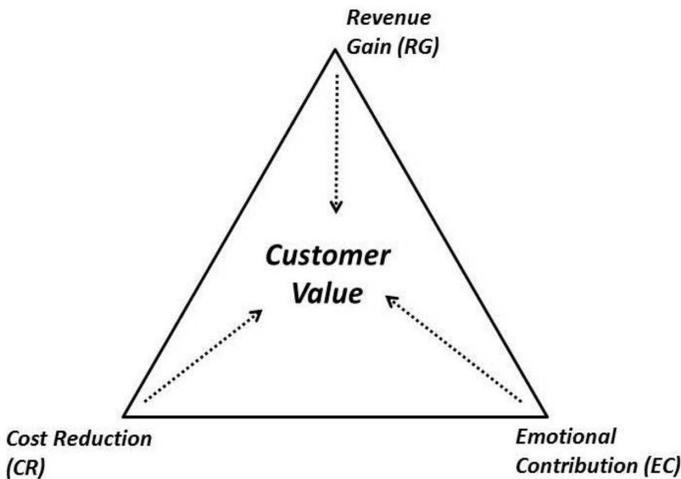


Figure 19.1 The value triad

The three elements of the value triad are revenue gain (RG), cost reduction (CR) and emotional contribution (EC). Revenue gain and cost reduction focus on the functional, tangible, objective and inherently measurable elements of value. Emotional contribution focuses on how less tangible, more subjective and somewhat less readily measurable factors contribute to the purchase decision.

Revenue gains (RG) refer to the increases in customer revenue resulting from the application of products and services. Cost reduction (CR) relates to how products and services reduce customers' costs. The key issue is that output value to the customer is not compromised. Finally, emotional contribution (EC) is in general linked closely to the "feel good factor" (e.g. reduction of "hassle," peace of mind, increased confidence, greater safety, aesthetic appeal, trust, self-esteem, reduction or elimination of psychological risk, etc.).

Executives' opinions around tangible factors are generally closely aligned. The same executives, however, may have widely differing opinions about what affects them, personally, from an emotional perspective. Consequently, emotional impact is not absolute in the same way as are CR or RG. Different metrics apply to different people. Thus EC intangibles can be difficult, although not impossible, to quantify (Hubbard, 2010) supporting previous studies discussing the difficulty in assessing value (Anderson et al., 1993; Hinterhuber, 2008). Notwithstanding this, emotional considerations have a profound but often covert impact on the overall attractiveness, or even acceptability, of a proposal. An important aspect of EC is psychological risk. Even when all the value elements are lined up in a row, risk factors may scupper the deal.

Customer perceived risk is manifested in many ways in practice. These include fear of criticism from superiors and colleagues, worry about causing an opportunity loss, uncertainty and lack of confidence in the supplier's ability to deliver, supplier's inability to grasp the sensitivity of the customer's situation and frank distrust of the seller or the salesperson.

In every situation, the analyst must scrutinize the risk factors – from the customer's perspective. This is one of the important functions of the pre-sales research and of the discovery process.

### **Value drivers and the "so what?" question**

Value drivers are those factors that ultimately lead a buyer to identify a preference and make a purchase decision. In any given context, there may be several such drivers, each with different "weightings" in the choice process.

Table 19.1 shows (limited) lists of tangible and intangible value drivers. These, or a subset of these, ultimately are what most customers are looking to achieve as the result of purchasing products or services. They are not hugely interested in technical specifications or even technology. The task of sales and marketing is to stimulate their interest. The best way to make this happen is to "map" the clever parts of the product offer to the important parts of their customers' needs. This task goes well beyond the sales team and should engage the attention of

*Table 19.1* Tangible and intangible drivers

<i>Tangible Drivers</i>	<i>Intangible Drivers</i>
Increased revenues	Improved aesthetics
Faster time to market	Reduction of risk
Decreased costs	Greater peace of mind/less worry
Improved operational efficiency	Improved comfort
Increased market share	Reduced “hassle”
Decreased employee turnover	Reliability
Improved customer retention levels	Friendliness/absence of conflict

marketing, product management, development and design people at the very least. In short, value should run through the whole value chain, like a golden thread.

### *Illustrative example*

A company sells lighting systems and assemblies to OEM automobile manufacturers. The products are very clever. They can help drivers see around corners. They employ the very latest in halogen technology and are equipped with sensors that detect ambient light levels. They switch on automatically to the correct light intensity for the conditions and switch off again when not required. They are made with robust materials and employ designs that mean that the average time before failure is longer than other competitors, by a matter of months.

The first thing to consider is who might be even slightly interested in this list of product attributes? Clearly the end-customer/driver is one. These innovations might be quite interesting to him. Secondly, the OEM product designer who is looking to incorporate leading edge specifications in the product he is designing. He and other executives in the OEM may also be interested. A third group might be the dealer who sells and services the new vehicle after sales.

Let’s eavesdrop on the conversation with one of these interested customers – the OEM Warranty Manager, the executive in charge of managing warranty claims through the dealer network.

*Salesman:* Our new lighting assembly is built with cutting edge halogen lamp technology and equipped with sensors that can automatically adjust to ambient light conditions.

*W/Manager:* So what?

*Salesman:* It’s safer for the driver because she will have the right level of illumination always.

*W/Manager:* What does that matter to me?

*Salesman:* Well, it’s made with state of the art technology.

*W/Manager:* So, it is a new concept that can go wrong at any time?

*Salesman:* Yes, it is new and innovative but it’s been fully tested.

*W/Manager:* You are guaranteeing it won't go wrong and cause my people all sorts of problems sorting it all out?

*Salesman:* Well, no, but it's really cool for the customer.

*W/Manager:* What do I care?

This dialogue is not going anywhere fast and it's pretty obvious what is going wrong. The warranty manager frankly does not care anything about the "coolness" of the driver's experience. Why should he? He can't afford to own this car personally, so this assertion is completely irrelevant. He cares more about the leading-edge technology, but not in quite the way the salesman understands. The manager sees new technology as a source of real hassle based on his years of experience repairing clever components that have failed after a few days' use. This is not a really compelling value argument for him. Asking relevant questions ("so what" questions) could help to build a compelling value proposition (see Table 19.2).

Table 19.2 So what? analysis – warranty manager

<i>Attribute</i>	<i>So What?</i>	<i>So What?</i>	<i>Decision</i>
Innovative product design	Can help drivers see round corners	<b>Neutral for this stakeholder</b>	Don't care
Very latest in halogen lamp technology	Much greater illumination of road in dark conditions	New technology => teething problems => costs to replace => cost and hassle <b>Negative for this stakeholder</b>	Don't like – will cause me hassle and increase repair costs during warranty period
Ambient light sensors	Switch lights on when conditions warrant	Same as above <b>Negative for this stakeholder</b>	Same as above
Made with robust materials	More resistant to road use wear and tear	More durable => lasts longer => less replacement <b>RG, CR</b>	Like it but need evidence/proof
Plug-in design	Easy and quick to fit replacement unit	With competitive units usually hard to do in workshop => saves time, money, hassle <b>RG, CR, EC</b>	Like it but need proof
The average time before failure is months longer than competitors' products	Replacement during warranty period much less likely	Can reduce warranty repair incidents saving time, money, hassle. Also means time saved can be used for other things <b>RG, CR, EC</b>	Like it but need proof

What salespeople frequently fail to recognize is that different people in the same organization have different needs, wants and expectations, partly driven by their job responsibilities and partly by emotional factors.

Of all the value Drivers listed in Table 19.1, only five have any traction with this particular buyer:

- decreased costs (the warranty manager must work to a budget, after all)
- improved operational efficiency (this will be part of the pushback from his customers in the channel, associated with some level of hassle, too, no doubt)
- reduced hassle
- greater peace of mind (knowing that he has eliminated one important and recurring problem with the right purchase)
- reliability.

Some of these are economic in nature (cost reduction, improved operational efficiency) and others are more psychological/emotional in nature (reduced hassle and peace of mind). This set of drivers is quite different from those of the Chief Designer and different again from the end-customer's perspective.

So, what does the warranty manager really want? Let's try again.

*Salesman:* Our new lighting assembly is built with cutting edge halogen lamp technology and equipped with sensors that can automatically adjust to ambient light conditions. This means a great experience for the driver. It also means failure is almost unheard of within the first two years.

*W/Manager:* How often does the lighting system fail?

*Salesman:* The chance of a system failing is less than 0.005 percent within two years. So, you could see 200 cars without a single warranty claim based on lighting system failure.

*W/Manager:* So what?

*Salesman:* Because of the way the system is designed, not only is the failure rate lower than any other supplier, but it is quick and easy to replace. Just pull out and plug a replacement component back in again.

*W/Manager:* Thinking . . . So you are saying it can save my people time in dealing with warranty replacements and paperwork?

*Salesman:* Absolutely. Here are some independent studies . . .

This is much better. Whether this imaginary conversation would play out this way in the real world does not really matter; there are obviously other factors at play. What does matter, and matters profoundly, is that a competent value analysis must be undertaken before making any client contact. Or, for that matter, before creating any value proposition or developing any marketing collateral.

*Case Studies***Case Study 1 – Medical supplies (late 2011)**

A medical supplies company markets a range of wound dressings. Conventional wisdom in the health care industry, of which wound care dressings is a part, is to promote products primarily to clinicians on the basis that they are the principal players in an adoption decision. The sales arguments are backed up by a wealth of clinical documentation describing the results of clinical studies. The rather disturbing fact is that, for the most part, clinicians are rather uninterested in wound dressings. While they will listen politely to the salesman “detailing” the proposition, little ever happens after the visit. Why? The clinician is not the most important person to be speaking to. The salesperson should instead be speaking to nursing staff whose day-to-day job, among a host of other things, is to use and apply these products. The adoption decision is based on practical patient comfort and ease of use considerations at ward level and on procurement costs at hospital level. Complex clinical arguments, important as these are in validating the product, do not constitute a compelling adoption argument to actual users.

It is interesting to look at the issues that do matter and at the specific interests of “stakeholders” in this application. Figure 19.2 relates to U.K. and Western European hospitals that are publicly funded and do not have a profit motive. In this case, performance gain is substituted for revenue gain.

Notice the extent of variation in the importance placed by each stakeholder in the adoption decision on different Triad elements. Notice also the shapes and orientations of each triangle are also quite different. It very clearly sets out the bases of the value arguments to each group. These arguments will be different in content or emphasis, or both. If there are more than three stakeholders, focus would only be on those with, on aggregate, the greatest influence on the adoption decision. As many of the influence factors as possible should be covered.

The next step is to examine minutely the full extent of the value being offered to each principal stakeholder. A “copy-paste” from one stakeholder to another simply will not work. This is done using the So What? approach. Table 19.3 shows a partial So What? Analysis for one category of decision-maker – tissue viability nurse. This is a specialist nurse who acts as an advisor to colleagues managing severe and chronic wounds at risk of serious infection. (The remainder of this table is withheld for reasons of commercial sensitivity.)

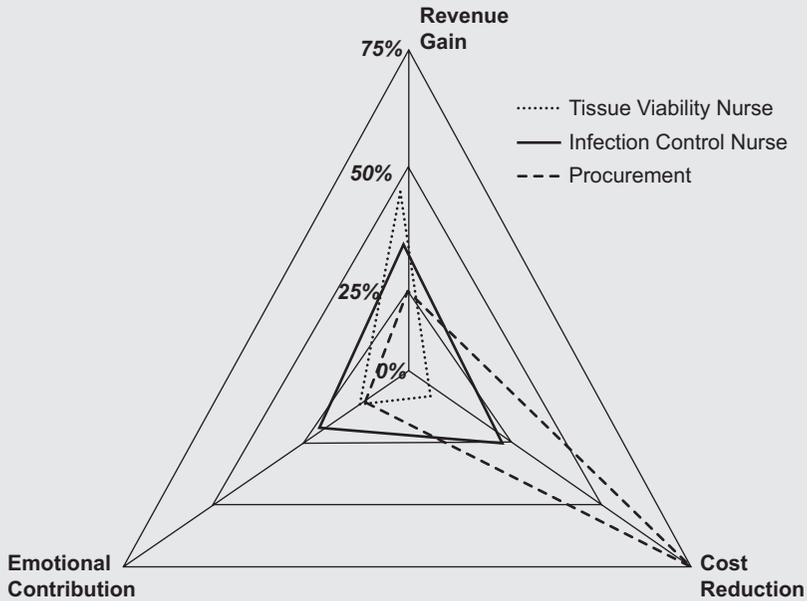


Figure 19.2 Importance of value triad factors to different stakeholders

Source: Discussions with product managers

Table 19.3 So what? analysis

Attribute	So what?	So what?
<b>Highly effective in protecting high risk wounds</b>	Improved clinical outcome	Wound looks much better => reduced patient anxiety (EC) Increased peer respect => enhanced self-esteem (EC)
	Reduces healing time	Eliminates additional costs of care from infections => saves staff and drug costs (CR) Reduced bed blocking => higher patient throughput => increased performance (RG, CR)
<b>Safe</b>	Reduced risk of complications	Reduced risk => greater "peace of mind" (EC) Improved patient outcomes => reduced patient stay in hospital (RG, EC)

The company undertook an analysis for each principal stakeholder. Starting from the product attribute (left hand column – Attribute), the first So What? question is asked. This leads to a general outcome statement, recorded in the middle column. The right-hand column contains responses to successive So What? questions and will lead to the identification of one or more value drivers for each Attribute. This provides an “audit trail” of the analyst’s thinking that others can challenge or accept as appropriate.

This is an essential step in creating a full statement of the value of a given product or service for each key stakeholder/purchasing decision-maker.

## **Case Study 2 – Industrial lubricants (mid-2011)**

An international company supplying lubricants to a variety of engineering and manufacturing businesses initiated a strategic program of change across its operating divisions. The main thrust of the strategy was to increase and intensify customer intimacy (Treacy & Wiersema, 1993) as part of a move away from the aggressively price-competitive approach widespread in the sector. The initiative was about deeply understanding the real needs of their diverse customer base and positioning themselves across key segments as the natural first choice for both lubricants and machine maintenance solutions. The intention was that, in the long term, the company would move to a value-based pricing platform. In the short to medium term, the value initiative was seen very much as a part of their strategy to halt and reverse margin erosion.

The immediate priority was to move from a highly competitive cost based approach, with its endemic “nickel and diming,” to one based on delivering real and sustainable customer value. The final “building block” of this transition was to move the sales organization away from transactional selling towards a selling approach based firmly on identifying, creating and capturing customer value. The hope and the expectation was that this would reduce or eliminate the current practice of discounting (sometimes deep discounting) on demand. This necessitated a complete re-think of how their products were delivering customer value and a move away from simple, commoditized “products” to integrated packages of product and services that offer more comprehensive “solutions.” This is an important “hygiene factor” for full implementation of value-based pricing (Macdivitt & Wilkinson, 2011).

The company was delivering terrific value but was apparently unable to benefit from it! Great piles of money were being left on the table with no way of capturing it. The new thinking around value, and internal discussions between managers, led to the realization that there was widespread lack of clarity about what their value proposition really was both inside the company and as delivered to customers.

Management fully understood that value was important but lacked a common language to articulate that value to the customer from the customer's perspective. Having been briefed intensively on the value triad, salespeople now have much more fruitful and structured conversations with customers. The focus of customer discussions has moved to how the supplier can impact key performance areas. Time is no longer being wasted, and relationships eroded, on futile and stultifying arguments about price discounting. In the process, and almost as a by-product, customer intimacy is being enhanced!

The company made full use of the So What? Analysis template but extended it in a way that enabled salespeople to identify and quantify value impacts interactively with their clients. An extract of a typical worksheet is summarized in Figure 19.3. The excel model is installed on salespeople's laptops and used as part of the customer dialogue to identify and quantify economic impact of all the value triad elements on the client's organization. Much of the value calculator is pre-filled by the salesperson during his pre-sales activity. The model enables both buyer and seller to engage in an informed dialogue about the various tangible and intangible impacts. By employing the value calculator, the supplier could calculate the real economic impact of the solution on his customer's business – often very much greater than the price charged.

This industry is intensely competitive and, in the case summarized in Figure 19.3, the buyer insisted "there is no way you can supply us cheaper than our current supplier (at that time £1.47 per liter)." The salesman completely agreed and went on to demonstrate how much additional value he could deliver. Using the value calculator, the customer realized for the very first time the true economic impact of the service and readily agreed, after validation of the data, to a price of £2.26 per liter!

It is interesting that, because of this new thinking, salespeople now perceive customers no longer as adversaries but as supportive clients and the sales dialogue as a means of jointly solving the client's issues rather than the combative relationship it had been previously. Even more interestingly, the new language of value has become part of the company's culture. Value, in this case, is truly being embedded into the value chain.

Product Attribute	Potential Impacts	Revenue Gain		Cost Reduction		Emotional Contribution	
		So what?	\$	So What?	\$	So What?	\$
<b>Effective Lubrication</b>	Extends machine life	More machine uptime		Reduction in scrap		Operator job satisfaction from higher bonuses and reduced hassle	5,000
	Better machining accuracy	More machine uptime		Lower spend on tooling Capex		Management reassurance on Health & Safety	
	Longer cutting tool life	More machine uptime		Lower spend on maintenance and Capex	2,250		
	Longer roll life	More machine uptime		Reduction in scrap	3,500		
	Better component tolerance and finish	Opportunity for Premium pricing based on superior quality/appearance.	22,000	Lower spend on energy	1,500		
<b>Effective Protection and Cleaning</b>	Reduced energy consumption						
	Reduced corrosion of components between process stages	More machine uptime		Lower scrap rate			
	Reduced corrosion of plant and equipment	Opportunity for Premium pricing based on quality/appearance.		Lower spend on maintenance and on new			
	Better final component finish	Shorter process cycle time				Avoids cost and hassle of further processing	
<b>Durability</b>	Fewer process steps required	More machine uptime		Lower spend on fluids and waste disposal			
	Longer refill intervals			Lower spend on fluid maintenance	750	More confident production planning	
	Reliable and sustained performance in use						
<b>TOTAL AMOUNT:</b>			<b>22,000</b>		<b>8,000</b>		<b>5,000</b>

Figure 19.3 Extract from value calculator – lubricant company

## Segmenting customers on value

The nature of the relationship the sellers in the above case now have with their customers has also changed. The quality of the conversation has improved immeasurably and rather than trying to sell things to the customer, they are now working with the customer to develop value adding solutions.

Not every customer wants to talk “value” and many remain intransigently price driven. This is a real challenge for both sales people and product management. Persuading buying agents to see past the dollars and cents to the intrinsic worth of the product or service to their organization can be a Herculean task. There is a great temptation to keep on pushing our value argument. Regretfully, in some cases, the ground is stony and realistically it just is not worth trying! So how do we know when to keep pushing and when to just give up and walk away – the hardest thing in the world for a salesperson to do!

In our experience, there are broadly three types of organization in terms of their response to a value offer: price buyers, value buyers and partner buyers. These categories are well known, but it is worth describing each of them. Armed with this understanding could save us a lot of wasted time, frustration and disappointment. Admittedly, this is a very crude segmentation but it is *practical!*

***Partnership and performance oriented clients*** perceive you as an essential part of their organisation’s success. To them, price is of lesser importance than your ability to enable them to achieve their strategic objectives. To that end, they will offer access to their resources, people and knowledge and will happily work with you to develop new products and processes. Make no mistake about it, these organisations are very challenging to work with. Their expectations and demands are high – you are, after all, an integral part of their strategy and they need you. But the rewards from a successful relationship can be enormous. Don’t mess it up! (Hill, McGrath & Dayal, 1998).

***Value focused and cost sensitive clients*** are good customers for companies with a value-based approach to their business. These customers will listen very carefully to your proposition and will do so with respect. They are generally not easy to persuade and are highly likely to seek extensive validation, data and research evidence to aid their decision. Such customers are cautious and sometimes slow to make purchase decisions. This, too, can be frustrating – but it is part of their process. They will acknowledge the value you present and, for them, a solid analysis will be essential. This might take some time and a bit of research to complete. The lubricants client described earlier is a typical example of a Value Focused buyer. They tend to be quite demanding in their expectations and will usually avoid over-dependence on any single supplier. For this category of client, cost is always an issue and they will negotiate hard on price.

Partner buyers and value buyers are the best target for a value-based approach to pricing and selling.

***Price focused clients*** in general do not make good customers. They tend to be very suspicious of value arguments, preferring instead to focus on price.

Every conversation with such customers always comes back to arguments about price and discounting. They perceive, or at least appear to perceive, your products as commodities. They are often masters of inappropriate comparisons and experts in comparing apples with avocados. They may occasionally adopt bullying tactics. They are hard to please and often demand unreasonable levels of service for the prices they pay. It is tempting to “sack” these customers but often they represent a significant proportion of our fixed costs and for that reason we may be “stuck” with them. What we can try to do is to research their requirements very carefully and identify a critical need, and, if you can do so validly, present your product or service as the solution to this need. This might work. Be aware that for some products, while a customer is a value buyer, for a different item he may paradoxically be a price buyer. It is all about proving business impact and getting the attention of the right person in the buying organization.

It is not difficult to fall into the trap of believing that a buying organization is a price buyer based only upon the behavior of their procurement manager when, in reality, the organization may be a value buyer or even a potential partner buyer. When confronted with this kind of behavior, it is always worth finding a way to engage others in the organization who “own” the problem that your product or service can resolve.

## **Conclusions**

A new approach is required that allows us to identify every particle of value that we create and leverage it in the markets we work in.

- Executives are preoccupied with retaining the business they have won and with stemming margin erosion.
- Many businesses are confronted by customers who claim their products are commodities, despite gallant efforts to differentiate them.
- Traditional methods to retain share and preserve margin are disappointing and many are seeking a new approach.
- Customer value provides this approach but there is no clear, easy to use process for managers to follow.
- The value triad can help facilitate more fruitful and structured conversations with customers by enabling all parties to focus on the customers’ key issues.
- If we properly understand our customers’ attitude to value, it will generally be possible to use this as the basis of prioritizing where our selling and marketing efforts should be directed.

## **Implications for innovation in pricing**

In many businesses, the most intractable pricing problems relate to presenting and defending vendor’s prices. This is particularly acute in cost-based and competition-based environments in which the usual objection is that the given

offer is a commodity and too expensive. Managers are hard-pressed to counter this because they have not assembled compelling evidence to make the customer believe otherwise. Their “microscope” is turned inward on the components of their offer. This prevents crafting of usable rebuttal arguments without which they are obliged either to capitulate or walk away. Most companies in this situation do not know how to calculate, or to engage the customer’s attention on, the critical customer value. The result is that they leave too much money on the table and enter a dangerous vortex of discounting to retain the business they do possess.

Calculating the price is merely arithmetic for the most part. The underpinning issue, which is the real cause of the problem, is value and getting this right in a given context. Much of the established literature on value focuses on the tangible aspects. Where there seems to be a relative dearth of thinking is in examining the impact of the psychological/emotional components of value. The emotional contribution factor can often be an enormous influence on the acceptability or otherwise of a proposed price. Because the customer rarely articulates it (at least in macho B2B business), it is also almost always forgotten or written off as unimportant. Yet in any given case the hidden emotional issues may dwarf the economic aspects. It may quite genuinely be the “elephant in the dining room.” We would advocate that pricing people take serious stock of the emotional impact of their product or service offer on customers and to factor it into the pricing equation and the value proposition.

The value triad approach compels us to examine, minutely and explicitly, this aspect of the transaction. In the companies in which this model has been applied the approach was completely new and led to changes in the vendor’s value chain, the way in which the value proposition was created and presented and to the levels of prices realized. Margin erosion was halted and relationships with customers greatly improved. But managers need to learn to turn the “microscope” on customer value – and move to high magnification! A focused, assertive and single-minded attention to this matter will help businesses justify their prices fully, reject the commoditization objection and halt margin erosion.

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# 20 Innovation in estimating willingness to pay

*Neil Biehn and Craig Zawada*

## Introduction

Pricing professionals frequently use the term “willingness-to-pay” (WTP) to discuss the spending limit of customers for products they buy. The concept holds promise for business-to-business (B2B) manufacturers and distributors when trying to estimate the right price for each of their products and markets. If you knew each of your customer’s precise WTP for each product, you could simply charge that price. The result would likely be a huge increase in your profit *and* market share.

However, common business techniques to determine willingness-to-pay don’t apply very well in the B2B environment. In 2006, researchers Breidert et al. (2006) reviewed the current methods for measuring WTP along with others such as Nagle and Holden (2002). These authors categorize methods for determining WTP into four key approaches: experiments, direct surveys, indirect surveys and market data (see Figure 20.1).

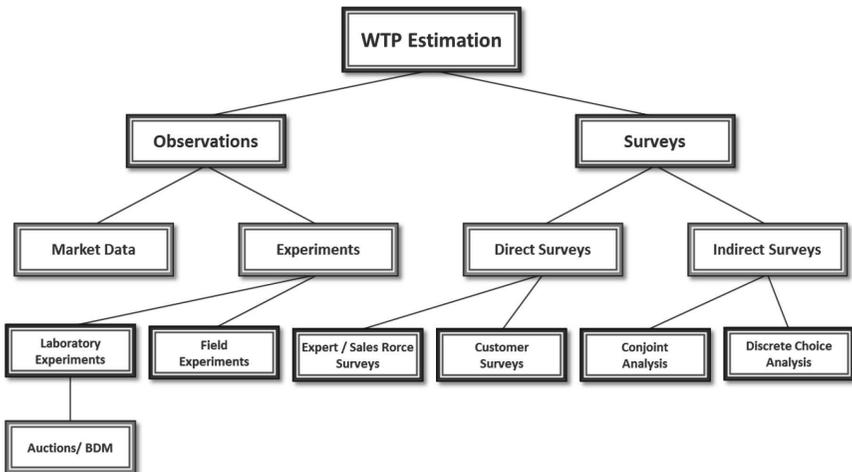


Figure 20.1 Methods of WTP estimation

Can we use these techniques when estimating the willingness-to-pay of customers in B2B markets?

**B2B pricing models**

To start answering this question, we will examine the different types of business models commonly found in B2B. As seen in Figure 20.2, B2B pricing models include spot pricing, agreement or contract pricing, list or matrix pricing, subscription pricing and promotional pricing.

*Spot pricing: every transaction is priced individually*

Commonly used terms include quotes, bids, special price requests, spot pricing, make to order pricing and invoice prices.

What makes spot pricing unique is that there is the inherent expectation that prices are subject to change at any time. Businesses that customize, or make to order, have a spot pricing model as requirements and product configurations are ever changing. Companies that bid on projects can use a spot-pricing model. Like make to order, each project has its own unique characteristics. Finally, companies that have agreement/contract pricing often receive special requests that require a one time spot quote.

*Agreement/contract pricing: pricing is set for a length of time*

Commonly used terms include deals, tenders, into stock pricing, agreements, contracts, custom contracts, customer pricing and buying group pricing.

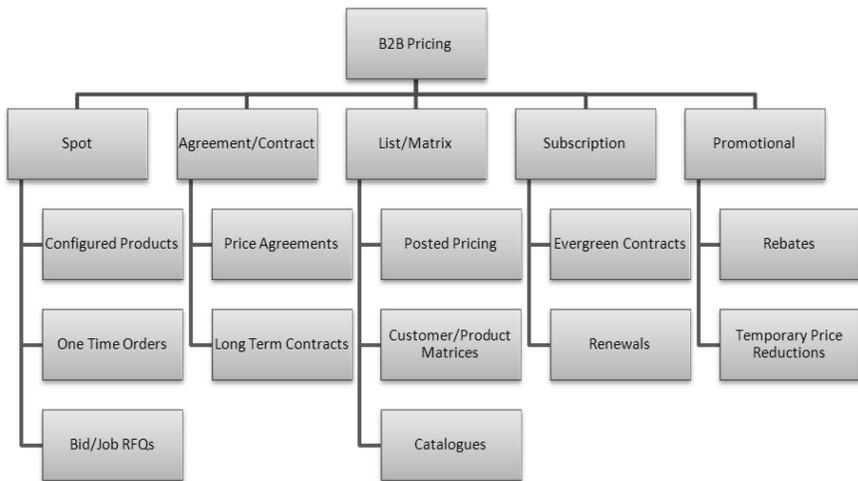


Figure 20.2 A pricing taxonomy: common pricing models in B2B

A large number of B2B customers have an agreement or contract-pricing model. Special pricing agreements (SPAs) are set up because customers want special treatment beyond a standard price. Many businesses with agreements/contracts have customers that order frequently and don't want to negotiate every time they order. In other cases, contracts are sent out through a request for proposal (RFP) process to encourage competition. Under this pricing model, pricing is updated on a quarterly, semi-annual or annual basis where follow-up negotiation occurs upon contract expiration. While there is an expectation that prices will be predictable, there may also be special contract terms and conditions that allow prices to fluctuate based on changes in cost, or if customer orders do not meet agreed upon thresholds.

***List/matrix pricing: non-negotiated pricing***

Commonly used terms include Catalogues, Rate Cards, Price Matrix, Posted Price, Rate Table, Price Book, Rate Sheet, Flat Rate and Customer Tier Pricing.

Here, companies set non-negotiated pricing by product and/or customer tier. Special customers may get agreement/contract pricing, but the rest are subject to a list price, which may include a set discount for different classifications of customers (e.g. based on annual purchases, region or channel). Companies with list prices have a catalogue or website that allows their smaller customers to order products without negotiation. Businesses with matrix prices segment customers into categories like bronze, silver and gold, and may also set list prices by region. In the past, list prices were generally very static – i.e., not changing much during a year. However, due to more flexible pricing systems, many are updating their prices lists on a much more frequent basis.

***Subscription: per year/month pricing model with no expiration date***

Commonly used terms include Subscription Pricing, Renewal Pricing, Annual Fees and Evergreen Contracts.

Companies that utilize a subscription-pricing model are typically those that allow customers access to a service. In this model, a subscription price is set for as long as customers use the service – sometimes called an evergreen contract. These evergreen contracts may include yearly increases or fee changes as costs fluctuate. Subscription differs from agreement/contract pricing in one fundamental way – cost to serve. Those companies that employ a subscription-pricing model usually have no way to estimate their customers' cost to serve – either because it is extremely difficult to determine or that costs are sunk.

***Promotional: alternative pricing that incents behavior***

Commonly used terms include temporary price reduction, rebates, quantity discounts and incentives.

Almost every company has some form of promotional pricing or rebate programs. Manufacturers incentivize resellers to sell their products, increase volume year over year, or increase the mix of more profitable stock keeping units (SKUs). Resellers may, in turn, have their own promotional programs. Agreements/contracts are often negotiated based on volume commitments or market share requirements, where promotional actions create incentives to order more.

## **WTP estimation techniques for B2B**

Now that we've outlined the different pricing models in B2B, let's examine how the different techniques for estimating WTP fit into those paradigms.

### ***Surveys***

Surveys can be a useful tool in B2B, but they are less useful in estimating elasticities for most of the pricing models outlined. For example, a survey completed by a chemicals distributor found that price was low on the list of why their top agreement/contract customers valued them as suppliers. Instead, customers valued service, quality, product mix and communication over price. However, this provided little direction on determining the price sensitivity on any of the company's 100,000 SKUs that it carried.

Most business-to-consumer (B2C) companies find techniques, such as conjoint analysis, very valuable in estimating the willingness-to-pay of their consumers. However, the procurement departments of B2B companies hold their cards much closer to their chest and will often give unreliable answers to even the most well-crafted price-focused surveys. These techniques can be helpful for companies whose sales are concentrated in a few products or for key new product introductions. And, the good news is that the costs have come down for doing this type of research. However, most B2B companies need a method to use across a disperse product or service line, and one that can be repeatable.

### ***Experiments***

All the B2B pricing models, except for list/matrix pricing, employ a sales force, pricing desk or price negotiators. Experimenting with price within a negotiated sales environment is extremely difficult. Sales people's commissions are at risk. Each negotiation is unique. The whole concept of experimentation is just difficult to make happen in practice. In addition, to account for all the potential variables to understand true cause and effect often requires a very large sample to get reliable insights. This somewhat negates one of the potential benefits of an experiment, which is the ability to test alternative price models with less risk than going to the market more broadly.

In the list/matrix and promotions pricing model, B2B companies can leverage the science of experiments to see how past price changes performed. By removing

all outside influences to volume, a B2B aftermarket auto parts manufacturer identified over \$3 million in recoverable profits simply by reverting price changes that decreased margin dollars. Even with that insight, only 4 percent of the historical price changes yielded conclusive statistical evidence around their customers' willingness-to-pay.

### ***Market data***

Utilizing market data is the most promising and practical way for companies to get a handle on customer WTP. Unfortunately, as evidenced in Figure 20.1, there is very little research on how to use it. Nagle and Holden concede that “if a researcher has a lot of historical data with enough price variation in it, useful estimates of price sensitivity are possible” (Nagle & Holden, 2002). Here's the good news for companies in B2B markets: Your transaction data has a wealth of information that can help isolate and identify your customer's WTP across your product portfolio. The key to unlocking WTP can be found in applying the science of pricing to your market data.

### **Willingness-to-pay: a constantly moving target**

WTP in the B2B sales environment is an ever-changing, moving target. Consequently, it isn't simple or easy to quantify. Take this example: if you lose your car key, how do you put a price on its replacement? Your car dealer has a battery-powered key fob that can detect when you are in proximity and automatically unlock your car. Alternatively, you can ask for a mechanical key that opens only the driver side door. What is your willingness-to-pay for the added technology? Some “traditionalists” would buy the mechanical key under all circumstances. Others would pay a significant price premium for the key fob convenience.

Consider another example: air conditioning. Is your willingness-to-pay different if you are replacing your old air conditioner during the winter months compared to a breakdown during the dog days of summer? What if you live in Houston, TX or Seattle, WA? Here's the point: WTP changes depending on the type of customer, product and transaction environment of the sale being executed.

With customer behavior, timing and environments constantly changing, a customer's WTP for a given product can be difficult to gauge. However, we have found that it is within reach of almost all B2B companies. The first step on the road to achieving WTP is the segmentation and normalization of market data.

#### **Box 20.1 Fully utilizing data key to evolution from “cost-plus” to value pricing**

Many manufacturers today still use cost-plus pricing techniques as a general way to price products in a B2B environment. Example: price = cost plus 25 percent of cost. Once prices are set, the effectiveness of that pricing

is judged by the product's P&L statement. In contrast, applying scientific analysis to the data that already resides in a company's information systems provides a fact-based, practical alternative that determines each customer's or customer category's willingness-to-pay.

Scientific analysis of transaction data allows companies to understand which factors influence different willingness-to-pay and then feed that information into recommendations for future transactions. Our experience has revealed, for example, that sophisticated transaction analysis often shows the most potential for margin improvement exists among customers in the middle range of the profitability distribution. Many companies have taken tactical measures to find the extremely low or negative profit customers. Few have applied the science to identify average profit customers that could do a little better when comparing them to other like customers. This is where scientific segmentation improves the negotiating confidence of the sales force in pushing for increases in prices and margins when it makes sense. Operating at a highly granular level, customer by customer, product by product, pricing science makes a value-based pricing approach possible – estimating the value that customers actually put on products versus what they might currently be paying.

Pricing tools can provide more accurate floor, target and stretch price guidance at the point of negotiation and empower the sales force while enforcing accountability. Such pricing insight is critical to assuring that manufacturers and distributors gain and sustain a competitive advantage through value-based pricing.

### **Segmentation and normalization: start with your own data**

B2B companies typically possess plenty of data around their own products (cost, life cycle, hierarchy, etc.), their customers (geography, size, industry, etc.) and their transactions, invoices and rebates (date, price, cost, discount, sales person, quantity, unit of measure, etc.). Do customers in different geographies have a different WTP? Does my customer base have a discount expectation based on the quantity ordered? Do customers react differently to a product that costs \$4,000 than to a product that costs \$20? Does my newest innovation get a value premium higher than its older version?

The science of segmentation answers these questions clearly and decisively by using your existing sales data. The process involves applying scientific algorithms using computer software to mine your data and analyze all combinations of attributes to determine the key variables that impact your customers' WTP. However, segmentation alone does not account for the dynamic nature of WTP discussed earlier.

Normalization is the principle that incorporates the variable of time to WTP that enhances the accuracy of future pricing products. Normalization works by looking at external factors (date, producer price index, inflation, etc.) that vary over time and then adjusts historical transactions appropriately. Economists use

this technique all the time. For example, gold is at an all-time high but not when normalized against history. The early 1980s hold the price record when you adjust for inflation (Leonhardt, 2010).

The science of segmentation puts different customers, products and transaction environments in separate WTP buckets. Normalization changes historical data inside each bucket to account for WTP changes over time. But you must go another step further by looking inside each segment and determining the unique WTP for each product through distribution analysis.

## Using sales transaction analysis to estimate WTP

Once you've segmented and normalized your customer, product and transactional data, the next step is to examine the distribution of prices within each specific segment. How you proceed from here depends on the availability of *loss data*. If you know those price points in a segment where your customers walk away and where they buy, a clear distribution of WTP emerges. Research by Agrawal and Ferguson (2007) and Phillips (2005) explain how to use loss data to model win-elasticity across a specific customer segment.

Unfortunately, most B2B manufacturers and distributors do not have access to their loss information. Even if you could mine the data from RFPs or call center transactions, it's almost impossible to know why someone *didn't buy your product because of price*. Therefore, a realistic yet robust WTP estimation for most B2B manufacturers and distributors must come from win-only data.

## Estimating WTP using win-only data

Let's revisit the definition of WTP: *the highest price an individual is willing to accept to pay for some good or service*. Consider the price distribution for a specific product that sells between \$1.00 and \$3.00 as shown in Figure 20.3. If one of your customers buys that product for \$1.45, then their WTP was greater than or equal to that price. Since we only have win data that means the data distribution is *skewed* as it relates to the WTP of that customer or segment. Take a closer look at Figure 20.3 – a specific segment's win distribution. Prices cluster around \$1.45. Does that mean \$1.45 is your best estimate of the WTP of this segment? Answer: No. It means that your sales force, pricing desk and category managers feel comfortable charging around \$1.45 per unit. The true WTP of this segment is greater than \$1.45. So what is the true WTP distribution of this segment?

Applying proven science to pricing can give you the answer.

*Pricing science can estimate the true willingness-to-pay even if loss data is unavailable.*

The ability of pricing science to unlock WTP depends on two key factors:

- 1 Lots of sales-win information – there must be enough data in each individual customer or segment to statistically support WTP estimates.

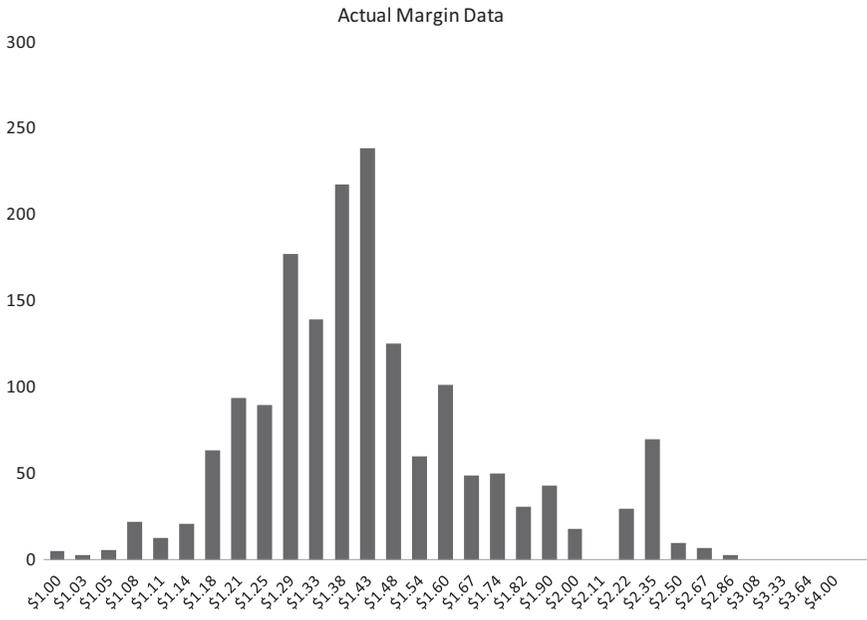


Figure 20.3 Histogram of volume versus price

- 2 Variation in pricing – pricing cannot be uniform across all customers in the sense that contract, agreement, subscription or spot pricing decisions are customized through negotiations (e.g. by a salesperson or through some form of price approval process).

The key to determining the true Willingness to Pay distribution from the actual price information is the definition of the WTP of a customer itself – it is greater than or equal to the price paid. Hence, from a statistical standpoint, prices where we’ve won are *biased*. Statistical un-biasing techniques can be applied to the pricing data to uncover an estimate of the true customer WTP. Since the publication of the 1st edition of this book, published research has emerged on this topic. The interested reader can learn more about the science behind using win-only transactional data to determine WTP from Simsek (2013) and Kambour (2014).

### Prescriptive pricing based on WTP produces results

Prescriptive pricing means providing pricing decision makers with clear and concise recommendations on the price to charge. Other types of pricing analytics include (1) descriptive pricing – looking at historical and current trends and pricing errors/leaks in order to make better pricing decisions and (2) predictive

pricing – arming decision makers with estimates of future demand patterns, price response and what-if capabilities. In the case studies below, willingness-to-pay was used to generate prescriptive pricing actions that drove significant value in a short time frame.

### **Box 20.2 Paper company**

Using internal win-only data to estimate WTP, a paper manufacturer generated an additional \$18 million in revenue within six months. Some of the key variables in determining WTP included:

- Size of customer.
- Geography and location.
- Product category customers were buying from.
- Contract type and terms of contract – the inclusion of caps, payment terms, etc. greatly affected WTP.
- Product centrality – WTP of customers changed based on the total spend of that product compared to the entire portfolio of products purchased. For example, if a customer’s total spend is 100 percent, then if one product takes up 40 percent of portfolio, it will be sensitive to price and WTP will be lower. But if spending only 1 percent of portfolio, then WTP is higher.

### **Box 20.3 Electronics distributor**

Using extensive data on tens of thousands of products, this company analyzed and determined WTP by automating cumbersome manual processes and using statistical methods to segment its customer base into peer groups. Key WTP predictors included market share, customer type, volume and product cost. The company then developed scientifically generated target, floor and expert prescriptive pricing guidance for front line sales. Guidance increased margins of low-performing customers in each peer group, while ensuring that high performers continued to be highly profitable.

The approach helped reduce “below-floor prices” by more than 10 percent, while also increasing the number of invoices exceeding sales targets more than 10 percent, resulting in a gross profit increase of over 230 basis points. Revenues increased by more than 2 percent in individual segments.

## **Implications for the field of pricing**

B2B manufacturers and distributors constantly customize and adjust their pricing for good reasons. Certain products demand a premium over others. Different regions have varying competitive landscapes. Contracts expire under varying

circumstances. Yet most companies are missing out on a big opportunity. They do not possess what we call an “institutional memory of pricing.” That is, the collective wisdom of pricing in the organization and in the market is not brought to each and every deal and each and every pricing decision in determining the true customer willingness-to-pay. This results in non-fact based rules of thumb and risk-averse decision-making. Companies are not able to respond as nimbly as they should to customer, cost, competitive or market changes.

There are many ways for companies to use advanced techniques to manage pricing and profitability. Some of the early efforts focused on “backward looking” analytics. While companies may be able to find pricing opportunities, often the insight is too late because the sale has already happened. Newer approaches look to provide guidance on customer willingness to pay at the point of sale to get the right price the first time.

This is also critical as companies seek to modernize their selling approaches – leading to quicker quoting and/or consistent multi-channel prices. It is clear that a new battleground for revenue growth is being driven by companies able to provide a better selling experience. B2C buyers used to a frictionless experience are taking those same expectations to the B2B purchasing process. Companies that have a cumbersome selling process, where prices take long to review and quote, will increasingly be at a disadvantage to more nimble competitors. Also, buyers are increasingly moving between channels – researching the product and prices online, and then engaging a salesperson when they are further down the process. Thus there is an increased need for coordination, consistency and lack of friction with prices across these multiple channels.

A key to improving this selling approach is to not only make sure the prices get to the sellers quickly – but to also make them personalized based on a scientific understanding of customer willingness to pay and to be able to move these prices dynamically when market conditions change.

As such, companies looking to modernize their commerce will need dynamic pricing science that estimated customer willingness to pay to get the full benefit from these initiatives.

Advances in computing power and data storage have made available to companies a virtual treasure of data relevant to pricing – both within their own transaction history and from outside sources. Recent innovations for using this data and determining willingness-to-pay, as outlined in this chapter, are proven and practical and should be used by every B2B company.

Whether you rely on a centralized price matrix with customized exceptions, or a totally autonomous sales force, understanding the willingness-to-pay of your customers under various conditions gives you a significant competitive advantage.

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# 21 Cross-functional collaboration in value-based pricing

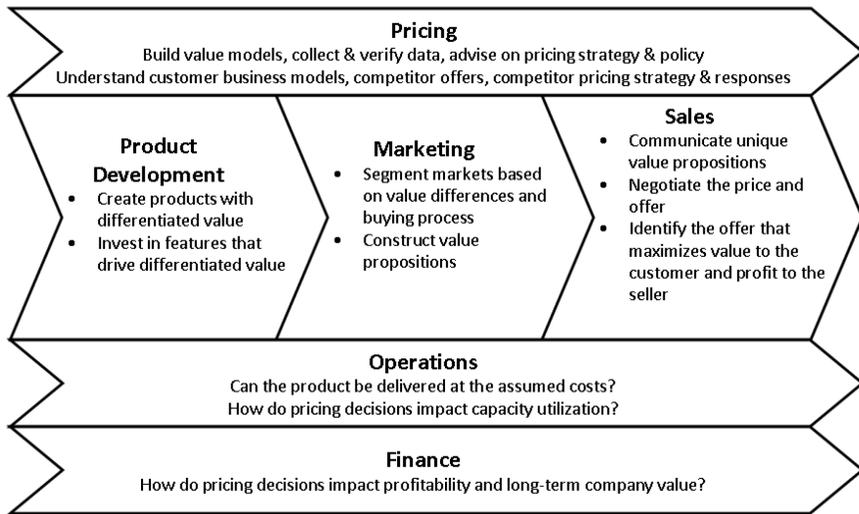
*Steven Forth*

## Introduction

Pricing can be a solitary and technical discipline. It requires mastery of concepts that are not always well known outside the profession, time needs to be spent gathering and analyzing data from disparate and often incompatible sources and, in many companies, pricing does not have the attention of the executive. A study by one of this book's editors, Stephan Liozu, has found that CEOs spend little of their time thinking about pricing issues (Liozu, 2010), and pricing is sometimes referred to as “the forgotten P of marketing” (Kolassa, 2009). This is odd given the power of pricing as a profit lever (Meehan et al., 2011; Mohammed, 2010). More importantly for this chapter, pricing is a critical consideration when making decisions about the other three Ps: Product, Promotion and Placement. As E. Raymond Corey of Harvard Business School famously wrote in 1962, “Pricing is the moment of truth – all of marketing comes to focus in the pricing decision” (Corey, 1983). In some cases, pricing experts face active opposition and not just benign neglect. Sales has been known to refer to pricing as “the sales prevention organization.”

The isolation of pricing from other business functions is emerging as an issue for the pricing community and for the businesses that rely on pricing experts to guide their pricing strategies and tactics. It is also a concern for pricing professionals as individuals, who can feel ineffective and alienated from the powers that be in their organizations. At the same time, companies are adopting powerful pricing management systems that are integrated with customer relationship management systems (CRMs). These software platforms are bringing pricing experts closer to other business functions such as sales. There is also interest in marrying pricing with product lifecycle management (PLM) and the enterprise systems that support it. Chief financial officers (CFOs) are getting into the game as well as they come to understand the impact that pricing has on profitability and its power as a decision-making framework (see Figure 21.1).

Increasing awareness of pricing as a profit lever, the rise of pricing management systems and the integration of pricing with other business functions is making pricing a more collaborative discipline, one that must interact with and support people in product development and management, marketing strategy, marketing



*Figure 21.1* Internal participants in the pricing conversation

communication, operations, finance and, especially, sales. And pricing must do this in the context of distributed organizations, where people work in different locations, even different time zones, and come from diverse backgrounds. Can the pricing function learn from the many years of research on computer supported collaborative work (CSCW) and by blending the concepts from CSCW with pricing can a new class of software applications be developed that support the integration of pricing across business processes? This paper discusses the approach taken by a software company as it went through the process of developing a new software application to support value-based pricing and iterating this development with customers. The author was a member of the management team of this company. The lessons learned are more generally applicable to business-to-business (B2B) pricing practices and the development of software to support collaborative business processes.

## Theoretical foundation

Computer supported collaborative work (CSCW) deals with the class of applications between the enterprise data processing (systems such as those offered by SAP and Oracle) and individual productivity solutions that are used by teams to coordinate their activities (spreadsheets, presentation software, word processors and simple databases). For a good summary see Grudin (1994). Groups are meant to use these applications to accomplish shared goals. In recent years, CSCW and groupware systems have been caught up in the wave of social media software, of which the best-known examples are Facebook and LinkedIn, although

within-companies solutions, such as Jive, are more common (Li & Bernoff, 2011). Unlike enterprise data management and enterprise resource planning (ERP) systems, collaborative work systems are meant to help groups of people to communicate, share information and make decisions together. They operate under different design principles. ERP systems are generally designed around a command and control metaphor and support transactional data that respects the ACID rules of atomicity, consistency, isolation and durability (Gray & Reuter, 1993). Collaborative systems are based on a conversation metaphor where iteration and revision are part of the work flow. Additionally, a common visual framework has often been found to support conversations and mutual understanding (Tuft, 2001).

The rise of social software has been accompanied by a more general acceptance of cloud-based software as a service solution (Benioff & Adler, 2009). Cloud-based software is software that is hosted on multiple distributed servers that are accessed remotely over the Internet. Some companies, such as salesforce.com, operate their own clouds, but most companies rely on third parties, such as Rack-space or Amazon. Software as a Service (SaaS) is software that is hosted in the cloud and is paid for by subscriptions (generally monthly or annually) rather than through licenses. Cloud-based SaaS solutions can be evolved and scaled much quicker than conventional on-premise software, as there is only one instance to maintain and develop. Cloud-based SaaS applications are also easy to integrate with each other and work well with the always-being-updated nature of the Internet.

In developing collaboration software for complex business processes like pricing, it is important to have a formal model. Generic systems, such as Microsoft Share-Point or 37 Signals Basecamp, do not provide enough context to shape and direct conversations, to create a shared language system or to organize and search the many types of data used in pricing decisions. A shared conceptual framework is needed. Ideally this framework should include a visual representation.

One obvious candidate for collaborative software systems to be used in pricing activity is economic value estimation (EVE), a framework for value-based pricing introduced by Tom Nagle and Reed Holden in the second edition of *The Strategy and Tactics of Pricing* and advanced in subsequent editions (Nagle & Holden, 2002; Nagle et al., 2011). EVE is a powerful framework for collaboration, as it requires information about the offer being sold, the competitive alternative and the customer's business model. It organizes these into a standard image that is well known to many people in the pricing industry and easy for people from other disciplines to understand (see Figure 21.2).

### *Offer*

Features, benefits and value drivers of the offer are mapped. Value drivers (statement of the economic benefit of the offer for the customer) come in at least four flavors: revenue drivers, cost drivers, operating capital drivers and capital spending drivers. Each value driver is formalized as a mathematical formula (sometimes referred to as an algorithm in the literature), and this formula generally has

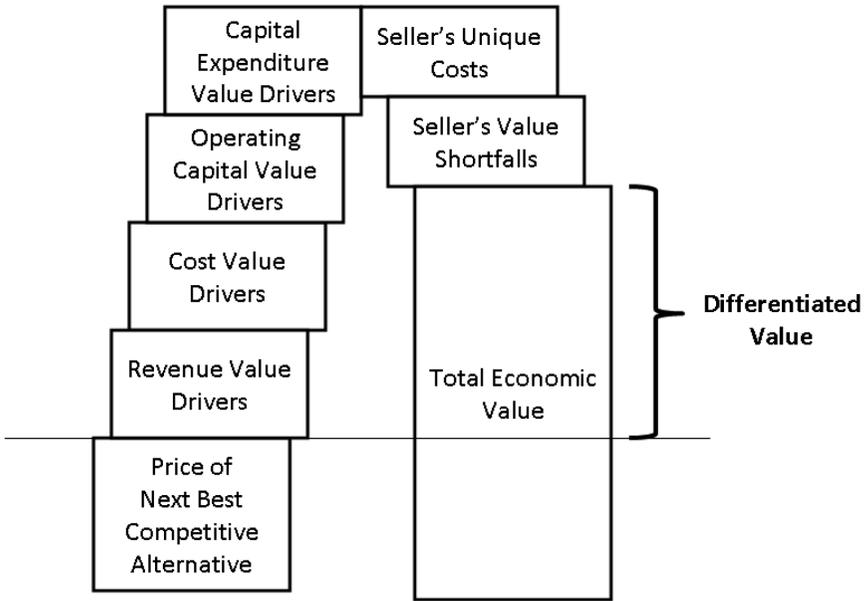


Figure 21.2 The canonical value model

a number of variables that depend on the customer, competitor and offer. A very simple example of a value driver formula is  $(\text{scrap costs savings}) = (\text{scrap costs}) \times (\text{reduction in scrap costs using solution}) - (\text{scrap costs}) \times (\text{reduction in scrap costs using competitive alternative})$ . Value driver formulae can become quite complex, using many different variables, though the best practice is generally to keep them as simple as possible and when they get more than five variables to see if they can be separated into two value drivers. There are two classes of value drivers, positive and negative. Positive value drivers increase the differentiation value of a solution. Negative value drivers decrease the differentiation value. One type of negative value driver is any unique costs of using the seller's solution. These costs can come in many forms: training costs, inventory costs, new investments and so on. The other type captures shortcomings in the seller's solution compared to the next best competitive alternative.

### *Competitive alternative*

With the exception of monopolies, pricing always takes place in a competitive environment. Even with many monopolies the buyer may have the option of doing nothing and not consuming. EVE requires pricing experts to identify the competitive alternative and the price of this alternative. Beyond that, the competitive alternative can create negative value drivers. In some cases, the competitive

alternative will provide value that the seller does not. This value needs to be captured as negative value drivers.

### ***Customer business model***

Value drivers are always calculated as the impact of the seller's solution on the customer's business model relative to the competitive alternative. This information is captured in the value driver formulae. Additionally, value drivers are calculated in terms of the pricing metric, the unit in which price is quoted. It is much easier to build a value model when the pricing metric is one that maps to how the customer gets value. For example, the best pricing metric for an additive to a cement mix that reduces surface processing might be "per square foot covered." As this additive may actually be sold by the bag, the collaborative software supporting value-based pricing must make it easy to move back and forth between "per bag" pricing and "per square foot pricing," and possibly even "per project pricing."

Value-based pricing is widely acknowledged as the best practice in B2B pricing (Hinterhuber & Liozu, 2012; Liozu et al., 2012), but, in practice, many companies have struggled to implement this approach (Toytari et al., 2011) or even to agree on its meaning (Liozu et al., 2012). A collaborative software platform may be able to give organizations a shared understanding of value-based pricing, a language system to talk about it, a virtual place for conversations to take place and a database for the many types of data collected.

An important part of collaboration is trust. Value-based pricing requires a great deal of data about customers and competitors. The people presenting the value model and using its outputs, such as value propositions and value messages to negotiate price, have to trust the data they are using and they need to be able to show the customer why they should trust this data. Research has found three key determinants of trust in collaborative software: transparency (the processes to generate the data and the use to which the data will be put is visible), provenance (one can track where the data comes from) and security (data shared is secure and will not be shared beyond the intended recipients) (Botta et al., 2011; Braithwaite, 1998). And, of course, honest conversations help to build trust. Success in value-based pricing requires the development of trust between product development, marketing, finance, pricing and sales. Another foundation for trust is the credibility of the data used in the models. Credibility is earned by making sure that data provenance is transparent, by validating the data through repeated conversations and ensuring that unfavorable and favorable data is presented.

Part of the power of EVE comes from its construction as a concept blend. Concept blending has been identified as a key approach to user design innovation across many disciplines (Imaz & Benyon, 2006). For example, the common user interface metaphor of the Window is a blend of the concepts of physical windows and actions we take on them (open a window, look through a window) and the computer screen. It is also the way that apparently contradictory concepts can be combined into a more powerful synthesis (Fauconnier & Turner, 2003).

In the case of EVE, it resolves the apparent contradiction between the economist's view of pricing and that of marketing and sales. Most economists believe that efficient markets are the key to economic prosperity and accurate pricing. An efficient market requires transparent information about prices and products that can easily be substituted one for another. Price is set by market mechanisms and is assumed to trend towards the level at which supply and demand are balanced. Most companies have a very different view of the world. Product development and marketing generally want to create differentiated offers that can be branded and where the differentiation and brand are rewarded with a price premium and higher market share. They try to create and shape markets, not just respond to supply and demand.

What about buyers? Some prefer commoditized products where they can easily substitute one vendor for another and drive prices as low as possible; in other words, they want to see the market at work. This is especially true of the procurement function in large companies. Other buyers are looking for a strategic edge for their own business and want to buy the solution that will have the most economic impact and support their own differentiation. The business buyer, who is responsible for creating value at his own organization, often thinks in these terms.

This contradiction between commoditized market prices and differentiation is resolved by EVE because it blends market forces with differentiation in a way that combines the most important characteristics of each. When using EVE to implement value-based pricing, one begins by recognizing that each customer differs in how much value they can get from a solution and by identifying the competitive alternatives. Buyers always have alternatives, and the market sets the price of alternatives. But the alternatives are generally not identical. Each will have advantages and disadvantages for a specific customer, and it is these differences that create differentiation. With differentiation comes opportunity. In the real world of B2B selling, true commodities are rare, especially when the complete package of product plus services is considered (see Figure 21.3)

## **Findings**

### ***Value models evolve based on conversations – so does the software supporting value modeling***

We developed a software platform iteration by working with users. Modern Software as a Service platforms (Fried & Hansson, 2010) combined with Agile/Scrum (Schwaber & Beedle, 2002) development methods support this approach and make it easier to track how users are actually using the software. This approach led to important discoveries about how people develop and use value models in distributed environments. Some of the key findings are summarized below.

- People work on value models together.
- Value models evolve over time.

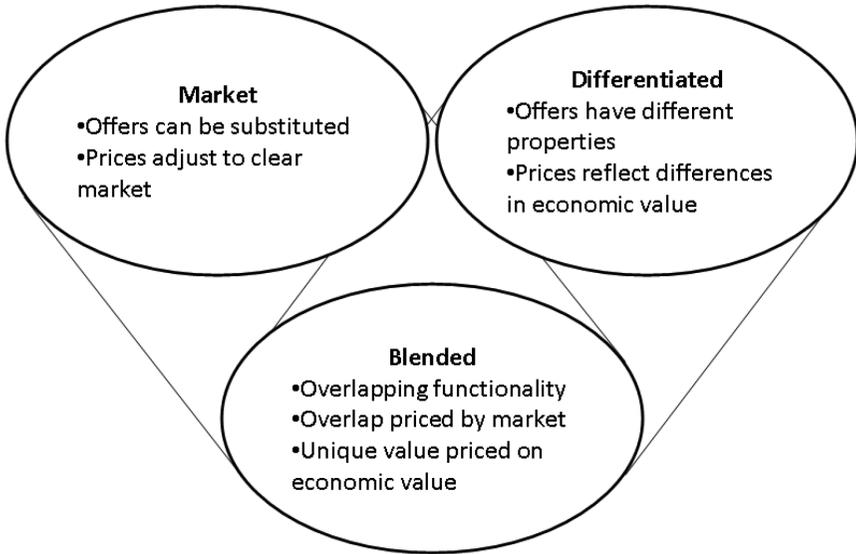


Figure 21.3 Conceptual blending of commodity and differentiation pricing

- Most value models start with a parent value model and are made using a “save as” to create a new model that is then revised.
- Sales people want to be able to modify variables.
- Customer conversations give Sales access to great insight into variables for specific customers.
- Customer conversations give Sales insight into competitor offers.
- Variables are reused across value models.

### ***Organizational issues in information sharing and control***

The above findings about users helped uncover some critical organizational issues around information sharing and control. Many of these issues depend on company culture and its general approach to who should have access and edit privileges on pricing data. As pricing has such a direct impact on business performance, the importance of these decisions and the emotions provoked are emphasized. The most important issues are given below in the form of questions that companies adopting value-based pricing will need to answer.

- How much control should Sales have over which value messages are delivered to the customer?
- How much control should Sales have over variables (unlimited, adjust within a prescribed range, none)?

- How much control should sales have over pricing and discounting?
- How much information should sales be given about costs and how granular should that information be?
- How should marketing and pricing inform Sales about the use it makes of information gathered by sales?
- How much control should Sales have over presentation formats?
- Can and should Sales be able to construct value models for customers?

Initially we erred on the side of not giving Sales enough control. But after observing sales people in selling situations using value models, the software was revised and sales were given additional tools and control. Additional feedback and communication channels were also built into the software to improve transparency for sales.

***A common language system is necessary but not sufficient – business functions, industries and customer all have unique vocabularies that need supporting***

Product development, marketing, pricing and sales all have their own language systems that need to be supported. Part of the power of value-based pricing is that it gives people from different functions a common language system to discuss customers, competitors, value and pricing. But in practice each business function still needs to use its own frameworks and vocabularies. To accommodate this, we added modules specifically designed for marketing (value communication-marketing where marketing creates value propositions) and for sales (value communication-sales where sales people create unique value propositions that they can customize for specific customers) that provided a bridge from value-based pricing language to marketing language to sales language. In the future this may need to be done for product development and management, operations and finance.

***Transparency builds credibility and trust***

People in all business functions, and especially customers, need to understand where data comes from in order to build trust and to be willing to share their own data. The first step towards this was to make it easy to document the source of each piece of data and for Sales to access this data provenance information with customers. The next step was to provide methods to share data across value models so that data becomes more consistent and so that cases where different values are being used can be uncovered and investigated.

***Data is refined in conversations with customers***

One of the most common objections to value-based pricing is that the data needed to construct value models is not available. To some extent this is the result of a perceived need for precision. The underlying assumption is that data is more trustworthy and useful the more precise it is. Observing users, especially sales users,

suggests a different approach. It is important to identify the most relevant value drivers for the customer and to be honest about the negative value drivers (acknowledging shortcomings helps to build trust). It is also important to have the value driver formula right; the math must capture the key variables and their relationships. It is less important to have the actual values in the variables precisely correct. These can only be estimates and if they are at least “in the ballpark” they can be refined in the conversation with the customer. This level of precision is enough to support value-based pricing and value-based selling. Collaborative software makes it possible to channel the values for variables uncovered by sales back to a database where they can be used in analysis of trends and to improve the value models.

## **Conclusions**

Computer supported collaborative work (CSCW) and social software provide an alternative model to ERP in the development of software to support pricing professionals. The value-based pricing framework as exemplified by economic value estimation, or EVE, provides a compelling way to organize conversations between the stakeholders in B2B pricing: product management, marketing strategy, marketing communication, operations, finance, sales and, of course, the pricing function itself. By combining these two approaches, a new class of pricing software can be developed that supports collaboration on pricing decisions and helps the sales force to negotiate prices based on differentiation value, rather than defaulting to price negotiation and discounting (see Geisman, 2003 for a discussion of discounting practices in the software industry).

B2B pricing is the outcome of a series of conversations, both internal conversations between the various stakeholders and external conversations, primarily with customers, but also with analysts and the media. Software to support the pricing function must support these conversations. Conversations involve two or more parties and take place over time. Software for pricing must support multiple roles, create communications channels and provide a collective memory of the conversations. Effective conversations require trust between the parties. Trust is the outcome of credibility, transparency, provenance (the ability to track back the source of data and claims) and shared language systems. Pricing software needs to provide all of these if it is to be trusted by users and build trust between them.

Pricing requires data from many different sources: product development and management, marketing, operations and finance departments; open source data from the Internet and other publicly available sources; private sources such as market research surveys and closed data sources; and, most importantly, from customers. One can only execute B2B pricing in the context of conversations with customers. Pricing data goes well beyond historical records of pricing transactions. It includes data about one’s own products and solutions, the customer’s business model and the competitive alternatives. This is sometimes seen as a barrier to the adoption of value-based pricing and sales. It is difficult to gather precisely accurate data for each value driver and each customer. It can even be difficult to get accurate information on competitive alternatives. But this is why conversations are important. Conversations can support successive approximations

that circle in to values that are “good enough” for a customer to accept a price and make a buying decision.

The initial hypothesis behind this project was that pricing would benefit from a collaborative software system built using the framework provided by EVE. By building this software in an agile, iterative manner, we are generating insight into pricing-related behaviors by pricing, marketing and sales organizations. These insights in turn support further development of the software in a virtuous circle of improvement.

## Implications for the pricing field

*The Cluetrain Manifesto* made the provocative claim that “markets are conversations” (Locke et al., 2000). The conclusion of this chapter is that “pricing is a conversation,” and if the pricing function wants to play a larger strategic role within organizations and realize its full business impact, then pricing professionals must get better at conversations. These conversations are both internal and external and based on trust. Pricing experts have to learn to trust their colleagues in sales and their customers. In today’s world many conversations take place through or are augmented by software. The path forward for pricing software is to support the conversations about pricing that need to take place within organizations and with customers and to give pricing experts insight into the conversations that take place when they are not in the room.

Pricing starts with the customer and the customer’s competitive alternatives. The pricing conversation has to begin with the customer and be focused on understanding how to create differentiated value for customers. Only then can one design a product that creates that differentiated value and set a price. Too often, products are designed and costs built in before pricing even gets to the table. And value, for the customer – well, that is an afterthought (see Figure 21.4).

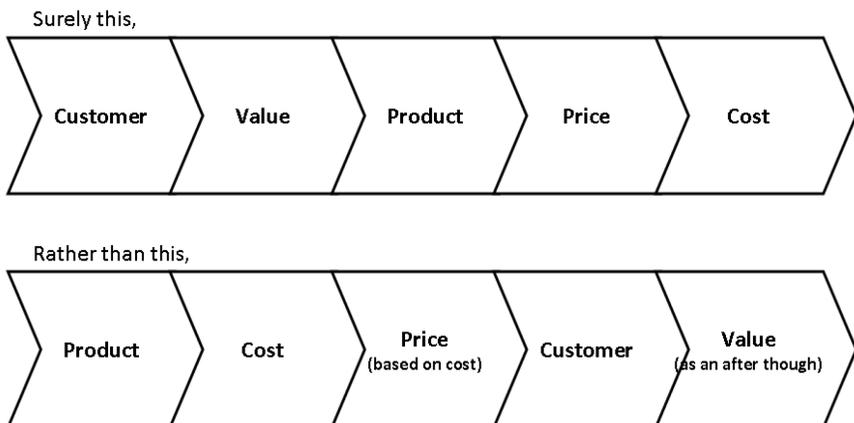


Figure 21.4 Order of conversations

By getting involved in the conversation as products are developed and staying with the conversation through sales, pricing can begin to realize its promise and transform business so that industries can support more differentiated offers and more profitable companies.

## Thanks

Development of the LeveragePoint platform for Value-Based Pricing was led by Ed Arnold and Neil Davies of LeveragePoint Innovations Inc. Subsequent versions have benefitted from the insights of Jay Manson and many others on the LeveragePoint team, as well as users at LeveragePoint's customers. Dr. David Botta and Dr. Lee Iverson have taught the author many lessons about the development of collaborative software and trust-based systems. Stephan Liozu challenged my thinking and provided insights from a wide range of pricing research.

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## 22 **Winning on the margin**

### The B2B value imperative<sup>1</sup>

*Mike Moorman*

Today's business-to-business (B2B) Sales and Marketing executive faces a uniquely challenging selling environment. Rapid advances in buyer sophistication, Internet access to product information and social media access to seller references and past performance have shifted power from sellers to buyers. These forces are further reinforced by continued product lifecycle compression, globalization and vendor base consolidation.

The imperative to grow while protecting margins is forcing organizations to fundamentally transform their Sales and Marketing functions and the way they go to market. For many organizations the path to success includes significant advancement in their value-based selling capabilities.

Value-based selling (VBS) is not a new idea. It dates back more than 20 years. VBS is simple in concept: win and grow customers through product, service and program offerings whose total value relative to price exceeds that of alternatives. By providing greater value the seller is able to win at a price premium.

The reality has proven more difficult. VBS requires a challenging shift in culture, strategy, operations and execution capability. While most organizations have made steps in the right direction, few have yet achieved the degree of VBS capability required for sustained success in today's environment. Furthermore, as more organizations move to broad solutions selling, the degree of VBS difficulty increases. Solution selling typically involves broader coordination across the seller's business lines and an ability to sell at higher levels in the buyer's organization.

This article provides an introduction to the critical components that must be addressed to build world-class VBS capabilities. The insights shared derive from extensive VBS initiatives with more than 40 companies across 13 industries in North America, Europe and Asia.<sup>2</sup>

The focus of this article will be on four success factors that have proven to be the most critical to VBS capability building:

- 1 VBS capability building requires a comprehensive and systematic approach that addresses the full sales and marketing system. Many organizations are falling short due to piecemeal approaches.

- 2 VBS requires a degree of Sales and Marketing alignment and integration that transcends that required by past models. Collaborative business processes must replace age-old division of labor practices that separate Sales and Marketing.
- 3 VBS is a go-to-market strategy, not just a sales discipline. Segmentation strategy, value proposition strategy, sales process strategy, channels strategy and sales force structure must come together to cost-effectively provide unique and compelling customer value.
- 4 Implementation of VBS requires skilled change management practices for transforming deeply entrenched sales force beliefs, behaviors and skills. Top-down initiatives alone have failed.

The next section provides a brief introduction to VBS and is followed by sections that address each of the four success factors.

### **Introduction to value-based selling**

Value-based selling capitalizes on the rational B2B buyer's goal to select and grant loyalty to the suppliers that provide the greatest economic benefit, or value, to their organization. "Buyer value" is measured in terms of the worth that a buyer perceives a supplier's offering will provide relative to price. "Supplier value" is the revenue stream the supplier is able to command minus the cost to provide the associated offering. VBS focuses on achieving greater value than alternatives for buyers while delivering attractive value back to suppliers.

Many organizations and sales people today remain entrenched in feature-, friendship- and price-based selling. The proliferation of purchasing committees and increased oversight of buyers is rapidly neutralizing this age-old sales practice. The buyer paradigm has shifted from "buy from the seller with a good product and competitive price that I most like" to "buy from the seller who presents the best total solution and terms that maximize the economic benefit to my company." Furthermore, because of the extensive product information now available on the Internet, buyers' expectations of sales people are changing. In particular, buyers are becoming less willing to meet with sales people who are essentially information providers. The entry chip is increasingly becoming the ability to bring new ideas and to prove economic value.

The financial stakes fueling VBS are underscored by a great deal of research conducted over the last 20 years. Three particularly relevant and compelling insights are the following:

- On average, a 1 percent increase in price translates into an 11 percent increase in profit (Marn & Rosiello, 1992).
- New customer cost-of-sales is typically three to ten times as high as existing customer cost-of-sales.<sup>3</sup>
- Reducing unwanted customer defections by 5 percent can impact profits by 25 to 85 percent.

In short, even small improvements in price and customer loyalty translate into significant contributions to company performance, and vice versa. Effective VBS is widely viewed as a means to positively impact all three of these metrics while also driving higher win rates, larger deal sizes and reduced cycle times.

Four fundamental strategies exist for creating customer value:

- 1 *Lowest price accompanied by efficient purchasing and order-fulfillment.* This strategy equates to transactional “commodity-selling.” Only the low cost producer in a given market can sustain this strategy – which typically negates the need for a sales force.
- 2 *Lowest total cost-in-use including acquisition, possession and usage costs* (Figure 22.1). This strategy is a form of “value-based selling” that focuses on creating buyer cost advantages beyond just price.
- 3 *Higher value added to the buyer’s own market offering.* This strategy is also a form of “value-based selling” and focuses on the upside revenue the buyer will attain by using the seller’s offering.
- 4 *Multi-dimensional* strategy that combines elements of 1, 2 and/or 3.

The optimal VBS strategy is situation specific and depends on four factors:

- customer needs and preferences
- supplier capabilities
- the value of the customer to the supplier
- the competitive alternatives.

Because these four factors vary across the customer universe, many organizations are best served by hybrid VBS strategies. These strategies customize value propositions, sales processes and sales channels by customer segment or groupings of segments. Much of the challenge in VBS strategy design is determining the most cost-effective hybrid strategy that provides optimal effectiveness, efficiency and flexibility, and that enables world-class execution.

### The sales effectiveness system

At a fundamental level, VBS is best viewed as a continuous “customer value management cycle” (Figure 22.2).

Acquisition cost	Possession costs	Usage costs
Price	Interest	Field defects
Paperwork	Storage	Training
Shopping time	Quality control	User labor
Expediting	Taxes and insurance	Product longevity
Mistakes in order	Shrinkage and obsolescence	Replacement
Pre-purchase product evaluation	General internal handling	Disposal

Figure 22.1 Total cost-in-use components

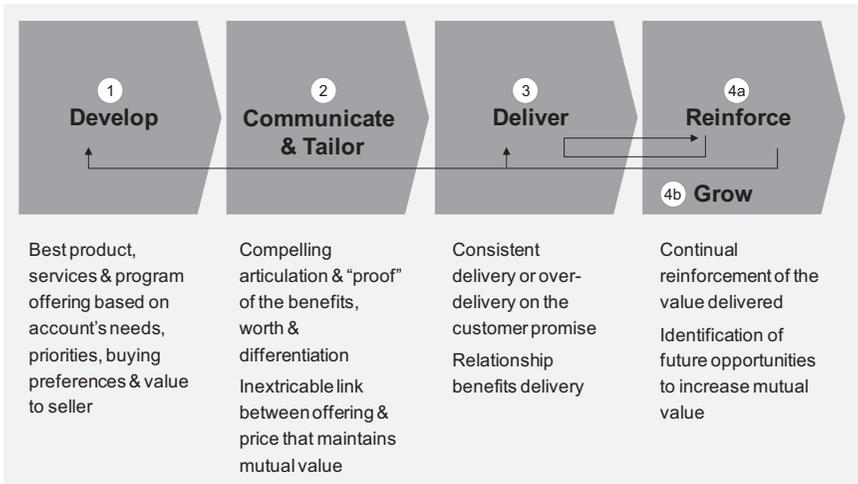


Figure 22.2 VBS customer value management cycle

End-to-end excellence in the customer value management cycle is the hallmark of exceptional VBS organizations. Gaps at any step result in value leakage in one of four forms: value given away, lost opportunity to create value, incomplete customer perception of value offered or incomplete customer perception of value actually delivered.

Effective VBS has a specific and recognizable signature. Market offerings are developed according to customer-specific needs, buying processes, buying preferences and addressable potential. These offerings are communicated and proven in terms of functional and economic benefits and worth. Meaningful differentiation from the next best alternative is clearly established. Pricing is based on value, and price reductions are always accompanied by reduction in the overall offering. The customer promise is kept or exceeded. Value delivered is quantified, reinforced and leveraged to build the relationship to the next level. Both the buyer and seller benefit.

When successfully executed, VBS removes the burden from the buyer to "figure out" worth and reduces the risk to the seller that the buyer will fail to do so. It provides buyers with the business case needed to justify the purchase decision within their own organization, based on terms that are meaningful to the spectrum of decision influencers. It also provides the seller with the business case needed to command a value-based price premium. VBS elevates the relationship from a friendship to a business relationship, predicated on mutual and verified benefits that over time result in strong trust and loyalty.

There are no silver bullets or shortcuts to achieving competitive VBS capabilities. The landscape is littered with leaders who have over-relied on training, new compensation plans and updated brochures. In many cases, all three were pushed top-down with little consideration to addressing the barriers associated with truly changing sales person understanding, beliefs, behaviors and skills.

Meaningful advances in VBS capability require a comprehensive, systematic and integrated approach to strategy design and capability building. Sales and Marketing is a dynamic system and is arguably one of the most complex functions in any business. Each of the key components in this system must be addressed and aligned to accomplish end-to-end excellence in the customer value management cycle. A detailed overview of these components is depicted in Figure 22.3.

The sales effectiveness system has a strong left to right hierarchy. Organizations frequently undermine their VBS efforts by investing in downstream components before they have sufficiently addressed those upstream. Effective and detailed customer insight, competitor insight, segmentation, value propositions, sales processes, and sales force structure and roles are a precursor to sales force implementation. Otherwise, individual sales persons are left to their own devices to develop their own value propositions and sales processes in the face of sophisticated and demanding buyers. Past experience suggests that the top 10–20 percent of the sales force could do this well but that the remainder will falter.

Alignment of the operational elements is equally important. Team sizing and individual account assignments have to ensure appropriate sales force capacity to cover target segments. New VBS knowledge, skills and behaviors must be fostered through competency evaluations, training, coaching and hiring. Performance measures and incentive plans must be aligned to motivate performance focus and accountability. And new tools must be put in place to enable the sales force to execute VBS.

Failure to address any one of these critical components, as well as other marketing program and operations elements, will reduce VBS effectiveness. When it comes to VBS, the sales effectiveness system is a recipe, not a menu.

## **Sales and marketing alignment**

The sales effectiveness framework helps underscore the criticality of Sales and Marketing collaboration to VBS capability building. Customer insight, competitor insight, segmentation strategy and value proposition strategy (including pricing) are the domain of “strategic marketing.” Furthermore, it is Marketing that should assume the responsibility for maintaining and providing the detailed value proposition content critical to effective VBS.

The traditional division of labor between Marketing and Sales has failed to accomplish the coordination between strategy and execution required for VBS. In many companies the relationship between Marketing and Sales is designed to be more or less a “baton hand-off.” Marketing creates the strategy and then hands off the baton to Sales to execute.

This model has failed to lead to strong VBS for at least three fundamental reasons:

- 1 In many B2B companies, Marketing is predominantly focused on marketing communications. These companies may not have a strategic marketing capability.
- 2 The strategies that have been developed may not reflect market realities or may not lend themselves to effective execution.

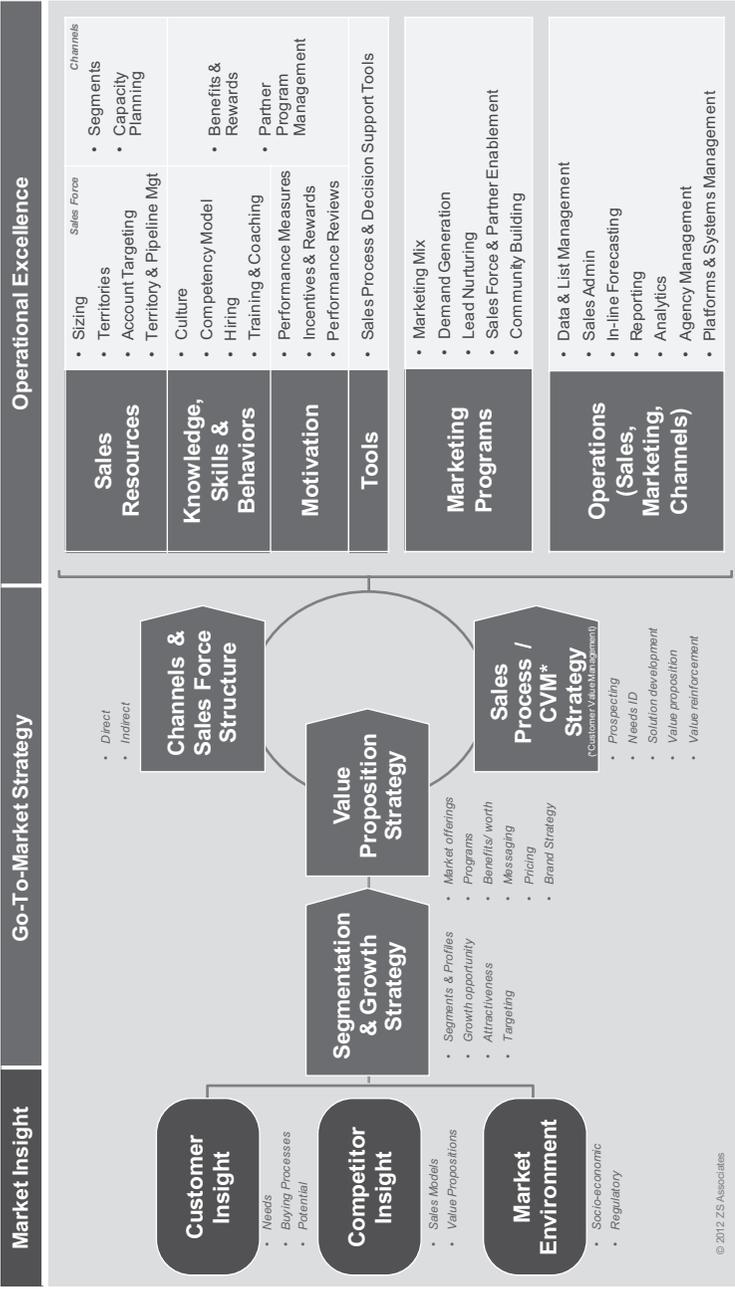


Figure 22.3 Sales effectiveness system

- The sales force is not confident in the strategy and is therefore unwilling to take the personal financial risk associated with implementation (e.g. vis-à-vis their variable incentive compensation plans).

Overcoming these barriers requires Marketing and Sales to move from a “baton hand-off” to a “three-legged race.” Each function has unique information and skills critical to many aspects of both strategy and implementation. Both are major stakeholders in the success of VBS. New “collaborative business processes” hold promise for achieving the alignment between Marketing and Sales necessary for VBS (Moorman et al., 2007). As a case in point, Figure 22.4 shows the mutual roles that Sales and Marketing played in a recent and highly successful VBS effectiveness transformation at one Fortune 200 company.

Marketing’s and Sales’s shared imperative to develop VBS capability is likely to be the “burning platform” that finally leads to more effective collaboration between these two mutually dependent functions.

### VBS go-to-market strategy

Many practitioners narrowly view VBS as a sales practice. The reality is much different. VBS is as much a go-to-market strategy as it is a sales methodology. Segmentation strategy, value proposition strategy (including pricing), sales process strategy, channels strategy, and sales force structure take on unique characteristics under VBS.

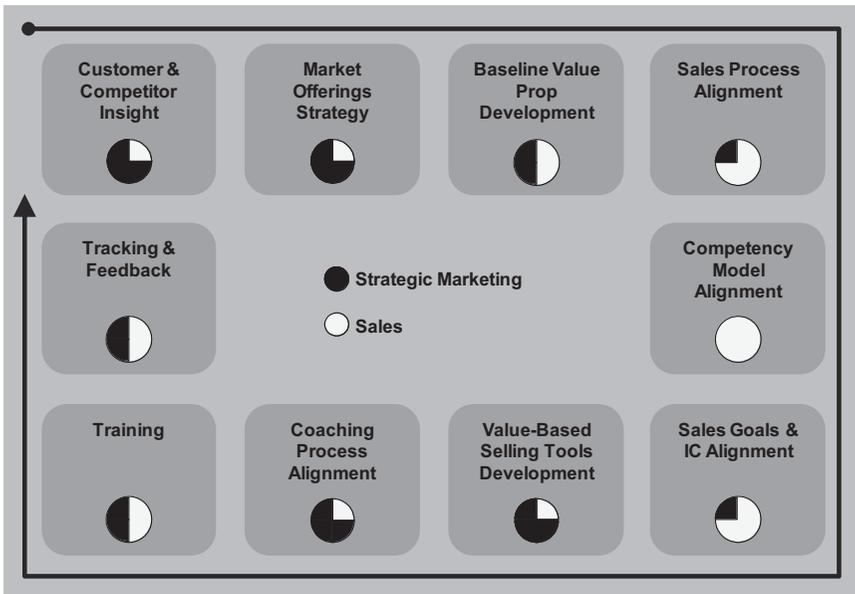


Figure 22.4 Sales and marketing “three-legged race” collaboration (case example)

		What is valuable to them			
		Needs Segments (Primary Marketing Research)			
How valuable they are to us ↑ Potential Segments (Secondary Data Analysis) ↓		Solution Seekers	Relationship Oriented	Best of Breed	Price Buyers
		Quintile 5 (\$15-7M)	149 (accounts)	61	250
Quintile 4 (\$6.9-\$4M)	217	112	493	845	
Quintile 3 (\$3.9-\$2.5M)	127	237	982	1,295	
Quintile 2 (\$2.4-1.0M)	198	192	2,031	4,754	
Quintile 1 (\$0.9-0.1M)	72	450	3,972	7,463	

Figure 22.5 Two-dimensional B2B segmentation (case example)

### ***Account segmentation strategy***

Value-based selling requires B2B segmentation strategies comprised of at least two dimensions, as illustrated in Figure 22.5. The horizontal dimension partitions the account universe into “needs-based” segments. These segments group accounts based on common needs, buying preferences and buying processes. The vertical dimension partitions the account universe into “potential based” segments. These segments group accounts based on similar total opportunity to the seller.

Together these two dimensions provide an actionable picture of the account universe based on (1) what buyers in the segment value and (2) how valuable the accounts in the segment are to the seller.

Segments are the building blocks around which value proposition strategy, sales process, channels strategy and sales force structure are designed. Effective segmentation strategies rely on deep customer insight.

To be useful to strategy design, customer insight must be available in a way in which it can be collectively evaluated and considered. This implies a business process that is led by Marketing and that captures and integrates information from many sources. Common customer insight sources include the following:

- 1 Primary marketing research.
- 2 Acquired account-specific data (e.g. D&B, Info Group, Hoovers, etc.).
- 3 Internal customer relationship management (CRM) systems.
- 4 Sales, customer service, customer support and engineering feedback.

- 5 Customer loyalty and satisfaction tracking studies.
- 6 Win/loss assessments.
- 7 Syndicated studies.
- 8 Internet searches.
- 9 Social media.

Many companies underinvest in customer insight at the expense of their VBS aspirations. Exceptional customer insight is a strategic advantage when it comes to VBS.

### ***Value proposition strategy***

Value propositions are the detailed communication of the benefits and worth the customer will realize from the market offering being proposed to them (Figure 22.6). The opportunity to create customer value extends well beyond the functional benefits of a seller's product. Companies also create customer value through the services, programs and relationship benefits they provide their customers.

A frequent challenge that organizations struggle with is the difference between a value proposition, a positioning statement and brand strategy (Figure 22.7). Marketers often talk about "the 30 second elevator speech" that the sales force needs. This view is flawed and based on a lack of understanding of a sales person's actual operating environment and role.

As was shown in Figure 22.6, value propositions are a detailed articulation of the company's proposed market offering – and the economic benefits and worth associated with that market offering – in relation to a buyer's needs and opportunities. While the sales force can benefit from a succinct 30-second version of the value proposition, the conversation that they have with buyers is much more involved. This is another example of a situation where a collaborative business process can overcome a disconnect that can occur between Marketing and Sales.

Development of compelling value propositions can be viewed as a step-wise process (Figure 22.8).

The process begins by inventorying all of the ways the company already does, and could, create customer value. Defining the potential "market offering inventory" requires consideration of the customer value chain – both in terms of total cost-in-use and customer revenue generation.

The second step is to conduct broader primary marketing research to explicitly evaluate customer needs and priorities relative to the specific set of market offerings that are in question (i.e. those being debated). A critical success factor in this research is to understand the relative degree of importance that different customers place on each potential market offering. Research that poses the question "what is important to you" will usually get the response "everything and at a low price." Choice-models that force the respondent to communicate relative priorities amongst possible market offering alternatives are the most effective techniques for establishing relative importance.

<b>Market Offering Element</b>
Through our inventory management service, we will staff your supply room with our employees (a feature).

<b>Benefit</b>	<b>Economic Worth</b>
Our inventory management service will lower your labor costs because our workers do not belong to a union	With our inventory management service, your firm will lower its annual inventory costs by \$225,000

### Example for A Complete Market Offering

<b>Market Offering Elements (Features)</b>
<p><b>Expertise in Customer's Business</b></p> <ul style="list-style-type: none"> <li>• Provide team with business &amp; technical expertise explicitly focused on your industry</li> <li>• Thought leadership in emerging issues and solutions</li> <li>• Knowledge management tools for reps</li> <li>• Account specific web page</li> </ul> <p><b>Tailored Solutions</b></p> <ul style="list-style-type: none"> <li>• Flexible solutions developed specifically for your needs and priorities (list products, services, programs, systems)</li> <li>• On-site technical expertise and customized configurations</li> <li>• Simplified pricing structures</li> </ul> <p><b>Productivity Improvements</b></p> <ul style="list-style-type: none"> <li>• Applications for streamlining resource requirements and minimizing total cost-in-use</li> <li>• ROI analysis tools</li> </ul> <p><b>Service Excellence</b></p> <ul style="list-style-type: none"> <li>• Seamless customer experience across all touch points</li> <li>• Second level response team</li> <li>• Response time contractual standards</li> </ul> <p><b>Purchase Efficiency</b></p> <ul style="list-style-type: none"> <li>• Streamlined contracts</li> <li>• Service charge transparency</li> <li>• On-line purchasing for repeat and simple orders</li> <li>• Integrated electronic invoicing</li> </ul>

<b>Benefits</b>	<b>Economic Worth</b>
<ul style="list-style-type: none"> <li>• Don't have to repeat myself or train the next person when I call</li> <li>• Don't get handed off to the next person</li> <li>• Get provider who knows me and my business</li> </ul>	<ul style="list-style-type: none"> <li>• Save \$3M per month thru increased labor productivity</li> <li>• Increase revenues by 5% through increased manufacturing capacity</li> <li>• Reduce product disposal costs by 3% per year</li> <li>• Reduce installation and operation risks (contractual guarantees)</li> </ul>
<ul style="list-style-type: none"> <li>• Client team who understands my needs</li> <li>• Cost-effective solutions that meet my needs</li> <li>• No unnecessary "extras"</li> </ul>	
<ul style="list-style-type: none"> <li>• Value-delivered reporting (proof)</li> <li>• Proactive issues identification and alerts</li> </ul>	
<ul style="list-style-type: none"> <li>• Rapid response</li> <li>• Single point of contact</li> </ul>	
<ul style="list-style-type: none"> <li>• Easy to work with (responsive)</li> <li>• Transparent pricing</li> <li>• Streamlined invoicing</li> </ul>	

Figure 22.6 Marketing offerings and value proposition (case example)

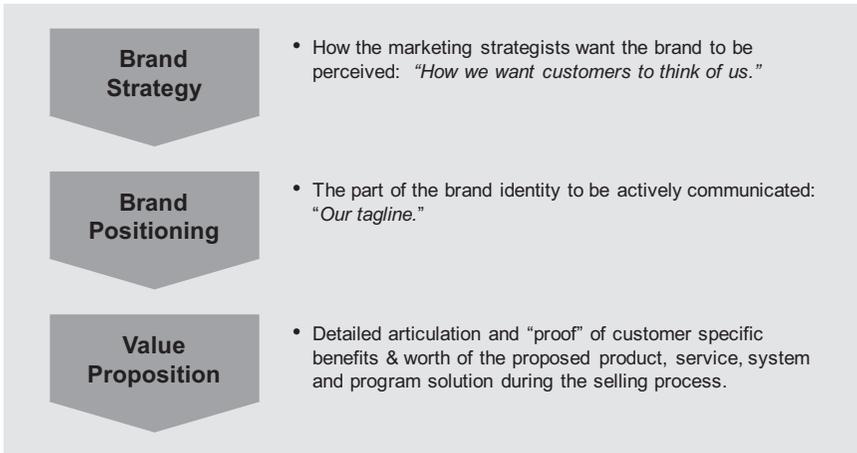


Figure 22.7 Brand positioning versus value proposition

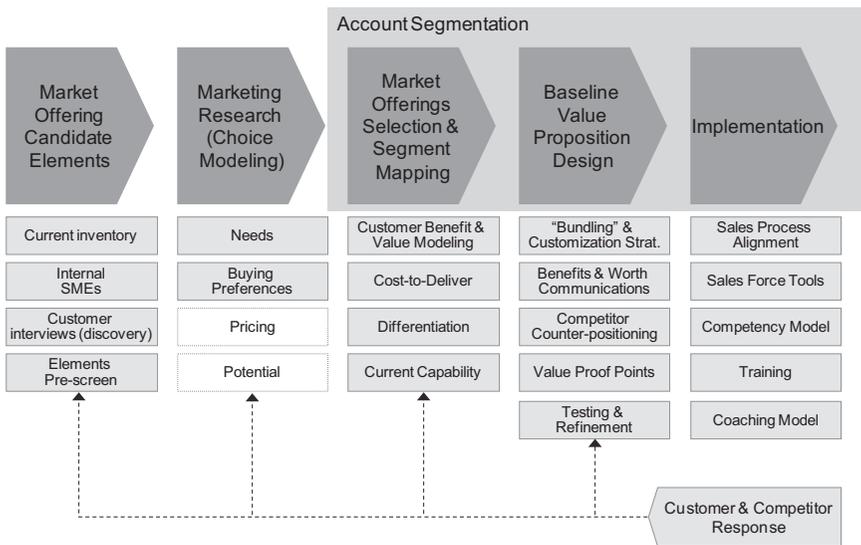


Figure 22.8 Value proposition development roadmap

Selection of market offering elements for each customer segment should be based on a number of attractiveness dimensions. Some of the most important include degree of value created for the customer, cost to deliver, degree of competitive differentiation achieved, current capability and customer willingness to pay. In some cases, impact on the customer’s total cost-in-use and revenue generation must be modeled to fully understand the extent of customer value created.

Once market offerings have been designed and mapped to segments, the challenge is to translate those offerings into specific customer benefits and worth. Benefits should be communicated in the customer's language wherever possible. Depending on the value proposition strategy, worth is communicated in terms of acquisition cost savings, total cost-in-use savings and increased customer revenue associated with using the solution. In most selling situations, the specific worth an individual customer will realize must be refined as part of the selling process itself. Best-in-class value sellers collaborate with the customer during the estimation process to ensure accurate data and strong buy-in to key assumptions.

There can be complex interactions between a given market offering and a buyer's total cost-in-use and revenue synergies. For this reason, and because the data required may be excessively difficult to access or highly confidential, it is not always possible to fully quantify the economic impact of every component of a given value proposition. In such situations the focus should be two-fold:

- Priority should be placed on quantifying the economic impact of the value proposition elements that are most differentiated from those of competitors and also highly important to the buyer.
- Where economic values cannot be estimated for these components, other performance parameters should then be quantified. For instance, these might include specifics on delivery times, defection rates or a host of other quantifiable factors important to the buyer's success.

In all cases, it is critical that the seller be able to "prove" the value being asserted. VBS companies use many techniques to substantiate their value claims. Common examples include quantitative modeling using customer data, case studies, side-by-side trials in conjunction with the buyer, third party trials and customer testimonials.

The degree to which value propositions will be tailored to specific customers is an important aspect of the value proposition strategy. A wide spectrum of value proposition strategies exists. Figure 22.9 summarizes the fundamental options ranging from completely standardized to highly customized.

As the degree of customer customization increases, the role of the sales force in developing the value proposition becomes more prominent. In highly consultative sales situations the seller may develop unique customer solutions that draw on a broad cross-section of the company's capabilities. In some cases the proposed solution may even require changes in the seller's and buyer's operations, or partnership with other vendors or business partners. High customization provides the greatest opportunity to create customer value. It also increases cost of sales and operations. Mutual value creation for both buyer and supplier is achieved when the VBS strategy balances customer benefits with willingness to pay. Providing benefits that a customer will not pay for, through either price or volume, equates to giving away value and profit.

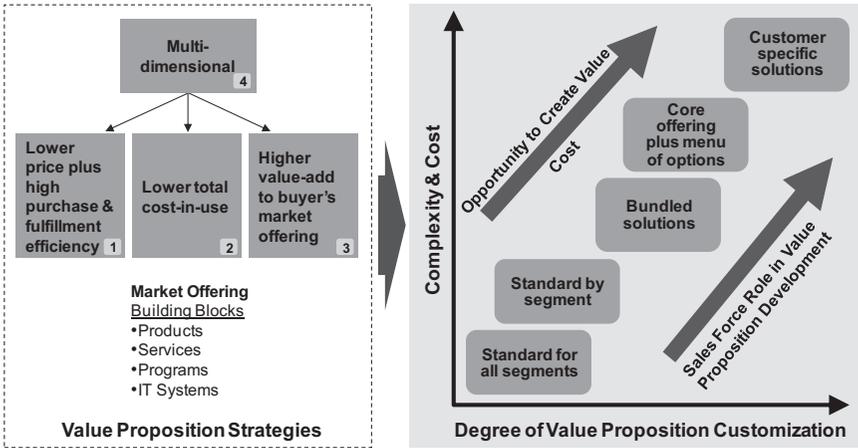


Figure 22.9 Value proposition strategy continuum

Hybrid value proposition strategies often present the greatest opportunity to profitably maximize value creation across target customer segments. Such approaches employ a mix of value proposition strategies based on customer segment or account-specific profile. For example, more standardized value propositions may be targeted at lower value segments or those that have simpler needs. Customized value propositions may then be targeted at higher value customers with more complex needs. Hybrid value proposition strategies lead directly to hybrid sales channels and more complex sales force structures. The reason is that different channels and sales structures vary considerably in their ability to cost-effectively deliver specific value propositions and sales processes.

Best practice VBS marketers create a “baseline” value proposition for each target segment regardless of the degree of customization that will ultimately take place. Baseline value propositions provide the market offering and associated customer benefits and worth starting point. For segments receiving no customization, the sales force can leverage baseline value propositions “as is.” For segments receiving customization, sales persons tailor the baseline value proposition based on the specific account’s needs, priorities and value to their own company. Even for enterprise and large “segment of one” accounts where significant customization may be required, it is beneficial to provide Sales with a starting point from which to work. Editing allows sales persons greater sales efficiency and effectiveness than creating from scratch.

The role of pricing within the overall value proposition is of special criticality to VBS. The difference between economic value delivered by the seller’s solution and the seller’s price represents the net benefit to the buyer. When this net benefit

is greater than that of alternatives, the buyer has a strong business case for selecting that seller. Obviously, one way to increase the net benefit is to reduce price. However, as has been pointed out, even small decreases in price have significant negative impact on profit.

Cost-plus pricing and match-the-competitor pricing are relatively common approaches used by many B2B sales organizations. Neither is tied to actual value creation and often leads to value and profit shifting from the seller to the buyer. VBS calls for “value-based pricing.” Under “value-based pricing,” pricing is linked to the actual economic worth of a given solution. The idea, then, is to set price such that two conditions are achieved:

- 1 The net benefit to the buyer is slightly greater than that of alternatives.
- 2 The commensurate net benefit to the seller achieves the seller’s margin requirements or better.

When these two conditions are not simultaneously met, one of two conditions exists:

- 1 The solution and associated price need to be further tailored to provide greater net benefit relative to the customer’s needs and alternatives.
- 2 The seller does not have a competitive solution or cost of goods sold (COGS) (and/or needs to reshape the buyer’s understanding of their needs and solution requirements).

VBS and value-based pricing are inextricably linked. One does not exist without the other.

### ***Sales process***

The sales process is in many ways the backbone of VBS. Sales processes, such as the example shown in Figure 22.10, provide the roadmap by which account-specific value proposition development, communication, proof, tailoring, delivery and reinforcement are consistently and effectively accomplished.

Sales processes are not recipes for success to be followed to the letter. For instance, they do not prescribe customer needs, the value proposition or the negotiation strategy to be employed. Rather, sales processes provide a logical progression of activities that maximize success at each stage in the customer value management cycle. Sales processes greatly improve sales discipline. Examples of the benefits highlighted by the sales managers of a large financial services organization are provided in Figure 22.11.

VBS sales processes dive deeper than just the top-level phases exemplified in Figure 22.10. The best sales processes incorporate a number of elements under each phase including: critical activities, advance objectives and metrics, roles and responsibility definitions for all functions engaged and key enablers available to support that phase. When developed in this way, the sales process provides the playbook for the company’s customer value management strategy.

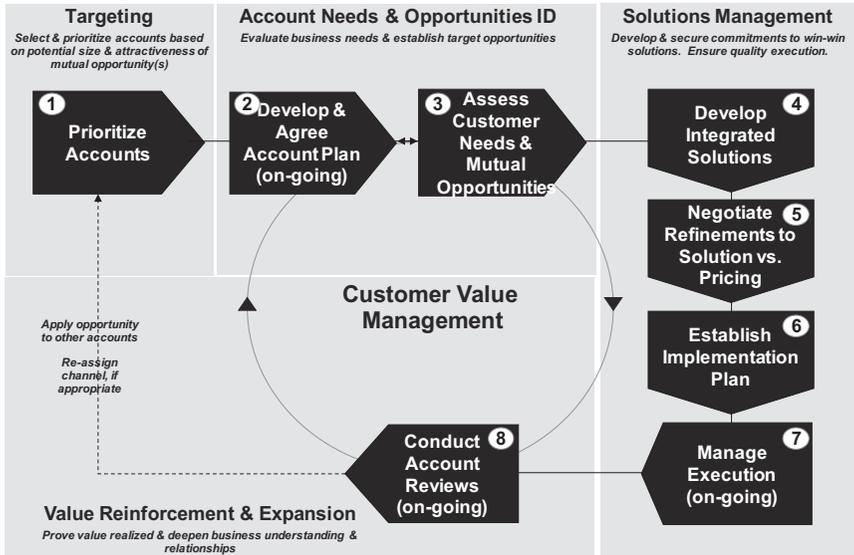


Figure 22.10 VBS sales process (case example)

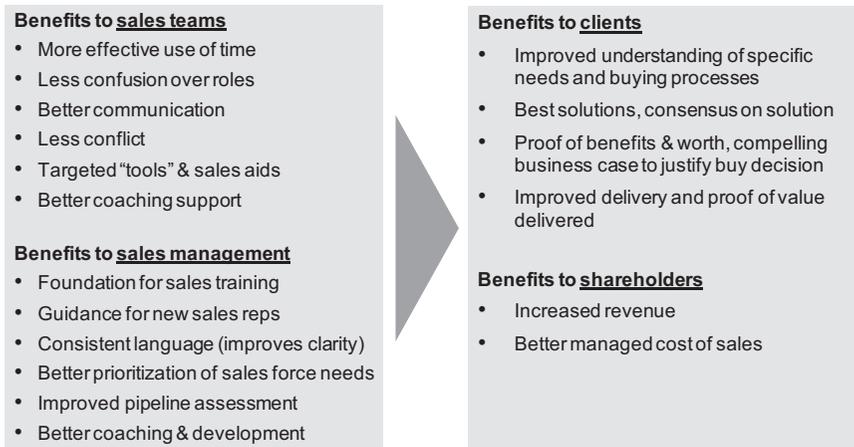


Figure 22.11 Sales process benefits (case example)

VBS sales processes tend to have a number of common traits:

- They seek to identify and confirm customer needs *before* engaging in discussions about the seller’s products and services.
- They seek to explicitly link the seller’s proposed solution back to the buyer’s needs and priorities. Oftentimes the seller contributes “consultative” value through this process alone.

- They seek to gain agreement that the seller's solution addresses the buyer's needs *before* addressing price.
- They link price to the specific value that will be contributed by the solution. They also seek to ensure that changes in the solution are accompanied by corresponding changes in price and vice-versa.
- They ensure that value actually delivered vis-à-vis the original customer agreement is tracked and communicated. In this way, they ensure that value perception does not trail off over time and establish an ongoing interaction that reveals new opportunities.

### ***Sales channels strategy and sales force structure***

Sales channels strategy and sales force structure dictate the type of sales resource that will be deployed against different activities, offerings and account types. The primary objective of sales channels strategy and sales force structure is to determine the most cost-effective approach for delivering the value proposition strategy and sales process to each of the company's target customer segments.

A diverse range of sales channels is being employed by today's B2B organizations. Common examples include the following:

- global account management
- key account management
- field sales
- inside sales
- business partners
- e-channels.

There are literally hundreds of permutations on these basic approaches. With the evolution to hybrid value propositions and the proliferation of sales channel options, sales force strategy design has become complex. Many factors must be considered in their design. The factors that we have found to be the most significant are summarized in Figure 22.12.

Assigning the right accounts to each sales channel is as important as the design itself. VBS organizations develop and manage centralized business processes that ensure objective account to channel assignment on a periodic basis. These business processes address both current customers and prospects. And they mitigate "land grabs" or other politically driven processes that create mismatches between sales resources and what is actually required. These same business processes tend to ensure optimal sales resource sizing and allocation across channels. Inaccurate sizing leads to coverage gaps and the inability for the sales force to fully execute the required sales process with target accounts.

### **VBS implementation and execution**

Transforming a sales force from a friendship, features and price focus to a value focus is always difficult. Tailoring and communicating value proposition benefits

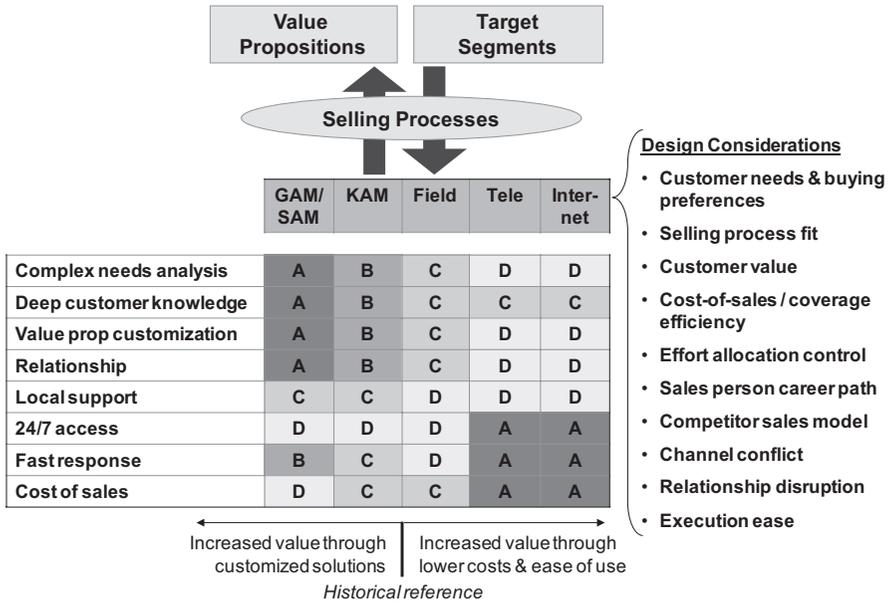


Figure 22.12 Sales channels and sales force structure design considerations

and economic worth requires strong business acumen and deep knowledge of their customers’ business models. In many cases VBS sellers must be able to model the impact of their offering on the buyer’s total cost in use or help forecast the increased revenue the buyer will achieve in the sales of its own product. They need to speak the language of finance while being able to address the unique needs and issues of diverse decision influencers. VBS requires knowledge, skills, effort, support and tools well beyond those necessary for friendship, features and price-based selling. This challenge provides one explanation for why so many selling organizations have not been able to break free of their old selling habits, even though they realize the imperative to do so.

Three downstream components in the sales effectiveness framework play a particularly critical role in driving VBS implementation and execution:

- VBS specific competency models
- VBS selling tools that support each stage of the sales process
- Expert VBS coaching and apprenticeship.

For most sales forces, a majority of sales persons will have been selling for many years. During this time they have developed deeply entrenched work styles and viewpoints on how to succeed. Convincing and motivating these individuals to reinvent themselves, and enabling them to do so, is perhaps the single greatest challenge associated with large-scale VBS initiatives.

An important tool in this regard is the sales force competency model and evaluation process. The competency model paints a picture of “what is expected” and “what success looks like” under VBS. A new approach to competency models and evaluation is typically required for VBS. In particular, VBS competency models tend to be organized around the VBS sales process. In this way they provide context for competencies that are meaningful for the sales force and that provide the template against which meaningful performance reviews and coaching can be conducted.

A well-designed VBS competency model sets the foundation for a number of downstream elements including: (1) the sales force’s understanding of the new expectations; (2) the evaluation and placement of sales people in new roles; (3) the accuracy and relevance of future individual performance evaluations; (4) the quality and specificity of coaching; and (5) the quality of future hiring decisions.

Quality VBS sales tools also play an essential role in both motivating and enabling the sales force to adopt and perfect VBS. Figure 22.13 summarizes some of the most critical tools and demonstrates how they fit into the sales process. These tools should not be confused with sales force automation (SFA) or CRM tools that the sales force may already be using. VBS tools are largely a new phenomenon and meant to enable the sales force at each stage of the selling process. Such tools allow the sales force to more effectively and efficiently identify needs, develop solutions, communicate and prove solutions, negotiate price versus solution trade-offs and reinforce value. Furthermore, since the tools sequentially align with each step in the VBS sales process, use of the tools indirectly helps sales people to learn and adopt the process.

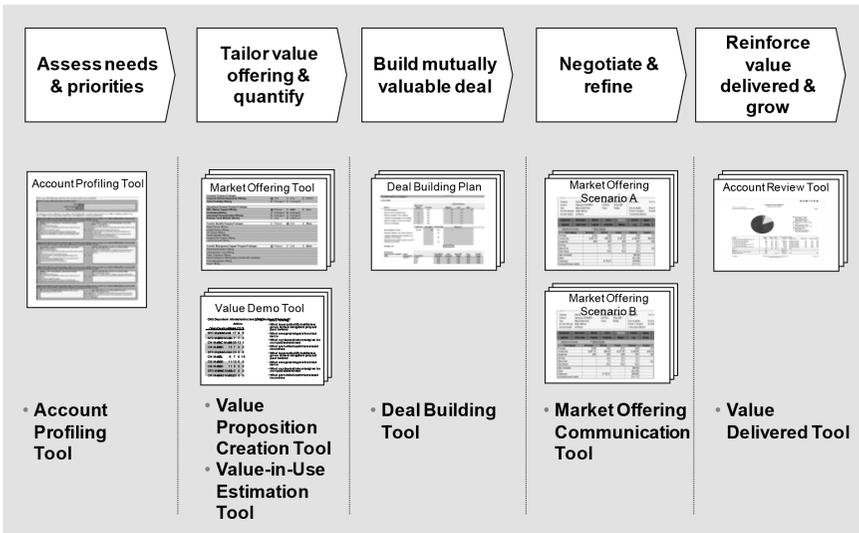


Figure 22.13 VBS software tools requirements (case example)

Of particular criticality to VBS transformations is winning the hearts and minds – and building the expertise – of the first-line sales managers. Their understanding, buy-in and expertise in value-based selling will strongly shape those of the representatives reporting to them. A first-line sales manager who is opposed to the company's VBS strategy, or who lacks VBS expertise and skills, can undermine the success of an entire district, or more.

Winning hearts and minds of the first-line sales managers – and of the sales representatives – can only be achieved to a limited degree through logical argument and leadership mandate. Top-down approaches alone are prone to fail. Sales force buy-in and engagement requires that four gates be opened. First, managers and sales people must fully “understand” how the new behaviors and skills are actually different than the current ones. A pervasive belief that “we already do that” has derailed many VBS initiatives. Second, they must “believe” two things: (1) that IF I adopt those behaviors and skills that I will be more successful, AND (2) that I have the aptitude to achieve those behaviors and skills IF I so choose. Third, they must feel motivated to make the effort and to take the risk associated with change. Fourth, they must experience positive aspects from the change early enough in the trial period to stay committed.

Two approaches in combination have proven particularly effective in winning sales force hearts and minds. Part 1 is a compelling case for change that clearly communicates why change is imperative, the specifics of the change relative to the present situation, a believable path to get there, ways in which the organization will assist individuals in the change and what's in it for the company, the customer and the sales persons. Part 2 offers compelling proof points that the desired change is feasible and will deliver. The best proof points typically derive from early-experience teams that trial the approaches and tools, or from individuals that are on an adoption fast-track relative to the rest of the sales force. Testimonials and case examples from these teams or individuals carry significant weight with their peers. Failure to adopt these types of bottom-up approaches to implementation and change management places VBS initiatives at high risk of sales force rejection.

Assuming that hearts and minds have been won, the quality and rigor of first-line sales manager coaching is in many ways the “secret sauce” for VBS capability building. This is particularly true when a large shift in mindsets, behaviors and skills are being sought. Training is an important and necessary aspect of developing VBS knowledge. However, value-based selling is predominantly an apprenticed skill. Training is good for conveying concepts, frameworks and methods. Value-based selling is a skill requiring complex problem solving, business acumen and adaptability. It is developed over time through practice and coaching from a VBS expert. Coaching also plays a critical role in motivating sales reps to trial and to stick with value-based selling behaviors during the uncomfortable period of new behaviors and skill building.

At steady state, world-class sales managers spend upward of 50 percent of their time coaching. During VBS implementation this allocation can be even higher. The primary focus of VBS coaching is depicted in Figure 22.14.

<i>High impact:</i>	<i>Hygiene:</i>
<ul style="list-style-type: none"> <li>• <b>Sales process</b> <ul style="list-style-type: none"> <li>– Needs assessment &amp; validation</li> <li>– Solution development &amp; validation</li> <li>– Negotiations</li> <li>– Communication/proof</li> <li>– Value reinforcement</li> </ul> </li> <li>• <b>Planning</b> <ul style="list-style-type: none"> <li>– Account planning</li> <li>– Call planning</li> <li>– Account targeting</li> <li>– Pipeline management</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• <b>Basic sales skills</b> <ul style="list-style-type: none"> <li>– Communication</li> <li>– Cold calling</li> <li>– Closing</li> <li>– Dealing with concerns</li> <li>– Time allocation</li> <li>– Tools</li> </ul> </li> </ul>

*Figure 22.14* VBS sales managers focus heavily on advanced coaching elements

First-line sales managers must be expert in VBS to be effective VBS coaches. This requirement presents a dilemma during large-scale transformations. Many of the first-line sales managers may themselves never have been apprenticed in VBS and are not VBS experts. In such cases, carefully designed programs are required to rapidly build manager expertise in VBS. Such programs typically include a combination of extensive training and reinforcement, outside hiring, frequent sharing of issues and best practices, coaching by senior leadership and enlistment of outside advisors.

Of course, the other components in the sales effectiveness framework are also mission critical for VBS. The measures, incentive systems and reporting have to motivate VBS. The organization has to hire and place the right kind of people. Performance reviews have to reinforce the right behaviors, skills and accountability. Marketing operations and sales operations have to help enable many aspects of execution. IT has to build and support the right information and tools. In this regard, VBS is a business initiative, not just a sales force initiative.

## **Conclusion**

VBS capability increasingly will be a differentiator between winners and losers in B2B markets. As VBS strategies become the norm in B2B markets, the strategic advantage will shift from strategy to quality of execution. The relative complexity of building and executing VBS strategies ensures that meaningful and sustained differentiation will be achievable for some time to come.

While there are many organizations that have minimal VBS capability, there are also many that have made great progress. This latter group provides an important proof of feasibility. Successfully transforming the Sales and Marketing organizations of today to avert commoditization and to compete with value-minded competitors takes strong leadership skills. A comprehensive, purposefully orchestrated

approach to capability building that systematically addresses all sales effectiveness drivers is required. Sales and Marketing has to adopt collaborative business processes. Customer segmentation, value propositions, selling processes, channel strategy and sales force structure have to be carefully designed and aligned. Special attention to competency models and the decisions they support is necessary. Strong coaching and VBS tools are required to motivate adoption, improve capability and sustain momentum. And the job is never finished. Sustained VBS leadership will result from focused continuous improvement.

### **Implications for innovation in pricing**

The point has been made in this chapter that “value-based selling” and “value-based pricing” are inextricably linked. When they are not, sellers will nearly always give away value or, alternatively, be viewed as too expensive by the buyer.

Value-based selling organizations rigorously link their pricing strategy to the market offering options. Pricing strategy for these organizations is dictated by three factors: the economic worth of the solution to the customer, the economic worth of the next best alternative and the cost to deliver.

With VBS, price is not negotiated independent of solution. “Too high a price” implies that there are elements included in the market offering that the buyer does not value. Negotiations are then oriented around price-offering trade-offs that optimize value from the buyer’s perspective. By approaching the selling process in this way, the VBS seller maintains their necessary margin and win rates and avoids the value and profit shifting so common in many organizations.

Value-based selling and value-based pricing place certain demands on the selling organization and individual sales persons including the following:

- 1 The selling organization must have deep knowledge of the buyer’s business model and the ways in which their offering will impact the buyer’s total cost-in-use and the buyer’s sales of their own products.
- 2 The selling organization must be able to quantify and prove the value relative to alternatives. In many cases, this will actually require the sales person to have the business acumen necessary to tailor the quantification and proof to individual buyers. Marketing will typically need to play a significant role in establishing proof points and enabling the field with the information and VBS tools they require.
- 3 Individual sales people will have to learn and apply a new level of discipline in their sales processes. They must resist the urge to jump into product or service discussions in advance of understanding and validating customer needs. They must also resist the urge to discuss price prior to presenting the proposed market offering. Price and market offering are inextricably linked.
- 4 Finally, leadership must have the courage to “walk away” from customers who reject a value-based solution and price once all solution/price combinations have been exhausted. Unprofitable customers are best left to the competition to suffer.

## Notes

- 1 An earlier version of this chapter was published as ZS Associates White Paper in 2007.
- 2 Source: ZS Associates B2B VBS engagements.
- 3 Source: ZS experience based on hundreds of sales force strategy studies.

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**Part V**

**Psychological aspects of  
pricing**



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# 23 Behavioral aspects of pricing

*Ben Lowe, Julian Lowe  
and David Lynch*

## Introduction

Since the first edition of this book there have been many changes in the pricing environment. Comparison websites have increased competitive transparency and new technologies like Uber have facilitated rapid adjustment of prices to demand changes; something originally prevalent in electricity pricing and airline yield management has now become widespread in a range of services, including transportation, sporting events and music concerts. Generally, the ubiquity of information technologies has helped consumers with better information but it has also helped sellers with the tools to extract the maximum value from demand surges. But in spite of better information, rules of thumb and seemingly irrational decision-making are still prevalent.

In a rational world where everyone has good information one might expect that consumers will buy when total perceived value is greater than price charged. The greater the difference, the greater is their “willingness to pay” (WTP). In determining WTP, many other behavioral factors can disturb the rational analytic perspective of buyers. For instance, the notion of fairness might be important. This is illustrated by the launch of Radiohead’s album, *In Rainbows*. Fans were asked to name their own price for the album. Interestingly, many consumers paid for the album and the average price paid was around £4. Similar examples have been seen for restaurant meals, concerts and other services (BBC, 2015).

Marketers try an increasingly broad range of approaches to “hide” prices. They partition prices, they trade-off price for quality or volume, they set prices that price discriminate across segments, psychological needs, geography and urgency of need. According to one report from the U.K.’s Office of Fair Trading, over 20 percent of advertisements, including prices, were deemed to be deceptive in some way or another (Ahmetoglu et al., 2010). Price is also an important signal; when Phillips, the electronics manufacturer, released the Philips Intimate Massager and set the price at £89.99, it was set at that level “to be seen as respectable” (Mortishead, 2008), reflecting the role of price to signal product legitimacy.

Hyper-competitive markets, globalization, online auctions, new purchasing and retail formats provide an increasingly complex array of contexts in which price has to be managed. The sellers need to understand the “value” the customer is

searching for, when price might itself be one of the most important attributes for consumers (e.g. Severin et al., 2001). Recent research suggests mood and environment can deliver major benefits in encouraging consumers to increase their WTP. Thus, price is multifaceted. While it is about “what price do I charge,” it is also “how,” “where” and “when.”

This chapter will explore key behavioral aspects of pricing, drawing on links to the rapidly changing world of technology. Specifically, the chapter will begin by contrasting traditional perspectives on price with more contemporary perspectives on price; it will then examine the notion of perceived value and its multifaceted nature. The chapter will then outline the key behavioral aspects of price including internal and external reference prices, pricing and consumer perceptions of fairness, price endings, decreasing and increasing price, price – quality perceptions and consumer price knowledge.

### **Perspectives on consumer response to price**

The essence of effective marketing is to create value for customers and capture that value for the firm through current profits and longer-term reputation and image. Value is created through a product that meets customer requirements, is available for them to access and is communicated effectively. These three Ps of marketing are complemented by the fourth P that involves the effective use of price as it is set to capture the value the rest of the mix has created. A pricing strategy involves setting a price that creates an incentive for consumers to buy a product or service and generate sufficient revenues to encourage the firm to sell that product. In short, consumers buy when perceived value from a product exceeds price. Perceived value represents their WTP; any price less than that, subject to a budget constraint, should lead to a purchase. Sellers need to understand WTP and competitor offerings when setting prices.

Some economic models assume that customers are perfectly aware of product features and competitive offerings and that all that is needed is to understand the demand – price relationship. Monroe and Lee (1999) list other restrictive assumptions of an economic model. This (rather narrow) economic perspective is sometimes contrasted with a marketing perspective, which explicitly sees price as an integral part of the marketing mix that signals and captures value. The manipulation of all four Ps together may create a difference between marketing and economic approaches to pricing, although such a perceived difference might involve a misinterpretation of textbook models of business behavior that merely seek to explain, in parsimonious fashion, the relationship between price, revenue, output and profit. Some empirical research on price – quality relationships confirms that more often than not, long-term prices reflect differences in products and attributes (Murray & Sarantis, 1999), and maybe there is less difference in economic and marketing approaches than is sometimes thought.

Fundamentally, consumers are expected to purchase an item whenever the perceived value of that item exceeds its actual price. The greater this gap, the greater the incentive to buy. Much marketing strategy is aimed at influencing behavioral

factors that increase perceived value and thus the size of the gap. Gourville (1999) suggests the behavioral factors that disturb the simple relationship between price paid, WTP and cost of goods and services, including the perceived fairness of price, the relative incentive to buy (e.g. value of consumer surplus relative to the price of the product), the difference between actual price and a consumer's reference price and price compared to perceptions of costs.

The economic notion of incentive to buy is when perceived economic value is greater than price. This gap is sometimes referred to as acquisition value or consumer surplus. The behavioral notion is that economic value plus psychological value needs to be greater than price. The marketing notion combines these approaches but recognizes that consumers often have less than perfect information, that price itself is a signal of quality and that savvy consumers might also consider the ease of purchase and use of a product as important creators of customer value, and therefore WTP.

Economic, marketing and behavioral factors influence WTP and, therefore, value to buyers. In addition, buyer knowledge of prices is affected by their past experience, search behavior and ability to disentangle complex deals. Increasingly, the view is that complex offers that surround products are sometimes interpreted poorly by buyers who deliberately bound or restrict their search for information or who are unable to disentangle competitive claims. Unit pricing, ethics, regulation and competition affect the consumer's response to the different factors affecting WTP and the pricing strategies of sellers. Most importantly, the nature of perceived value to buyers is complex and influenced by a myriad of subjective factors.

## **Perceived value**

The preceding section identified the delivery of value to customers as a fundamental element of the marketing concept that builds and sustains competitive advantage. By delivering value, companies try to satisfy customers, resulting in improved customer loyalty, sales and profits.

To this end, managers need to understand the nature of customer value and where they should focus their efforts to enhance the value they create for customers.

The concept of perceived value is defined above as the psychological and economic value gained from consuming a product or service. The difference between perceived utility/benefits and costs is the incentive to buy and is referred to as consumer surplus or acquisition value in the economics and marketing literatures, respectively. Perceived value may be confused with other similar marketing and economic terms, such as utility, price and quality (Sánchez-Fernández & Iniesta-Bonillo, 2007). The economic view of value as instrumental, task-related, rational, functional and cognitive (Sweeney et al., 1999) is criticized by some authors with the view that perceived value is a multidimensional construct that consists of several interrelated attributes (e.g. perceived price, monetary and non-monetary costs, quality, utilitarian and hedonic benefits). The notion of value creation in the marketing literature has traditionally focused on transaction, maintenance and

learning costs (e.g. Anderson & Sullivan, 1993, Monroe, 1971; Wilson, 1995; Zeithaml, 1988). Recent developments in the field have extended the definition of value to incorporate non-price elements, such as life cycle and privacy costs (Kumar & Reinartz, 2016; Vargo & Lusch, 2004). Karmarkar et al. (2015), using tools of neuroscience, find that for many regularly purchased or utilitarian products, leading a promotion with the price first significantly influences perceptions of value because considering the price first changed how people thought about the choice process and changed the way the brain coded the value of a product. The value proposition to customers is whether product functionality is worth the price. Price primacy (viewing the price first) induces bargain-focused perceptions of value.

The perceived value construct has been identified as a major source of competitive advantage (Parasuraman, 1997) and has been identified as the key determinant of repurchase intentions. Parasuraman and Grewal (2000) conceptualized this relationship through the development of the quality-value-loyalty chain. This framework posits that perceived value has three primary antecedents: service quality, product quality and price. The authors make the distinction that service quality offers the potential for the greatest competitive leverage, as it is generally more difficult for other producers to imitate.

The notion of perceived value suggests that subjective judgments of value, whether they are cognitive or affective, are what influences consumer decision-making. These evaluations are based on more than experience or knowledge relating to the benefits of the physical product but also a customer's individual perception relating to the purchase. Previous research has highlighted how such judgments of value are influenced by the context in which consumer decision-making takes place. Perceptions of value have been found to differ between product types, individuals and circumstance (over time and in different environments). Consumers can also differ in the value they associate between both different and the same products. Even a consumer's value of the same product may vary over time, and the types of values that are most salient are likely to vary with circumstance. In some research, four different types of value have been identified (e.g. Grewal et al., 1998; Woodruff, 1997):

- 1 acquisition value: perceived benefits relative to perceived costs
- 2 transaction value: the pleasure associated with a perceived fair price
- 3 in-use value: benefits derived from using the product
- 4 redemption value: the residual benefit after a product has been consumed.

The dynamic nature of perceived value means that the importance placed on each different value is likely to change over time and in different contexts. For durable products, acquisition and transaction value are likely to have a stronger influence on purchase decisions, with in-use and redemption value becoming more important during latter stages of usage. In such cases, the decision to trial a product is more likely to be influenced by perceived acquisition and transaction value,

whereas repurchase behavior and customer loyalty may be more strongly related to in-use and redemption value (Parasuraman, 1997; Slater & Narver, 1994).

Whether a simple or complex view of perceived value is used, recent developments in the field have shifted the emphasis away from a utilitarian and economic conception to a behavioral conception based on psychological theories that attribute consumer choices, in part, to simpler heuristics. An important heuristic identified in research studies into how buyers perceive the fairness or appropriateness of a price is that of the reference price, which can be defined as the price against which buyers compare the offered price of a product or service. This concept is considered in the next section.

### **Internal and external reference prices**

The notion of transaction value can be closely linked to a product's reference price (Urbany et al., 1997). The Nobel Prize winning work of prospect theory, whereby individuals evaluate their decisions based on losses and gains rather than absolute magnitudes (Kahneman & Tversky, 1979), has had important implications for our understanding of consumer response to price, and specifically perceptions of their transaction value. In applied consumer behavior studies, empirical research for fast moving consumer goods (FMCGs) generally suggests that consumers make decisions about price by referring to some of kind of reference price, whereby the gap between what one thinks a product's price *should* be (e.g. a normal price, a fair price – its reference price) and the actual price of the product is a better predictor of behavior than the price alone (Mazumdar et al., 2005). In other words, if a consumer's reference price is higher than the actual price, then the consumer is more likely to frame the purchase as a "gain" and view the product as a good deal. However, if the reference price is lower than the actual price, then the consumer is more likely to frame the product as a "loss" and think the product is not such a good deal. Therefore, an important part of the behavioral perspective on pricing focuses on this gap between the actual price and the reference price. This has been coined transaction value (Thaler, 1985) or "sticker shock" (Winer, 1986). Thus, in studies concerning consumer response to price, researchers typically study acquisition value and transaction value (Grewal et al., 1998; Lowe & Alpert, 2010; Thaler, 1985; Urbany et al., 1997). The implication is that longer-term price management and its impact upon these value perceptions is a more important objective than short-term price management because past prices signal a product's worth to consumers – it is the price history as well as the current price that consumers use to make purchase decisions (Winer, 1986). These past prices provide consumers with a reference price and the reference price is used to judge the expensiveness of a product.

For new products, the implication is that setting the right price for a product early on in its life cycle is especially important because it will set the standard against which the expensiveness of that product is judged in later periods. Therefore, reference price management is important to products in existing categories,

but especially important to products in new product categories where consumer price perceptions have yet to be framed (Lowe & Alpert, 2010; Marn et al., 2003). Thus, not only is price management important but, relatedly, so is *reference price management* (Nagle & Hogan, 2006).

Marketers try to influence our reference price, and therefore transaction value, through external reference price claims (e.g. “Was \$109.99, now \$59.99”). Such promotions are often accompanied by time-limited cues (e.g. “Hurry, before sale ends”). The most recent research in the area provides evidence, based on a series of field experiments, that reference price advertisements are generally more effective when consumers are shopping for a product, and that such advertisements are more effective when accompanied by a time-limited promotion (Howard & Kerin, 2006). This contrasts to some degree with prior work on reference price advertising, which seems to suggest that reference pricing alone is effective in influencing shopping intentions (e.g. Biswas & Blair, 1991).

### **Pricing and fairness**

The concept of a reference price has been shown to be multifaceted and context specific. For example, Lowe and Alpert (2007) show that different reference prices are used for new products as opposed to existing products. However, one commonly used reference price is a fair price (Mazumdar et al., 2005). Gourville (1999) identifies a variety of factors that influence the buyer’s perception of the fairness of a price. Earlier Scitovszky (1944–5), observed “the normal or fair price is contrasted to the actual price whenever they are different, and it is only when they are different that judgments of cheap or expensive occur.” This relates again to the notion of transaction value. A large perceived margin is unfair and dissuades buyers from purchasing. Thus, a price hike in the context of current shortages might similarly be seen as unfair, as would a small sale reduction on a high price compared to that same (absolute) reduction on a low price.

In these cases, it might be argued that individuals are effectively deciding their response to a price change judged on its fairness. Perceptions of fairness impact WTP by consumers being less willing to pay a price they feel is “unfair.” This might be extended to a long-term depreciation of a seller’s reputation and marketability of its products because of its perceived lack of “fairness.” Fairness is also an ethical issue that society in general might have a view on, and this might influence the control or pressure to control its prices by regulators. The pricing of medicines in developing countries is a case in point (Dolan & Gourville, 2009).

The main managerial issue is how to deal with customer perceptions of unfairness. That is, how does the seller encourage them to disregard “unfairness” in their decision-making? Gourville (1999) recommends actively managing price expectations and actively managing perceptions of cost of goods sold. The counterpoint to ensuring customer perceptions of fairness is that many firms pursue pricing policies that are considered “fair,” as in equitable, between product lines but that such pricing mismanages potential profits. Cost plus pricing is an example, as is

averaging prices across groups of very different consumers. Cespedes et al. (2011) note that,

Many executives celebrate a sort of pseudo-democracy in their pricing policies. For years, UPS charged one price to all customers . . . When it entered the market, FedEx became the fastest U.S. company to reach \$1 billion in sales in part because its pricing recognized inherent value differences between customers.

One aspect of fairness is the appeal of price transparency of sellers. Lowe (2015) and Mohan et al. (2014) argue that transparency over costs generates customer trust and increases purchase probabilities. This holds in a range of situations, particularly when higher prices are justified through higher costs caused by social or ethical choices

The notions of fairness come from customers, not pricing formulas. Fairness is important and can be managed, but it is not about equity *per se*. A key issue in fairness is the extent to which prices move away from some reference point. The behavioral effect of increasing and decreasing price is now considered.

### **Increasing and decreasing prices**

If managing consumer price perceptions is important, then understanding how price increases and price reductions affect consumer perceptions of value can be critical. It is quite common for marketers to reduce prices, usually through some kind of sales promotion, to stimulate demand for a product. To this end, marketers have a range of tools at their disposal, including price discounts, coupons, bonus packs, contests, free gifts, introductory prices, etc. One issue that is important when assessing consumer reaction to sales promotions involves the depth and frequency of sales promotions. For instance, for FMCG products discounts of greater than 5–10 percent are generally necessary before consumers notice that there is even a discount (Gupta & Cooper, 1992). This is known as the just noticeable difference (JND) (Monroe & Lee, 1999) and suggests that marketers should reduce prices by an amount that is noticeable to consumers. It is likely that the JND level changes as a function of the product category under consideration, consumer involvement with the purchase decision, knowledge about the product category and the magnitude of the product's cost to the consumer. Conversely, consumer response to discounts of different levels is not necessarily linear, such that larger and larger discounts have smaller and smaller marginal effects. For example, some research shows that discounts higher than 30 percent do not evoke a large marginal change in preference, as consumers tend to “discount the discounts” (Gupta & Cooper, 1992). Therefore, those managers responsible for setting discounts should carefully consider the level of the discount that is being set so it achieves its objectives in an optimal way. Managers need to also consider the frequency of discounting too. Discounts that are too frequent may lead consumers to perceive that a sale is not a real sale. For example, Alba et al. (1999) show that

a small but frequent discounting strategy may be most suitable for stores wishing to present a low-price image rather than infrequent but heavier discounting.

Another issue that is important to consider when selecting a sales promotion is the kind of sales promotion to use (e.g. monetary versus non-monetary) and its differing effect upon consumer value perceptions. Consumers react differently to different types of sales promotions. For example, Chandon et al. (2000) broadly distinguish between monetary promotions (e.g. a discount) and non-monetary promotions (e.g. a free gift), and they show that sales promotions techniques have benefits other than a monetary saving. These benefits include utilitarian benefits, such as monetary savings, enhanced value for money through increased quality, increased convenience and other hedonic benefits, such as increased entertainment and enhanced exploration ability.

Taking a somewhat different approach, other research contrasts the differences between monetary and non-monetary sales promotions based on their impact upon consumer reference prices. For example, Diamond and Campbell (1989) show that monetary promotions, such as discounts, lead to lower reference prices than non-monetary promotions, and this has consequences for transaction value. However, Sinha and Smith (2000) show *one-off* price promotions may not affect reference price. Intuitively, and based on prior research, it might be expected that introductory low prices or monetary discounts may downwardly bias a consumer's reference price (e.g. Diamond and Campbell, 1989), whereas the reference price is more likely to remain unchanged for extra free product offers (Sinha & Smith, 2000). This is important because if an introductory low-price promotion leads to a lower reference price than an extra free product promotion, then one might expect the gap between the product's reference price and its actual price to increase. As the gap increases, this reduces transaction value, which in turn reduces purchase likelihood. Based on a similar premise, Lowe and Barnes (2012), using a national sample of U.K. consumers, show that introductory low price promotions are more (less) effective than extra free product promotions when the product is perceived as newer (less new). This seems to be because newer products are seen to be more risky and monetary promotions can reduce perceived risk relative to non-monetary promotions.

On the other hand marketers sometimes wish to increase prices. Again, drawing on prospect theory (Kahneman & Tversky, 1979), this is most likely to be viewed as a loss by consumers, and in some cases consumers will perceive this to be unfair. Price increases are sometimes unavoidable due to increased input costs. Nonetheless, these increases must be framed in a way that consumers feel is fair. For example, Campbell (1999) shows there are two key causal influences on our judgments of price fairness. These are the inferred motive of the firm (e.g. whether the motive is judged to be negative or positive – as in whether or not the profits will be allocated to the firm or a good cause) and the inferred relative profit of the firm (e.g. a normal profit or a *more than* normal profit). This relationship is moderated by a firm's reputation (e.g. socially responsible or not socially responsible with other stakeholders – staff, the community, etc.). Bolton et al. (2003) extend this research and show that consumers' knowledge (measured

subjectively – e.g. their perceptions) of prices, profits and costs lead to changes in their perceptions of price unfairness. Therefore, based on this data, it appears that consumers are skeptical toward a firm's motives and tend to assume price changes and price differences are unfair based on some kind of perceived motive for firms to take profit, even when they are actually beyond the firm's control. They conclude that price increases deemed to be most fair are deemed to be fair as a result of quality differences; so perceived differences in quality are an important cause of price fairness perceptions and should be an integral part of marketing communications. Thus, when increasing prices marketers should “nibble” not “bite” (Kalyanaram & Little, 1994: 416), the opposite of when decreasing prices.

## Price endings

Consumer response to prices also exhibits some peculiarities in relation to an offering's price ending. The study of price endings and odd-even pricing tactics (e.g. \$19.99 or \$20.00) is not new to the field of marketing. However, relatively little empirical research has provided conclusive evidence of the nature of the effect and its moderating conditions. This is despite the fact that the practice remains widespread. For example, Schindler and Kirby (1997) show that the digits 0, 5 and 9 are over-represented in a large sample of newspaper advertisements, consistent with many similar studies. The practice has also been shown to transcend different cultures (Simmons & Schindler, 2003; Suri et al., 2004). Because of its prevalence and ability to influence consumer choice, the topic is important for marketers and consumers alike.

The main proposition that has been tested in price ending research is that small one-penny price changes can have large effects upon sales if prices are changed from an even number such as \$20.00 to an odd number (and in particular a number ending in 9) such as \$19.99. Thus, in some cases consumers could be highly price sensitive to price changes that are extremely small, and otherwise unnoticeable, leading to spiked demand curves at prices ending in 9 (Anderson and Simester, 2003). There are three main theoretical arguments for such effects. One argument is that price-ending effects are most likely to be seen when associated with cheaper products. However, Schindler and Kibarian (2001), based on a survey of market prices, show that 9-endings were not commonly associated with the cheapest products. Relatedly, there is evidence to suggest that 9-endings are typically associated with the presence of low-price appeals (e.g. a reference price or some kind of claimed saving, rather than cheaper products *per se*). Thus, a second explanation is based around retailing folklore, whereby managers who want sale prices to appear cheaper use 9-ending prices because they believe consumers will see these as being cheaper (Schindler, 2006). A third argument advanced in the literature is based on the premise that consumers read prices from left to right and that right-hand digits are less important than left-hand digits. Either left-hand digits are recalled better by consumers (e.g. see Guéguen & Legohérel, 2004), or if the left-hand digit changes, then this change is most salient to consumers, leading to a left-digit effect (Thomas & Morwitz, 2005).

In general, there is no widespread consensus about how price endings influence consumer choice, and because of limited systematic empirical research in the area, generalizations about price ending effects are not empirically verifiable. For example, some studies find that odd prices ending in 9 increase consumption relative to even prices (e.g. Anderson & Simester, 2003). Other studies find inconsistent effects or that odd prices *reduce* consumption relative to even prices (e.g. Bray & Harris, 2006). These findings point to a variety of conditions that moderate the effect of 9-ending prices.

Some research shows that the price magnitude of the product (e.g. low-priced versus high-priced products) is important in research on price ending effects. Anderson and Simester (2003) show that \$9 price endings (as opposed to 9 cent) can increase sales by as much as 40 percent relative to other price endings. This effect was stronger for newer products than for existing products, providing some rationale for the inconsistent effects found by Bray and Harris (2006). More recent research points to the importance of the left-digit effect (Thomas & Morwitz, 2005) as an important moderating condition. The left-digit effect suggests that 9-ending prices are only effective if the left digit changes as well (for example, from \$20.00 to \$19.99, rather than \$21.00 to \$20.00). This effect is shown by Thomas and Morwitz (2005) to be greater (smaller) when the difference between the two prices is smaller (larger). Therefore, the left-digit effect will be greater for a promotion such as “Was \$20.00, now \$18.99” (versus \$19.00) rather than a promotion such as “Was \$20.00, now \$11.99” (versus \$12.00). One aspect of price endings is the perceived exactness and precision of a price. Jerez-Fernandez et al. (2014) find that perceived exact prices yield better market outcomes than round-numbered bids. Their research emphasizes that price and its primacy in an offer provides consumers with important signals of value. Other recent research finds evidence for consumer use of round prices when consumers are purchasing for convenience – these round prices are seen to be easier to process cognitively leading to convenience benefits (Wieseke et al., 2016).

Therefore, in summary, the evidence suggests that price endings are important and that small price changes can have a dramatic influence on sales. However, this is not a universal truth. Based on the majority of research, the effectiveness of price endings seems to depend upon a variety of different factors, including association with other low price cues, price magnitude, product newness to customers, changes to the left digit and managerial interpretation of consumer response to price endings. While price movements and price endings need to be managed effectively, often the greatest challenge to sellers is how to price the quality or attributes of a product that influence whether something is considered a good or poor buy. These price – quality perceptions are considered in the next section.

### **Price – quality perceptions**

Price is usually assumed to be inversely related to demand. This is illustrated in Dolan and Gourville’s (2009) “Value-pricing thermometer” in Figure 23.1. Conventionally, a seller tries to increase the difference between price and cost of goods

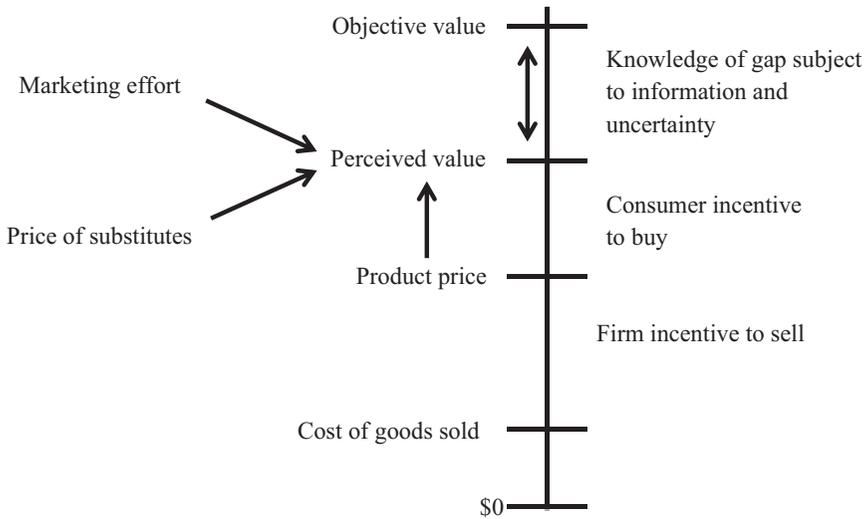


Figure 23.1 The value-pricing thermometer (adapted from Dolan & Gourville, 2009)

sold (profit) while consumers are more incentivized to buy, and the gap between perceived value to them and product price is greater. The expected price – quality relationship is for higher prices to be linked to more attributes and better quality because these lead to higher *perceived* and *objective* value. Research referred to earlier suggests that, over time, there is often a correlation between prices charged and the quality or attributes of a product or service. However, some research, as well as extensive anecdotal evidence, suggests that there might be a positive relationship between price and perceived value in some circumstances – even though objective value and product attributes remains unchanged. Some pricing research shows consumers may infer quality from price when they lack the ability or motivation to process product-related information (Suri & Monroe, 2003). Thus price *can* serve as a heuristic that provides information to consumers.

There are a number of circumstances when this price – quality relationship is likely. Higher prices may signal better quality to the consumer without adequate information when product attributes are difficult to measure except through experience or where there is high uncertainty on the part of the consumer about what to buy. Price might also be used as a quality signal where information search is difficult or there are few sources of available data (e.g. cars and electronic equipment versus perfume, clothes or wine). The assumption underlying these perceived positive price – quality relationships is that as well as uncertainty and lack of information, price is also determined with reference to another or expected price point. The buyer's receptiveness to price is about what he or she expects. Buyers also have some notion of perceived quality that can be different to objective quality. According to Zeithaml (1988), perceived quality involves a higher

level of abstraction than specific attributes and resembles attitude. Judgments about quality are made within a buyer's evoked set; comparisons with reference prices are critical. Such judgments about the superiority or excellence of a product or service is essentially user-based rather than product- or manufacturing-based (Garvin, 1983). This abstract view of quality is coupled with a view that buyers do not always know or remember prices paid but encode prices in ways meaningful to them. This is parallel to the emotional and intuitive decision-making processes that Kahneman (2011) contrasts with more deliberate and cognitive approaches.

Recent research by Bornemann and Homburg (2011) suggests that with increasing psychological and temporal distance, price – quality relationships are more likely. People are more likely to construe price as indicating quality and less likely to focus on price as a cost the more distant they are from the purchase. Thus, when a product is less part of a consumer's regular experience or when its purchase and consumption is for some time in the future, price – quality relationships are likely to be more pronounced. There is evidence that price – quality effects have decreased over the last three decades but still remain potent. Völckner and Hofmann (2007: 194), in a meta-analysis of price – quality relationship research, conclude that over the period of 1989–2006 the incidence of inverse price – quality relationships identified in the research literature declined. However, they comment that:

consumers still use price as an important indicator of quality . . . Managers must be aware that price – quality inferences remain important aspects of consumers' behavior and (should) consider them when setting prices . . . setting a low selling price or lowering a price with a discount not only lowers consumer costs but also threatens to lower their perceptions of product quality through negative signaling effects.

Thus, price – quality relationships are pervasive in many markets. However, there are limits to the extent that perceived value can be positively influenced by price. With the growth of social media, the buyer's ability to call-up data on price and quality comparisons has increased. Quality signaling using price may in the future require other strategies, such as bundling and product augmentation, to achieve increases in demand.

### **Consumer price knowledge**

The extent to which consumers use different heuristics might depend upon the accuracy of their price knowledge. Consumer price knowledge has long been a subject of interest for practitioners and academics alike. Conventional neoclassical microeconomic models assume that consumers *know* the prices of the products they are purchasing. However, a wealth of research suggests that this might not be the case (Dickson & Sawyer, 1990; Gabor & Granger, 1961). If so, this has important implications for what is known about price and about how consumers use price in their purchasing decisions. For example, reference pricing studies that

use scanner data to model consumer reference prices based on past prices consumers have been exposed to may not be accurate. Likewise, how reference prices are formed must be subject to some kind of systematic bias that is not yet well understood. More recently, Monroe and Lee (1999), in reviewing contemporary and emerging perspectives on pricing, argue that initial research in this regard is limited because it relies on the ability of consumers to *recall* prices. Instead, they argue, consumers may have knowledge about prices in a relative sense (e.g. being able to rank from cheapest to most expensive), even if they cannot recall exact prices. Using a sample of French supermarket shoppers, Vanhuele and Drèze (2002) provide an explicit test of this and tap into recallable price knowledge (e.g. whether or not the consumer can recall the price), price recognition (e.g. whether or not they can recognize if they paid a particular price) and the ability to spot deals (e.g. whether or not they can tell if something is a good deal). Like Monroe and Lee (1999) they conclude that consumer price knowledge is more pervasive than the ability to recall a particular price. This may account for the findings of reference price research using scanner data. Therefore, while shoppers cannot recall past prices accurately, they have the ability to spot good deals and bad deals. Estelami and De Maeyer (2004) expand existing research by examining consumer price knowledge for durable goods. They find that price knowledge varies considerably across a range of durable goods (e.g. higher for essential goods and lower for recreational goods). They also find that purchase frequency and amount spent on advertising are important variables that can explain consumer price knowledge, whereby more frequently purchased products and heavily advertised goods are associated with higher price knowledge. More recent research shows how the number of low-priced items in a store can affect the degree to which the store has a low price image and how different customers rely on different heuristics to make judgments in arriving at their perceptions. Specifically, they show that stores with greater numbers of low priced products are more likely to have a low-price image. However, this seems only to be the case for high-knowledge consumers; low-knowledge consumers associate a low-price image with the ease to which low prices can be recalled (e.g. the salience of promotions and other low price cues). Therefore, consumer price knowledge is an important variable for marketers to understand. Its link with other psychological concepts within the domain of pricing is important for theoretical and practical reasons, not least because marketers' actions can influence this rather malleable and subjective variable.

### **Behavioral pricing concepts in non-market settings**

So far the discussion has centered around market goods, but how are goods and services valued (and implicitly priced) when there is no market? In a free market economy, goods and services are sold for prices that reflect equilibrium between supply and demand, that is the costs of production and what people are willing to pay. Non-market goods or services (non-market goods) are not bought or sold directly and do not have a directly observable monetary value. Examples of this include nature-based recreation activities, such as visiting public parks and

gardens, wildlife viewing or rock climbing. A basic purpose of government is to provide citizens with non-market goods and to place value on such goods so that investment can be prioritized. Such decisions require governments to have an accurate understanding of the values attributed to such goods by society. To estimate the value of non-market goods, several economic tools have been developed, including contingent valuation surveys, attribute-based methods and travel cost methods (Brown, 2003). However, an alternative tool for valuing non-market goods – happiness economics – has been proposed recently.

In neoclassical economics, utility is not a psychological experience that occurs during or after consumption. Instead, utility is defined by revealed preference: preferences (i.e. utility) are revealed from behavior (i.e. choices) (Stigler, 1950). Proponents of revealed preference argue that information about utility is captured by choice, assuming that consumers act as rational agents (Kahneman & Thaler, 2006). The reliance on measuring value through economic measures of utility (e.g. revealed preference and stated preference methods) has recently been criticized (e.g. Kahneman & Thaler, 2006). The field of behavioral economics refers to the attempt to develop economic theory by providing it with more psychologically plausible foundations (Johnson, 2006). Much emphasis in behavioral economics concerning valuation of both market and non-market goods focuses on subjective well-being (happiness) as an experience-based measure of utility (Diener, 2009; Kahneman & Krueger, 2006).

The term subjective well-being refers to “a broad category of phenomena that includes people’s emotional responses, domain satisfactions, and global judgments of life satisfaction” (Diener et al., 1999: 277). There are two distinctive components of subjective well-being: an affective part and a cognitive part (Diener et al., 1999; Kahneman, 1999). The affective component refers to the presence of positive affect (i.e. emotions) and the absence of negative affect. The cognitive component of subjective well-being relates to an information-based appraisal of a person’s life as a whole (Schwarz & Strack, 1999).

Behavioral economists argue that experienced utility can be measured and is distinct from decision utility (Kahneman & Thaler, 2006). In response to criticisms concerning the measurability of experience utility, Kahneman et al. (1997) nominate how the concept can be operationalized through instant (hedonic and affective experience during consumption), predicted (beliefs about the experienced utility of future outcomes) and remembered (past hedonic and affective experience) utility. Following these major advances in the field of subjective well-being, much work is underway that evaluates the contribution it can make to informing policy decisions (Loomes, 2007). In particular, experienced-based utility, by providing measures of subjective well-being, can provide an alternative to estimating prices.

Recent studies in this field have used measures of subjective well-being as a proxy for individual welfare. This approach attempts to measure the marginal (dis) utility directly attributable to non-market goods. Although such an approach is still in its infancy, it has generally been applied in contexts that produce disutility and negative externalities, e.g. noise pollution (van Praag & Baarsma, 2005),

terrorism (Frey et al., 2009), droughts (Carroll et al., 2009), air pollution (Luechinger, 2009) and flooding (Luechinger & Raschky, 2009). Further empirical research using the experienced-utility approach offers potential to better understand and measure societal preferences concerning welfare maximization and public good investment decisions.

### **Implications for innovation in pricing**

Probably one of the most important pricing innovations of the last decade is a move to more “dynamic pricing.” Dynamic pricing, a strategy that changes prices rapidly to reflect changes in demand, is something practiced crudely in the retail electricity sector for some time and with some success, although Joskow and Wolfram (2012) propose greater and more refined use of dynamic pricing to enable better future resource use in the electricity industry. Cramer and Krueger (2016) identify dynamic pricing by Uber as one of the major contributors to its commercial success, even though the ride-sharing platform also gained some notoriety among its consumers for this policy. However, whilst the technique is becoming widespread, for instance in major sporting events, it is not necessarily consistent with improved profitability (Xu et al., 2016).

The first and most important thing managers need to recognize is that getting the “right” price is critical for both revenue and profitability. Clearly, what is “right” depends as much on customers’ differential response to different prices as it does on organizational objectives. But how can a manager gauge the “right price”? One way is through field experiments testing different price/promotion levels (Almquist & Wyner, 2001), an area in which the direct mail industry has previously led the way and in which digital marketers are progressing rapidly (with caution) given increased behavioral data and the chance to manipulate customer exposure to information. Other alternatives exist and simple direct approaches may yield reasonable solutions in some cases (Miller et al., 2011). Yet another part of the solution is the acknowledgment that the value of a product or service sets the upper limit for how high a price can be raised, and that value is made up of psychological and objective or utilitarian value. Managers must understand what this psychological value is and the attributes of their products and services that relate to it. The psychological value of a product is not only determined by its brand, rarity and social norms, but is also affected by perceived fairness or “rightness” of a price. These issues of fairness may be influenced by how, when and where prices are charged and involve both affective as well as cognitive decision processes.

Gourville and Soman (2002) assert that consumers typically tend to look at price differences in terms of the saving as a proportion of actual price and as an indicator of the size of the incentive to enter the transaction. Similarly, they may resent prices that are not a reflection of the costs of a good and sellers may need to add features that justify the perception of higher costs. For some goods, a reference price might be used to identify what is “fair,” while what is a fair price might be the subject of more intensive introspection for utilitarian goods compared to

luxuries. These insights suggest buyers make various judgments about perceived value and a fair price that, in common with decision-making generally, suffer from extensive biases.

The manager needs to understand these processes and the reference points most salient to their customers in order to be able to tweak price most effectively. Once these reference points are understood, managers must manage price expectations through establishing clear reference prices, avoiding major and discontinuous price hikes, invest in establishing some product uniqueness to avoid price comparisons and establish benchmarks for good value by outlining favorable price comparisons with *different* products known for being good value. Finally, managers can avoid cost of goods sold comparisons by bundling, adding abstract features and focus cost comparisons using absorption costing.

In the end, WTP is driven not only by the “economic utility” of the transaction, but also by the “psychological utility” of the transaction. There are many levers that managers can use to increase psychological utility or reduce dissonance. For example, adjusting price endings is one way where small price changes have been shown to lead to large changes in demand in some circumstances. However, these findings are based upon a variety of different factors including the product’s price magnitude, its relative newness, changes in the left digit and accompanying promotional material with other low price cues. Managers must consider these moderating influences when setting price endings. When managing price, adjustments and sales promotions should ultimately be based on a longer-term pricing strategy, not just a knee-jerk reaction to competitors’ promotional offerings. Maintaining pricing discipline through active management of reference prices and other salient consumer reference points will lead to more favorable price comparisons. However, reference price is multifaceted and managers must understand their individual customers, the reference prices those customers use in different circumstances and their attributions of fairness. For example, non-monetary sales promotions have been shown to take the focus off price and assist in maintaining reference price perceptions.

Ultimately consumers make apparently irrational decisions; sellers should be able to improve profitability by understanding these decision processes. In summary, sellers must understand how WTP is influenced by objective value and psychological factors. They need to be able to estimate price sensitivity by customer, outlet, context and use. Through establishing clear reference prices they need to integrate price decisions with the rest of the marketing mix.

## **Conclusions**

This chapter has described how research into pricing and using behavioral concepts represents a significant source of marketing innovation for alert sellers. Buyers without adequate information might make a number of seemingly conflicting purchasing decisions. Sometimes these are the result of time saving heuristics or the result of apparently irrational behavior. Consumers often behave in somewhat counter-intuitive ways (e.g. using price as an indicator of quality, purchasing

more with trivial price changes) and do not always have accurate information (e.g. low price knowledge) on which to base their decisions. These decisions might be thought of as irrational but they stem from the key driver of behavior – perceived value. Consumers may interpret price, a seemingly objective variable, in a *seemingly* subjective way. In order to understand how consumers might respond to price, managers must understand the reference points and heuristics that consumers use.

However, the information customers and companies are now being provided is changing the nature of transactions that take place and allowing buyers to be better matched with sellers. Further research can make a contribution by integrating the concepts discussed within this chapter into a new information rich environment.

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## 24 Research on odd prices

### Dead end or field of potential innovation?

*Carmen Balan*

#### Introduction

Half a century ago, the literature on pricing topics included several terms used as synonyms, respectively “odd prices,” “just-below prices,” “magic prices,” “charm prices,” “irrational prices,” “intuitive prices,” “rule-of-thumb prices” and “psychological prices.” There was no formally accepted definition of these terms and of the content of such strategies. In essence, “odd pricing” consisted in setting prices just-below an even denomination. The usual examples were the prices ending in 9, 0.99 or 0.95.

The first signs of odd pricing practice date back to the late 19th century in the United States. After many decades of debate, one may think that knowledge in this field reached a maturity stage. Are odd prices a domain of study about which no new insight may be added? Is the influence of odd prices on consumers fully understood and measured?

Criticism relative to this research field is not uncommon. The main problems are the inconclusive, and sometimes contradictory, character of the findings as well as the overall limited evidence about the consumer perception of odd prices. For instance, Gendall et al. (1997) stated that “Overall, the findings of research into the effects of odd pricing on demand have been mixed and inconclusive . . . Clearly, the efficacy of odd pricing remains unproven.” After a review of empirical studies about odd prices, Gendall et al. (1998) concluded that these represent “an inconsistent and sometimes contradictory picture. Some studies appear to provide evidence of odd-pricing effects, while others do not.” Harris and Bray (2007) noted that “Many authors have acknowledged that empirical evidence conclusively proving or disproving the theory that price endings affect sales volumes is extremely limited.” In addition, a gap between the research priorities and the managerial practice evolved, as Wagner and Beinke (2006) underlined: “Overall, the academic discussion of odd pricing focuses mainly on the verification of odd-price effects rather than offering effective decision-making support.”

Is the research on odd price topics at a dead end or is it a field open for potential innovation? To answer this question, this chapter analyses major research contributions and provides a systematic view of some of the most prominent findings.

## **Overview of the research on odd prices**

This section discusses the origin of odd pricing, the explanations for the effect of odd prices, the first research strides and the scope of the research on odd prices.

### ***The origins of odd pricing***

In the late 19th century in the United States, currency standardization acted as a facilitator of odd pricing. The imported British goods often had odd-price endings due to the currency conversion from pound sterling into dollars. The favorable image of these products among Americans enticed retailers to apply odd pricing to domestic products.

Another explanation of the odd pricing could be the use of cash registers (Landsberg, 1992). For the items priced 1 or 5 cents just-below a round figure, each time the vendor had to return change to a customer he had to open the cash register that rang up the sale, making it less possible to put money in their own pockets.

The practice of high-awareness retailers promoted the use of odd prices and subsequently was considered new and positive by consumers. Such an example consists in the 99 cent sales introduced by Macy's New York department store at the beginning of the 20th century. The main reason was also to issue change and record sales at the cash register. By 1885, Macy's – prominent retail chain in the U.S. – reached annual sales of \$5 million (Hower, 1943 as cited in Stigler, 1956). Competitive retailers did not hesitate to adopt the odd pricing.

### ***Between psychological bias and rationality: explanations for the frequent use of odd prices***

The widespread of odd prices was often explained based on the hypothesis of "price illusion," according to which consumers systematically underestimate prices with just-below endings. For instance, a price of \$399 may be perceived as "\$300 and something" rather than "almost \$400." Similarly, a price of \$3.99 is perceived as below \$4. Many retailers considered that odd prices may sometimes generate lower-price perceptions.

Consumers are considered to ignore the rightmost digits of the price (Nagle & Holden, 1995; Kotler, 2000). Thus, the behavior of consumers facing odd prices is marked by irrationality.

Huston and Kamdar (1996) confronted the "price illusion" hypothesis and tried to reconcile just-below pricing with consumer rationality. They examined the prices of garments from women's clothing catalogues. The two authors concluded that consumers face small but real costs when recalling and processing price digits. The disregard of the rightmost digits becomes a rational option for some consumers because considering more digits increases marginal costs. Sellers may yield profit from this behavior by charging prices ending in 9. The study did not

support the traditional argument that 9-ending prices signal low-price items to consumers.

To explain the frequent use of prices ending in the digits 99, Stiving and Winer (1997) have used consumer choice models and scanner panel data for two brands of each of two frequently purchased product categories (tuna and yogurt). Their findings support the taking into account of the price digits in consumer choice models and provide a rational explanation for the frequent use of odd prices. Consumers trade off the low likelihood of making a mistake against the cost of mentally processing the price digit corresponding to pennies. They prefer a good purchase decision with the least amount of mental processing. In addition, the research results showed the existence of both level effects and image effects associated with odd prices. The level effects refer to the underestimation of the value of the price and the image effects to the meanings inferred by consumers from the rightmost digits.

The prospect theory formulated by Kahneman and Tversky (1979) states that decision-makers assign value to gains or losses rather than to final assets. Their findings showed that “the value function is normally concave for gains, commonly convex for losses and is generally steeper for losses than for gains.” Boyes et al. (2007) relied on this theory to answer the question “Why odd pricing?” Their experiments showed that consumer behavior relative to odd prices is rational and informed. These odd pricing tactics reflect the preference function, as consumers dislike losses more than they value gains relative to a reference price.

Another approach in explaining the reaction of consumers relative to odd prices is based on the analogue model of numerical cognition. Thomas and Morwitz (2005) obtained empirical evidence that supported the model, reflecting the way the human mind converts numerical symbols to analogue magnitudes on the mental scale. Their findings demonstrated the left-digit affect, respectively the way consumers encode and compare multi-digit numbers. The 9-ending prices influence the magnitude perceptions of consumers only in specific situations: (1) when the leftmost digit of the compared prices differ (e.g. \$2.99 vs. \$3.00) and (2) when the numerical and psychological distances between the target price and the price of a competing product are short. The research of Chang and Chen (2014) also examined the context-dependency of the perceptual underestimation of 9-ending prices. During the experiments, they considered prices ending in 9 in the dollar “column,” not in the cents “column.” Their research confirmed the two situations identified by Thomas and Morwitz (2005), when a 9-digit price is perceived lower than a 0-digit price. In addition, a third situation was revealed, respectively, when the price number consists in three or five digits (e.g. \$299 or \$29,999). In that situation, price consciousness moderated the effect of the 9-ending prices.

The explanation for the wide spread of odd prices should be identified in relation with both consumers’ behavior and retailers’ reasoning. Gedenk and Sattler (1999) underlined that the pricing behavior of retailers is based not only on tradition, but also on economic reasoning. Based on their research results, they concluded that setting 9-ending prices is a rational way of dealing with uncertainty. More precisely, a retailer assuming the existence of price thresholds will not incur

a huge loss in case he is wrong. If thresholds exist and they are ignored, the losses may be significant.

The explanation of the usage of odd prices remains a topic open to further debate.

### ***Research on odd prices: the first strides***

Ginzberg presented one of the first studies relative to the impact of customary prices on demand in a one-page report published in 1936. The goal of the experiment conducted by a large American mail-order company was to study the effects of odd and even pricing on demand. The company hypothesized that the effectiveness of its odd pricing resulted from consumers' habit/inertia and from "universal indulgence." The company applied even prices for a representative sample of items in several regional issues of the spring catalogue (6,000,000 copies), while it maintained odd prices in other catalogues. The even prices diminished by half the sales of some items, increased disproportionately the sales of some other products and left unchanged the sales of the rest of the items. The results were inconclusive relative to the impact of odd prices and to the attachment of consumers to odd prices. The company was not interested in further testing because costs exceeded benefits. In the case of one item, "a change of one cent a yard led to a loss of \$50,000."

In 1967, Hollander mentioned that few studies attempting to measure consumer attachment to "customary prices" were reported until that moment. In 1972, Georgoff noted the absence of a clear definition of "odd pricing."

The research on odd prices has a long history. After 75 years since the first study endeavors, theorists and practitioners use a wide array of terms and do not share a common viewpoint relative to the concept of odd pricing.

### ***Scope of the research on odd prices***

A significant number of studies were designed to investigate the effects of odd prices on consumers. The major directions of study are presented in Figure 24.1.

From a chronological perspective, the first direction focused on the effects of odd prices on the demand size. Further, a new direction evolved and referred to various aspects that may be labeled "salience of odd prices," even if not all researchers used this terminology. Lately, several researchers started to explore the effects in specific sectors, customer segments, cultures, etc.

### ***Impact of odd prices on demand and sales***

One of the first research directions referred to the type and size of the impact of odd prices. Some of the studies provided empirical evidence for an increased demand.

The results of a mall intercept of 300 household shoppers organized by Gendall et al. (1997) supported the assumption of the positive impact on demand. The

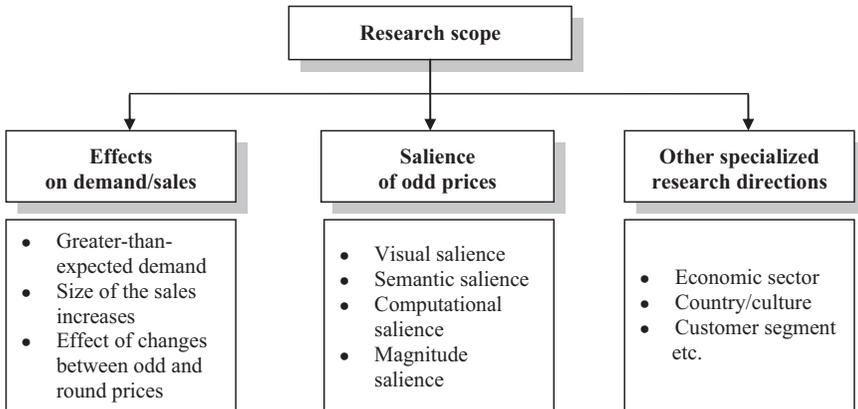


Figure 24.1 Scope of the research on odd prices

effects of odd prices on respondents' purchase probability were studied for six products: block of cheese, frozen chicken, box of chocolates, hair dryer, electric kettle and food blender. Two criteria were used to select products: the broad appeal and the existence of four critical price levels identified by retailers (under \$10, \$20, \$50 and \$100). According to the results, an odd price (e.g. \$9.99) generates greater demand than a slightly higher even price (e.g. \$10). The effect was more visible for lower-priced food items and for price endings in the digit 9.

A study designed by Gendall et al. (1998) also provided support for the assumption that odd endings like 95 and 99 cents produce greater-than-expected demand, at least at the individual brand level. Three brands of three products were considered: a \$4 can of fly spray, a \$7 block of cheese and a \$50 electric kettle. The experimental model assumed that consumer choice depends on the relative utility of the alternatives offered. For the electric kettle, the results showed a 6.4 percent increase in sales for a 0.1 percent reduction in price from \$50 to \$49.95. The increase was almost in the same range (between 8 and 10 percent) as in studies designed by Blattberg and Wisniewski (1987) and Schindler and Kibarian (1996). For the fly spray and the block of cheese, the equivalent relationships were less attractive but provided empirical support for higher sales increases when applying 99-ending prices rather than slightly higher even prices.

Three field experiments organized by Anderson and Simester (2003) led to the conclusion that 9 price endings increase demand. However, the effect is stronger in the case of new products for which customers have less relative price information compared to established items. The experiments demonstrated that 9 price endings are less effective at increasing demand when items already have "sales" signs.

In contrast, the study of Bray and Harris (2006) revealed that 9-ending prices do not always lead to optimum sales. The two authors organized a large-scale

trial in 12 stores with the support of a retailer with 400 stores across the U.K. that applied 9-ending prices on all non-promotional prices for more than 50 years. Prices were increased by one penny (from the retailers' traditional 9-ending prices to the pound-round prices) for a selection of 10 shopping products with broad appeal and relatively low cost (under £15). The results of the trial showed sales increases for nine out of the ten products. These suggest a statistically significant link between price endings and sales, but not necessarily in favor of the 9-ending prices.

Manning and Sprott (2009) found that changes between odd prices and round prices influence the product choices of consumers at the point of purchase. More specifically, the evidence provided by three experiments demonstrated the following: (1) choice share of a lower-priced alternative was maximized when it had a just-below price (i.e. \$1.99) and the higher-priced alternative had a round price (i.e. \$3.00); (2) price endings that minimized the difference in the leftmost digits of the prices (i.e. \$2.00 and \$2.99) produced the largest share for the higher-priced alternative compared to all other price endings; and (3) just-below prices shifted the share of choices towards the lower-priced option in the case of expensive products (e.g. a gift).

Studies found various levels of sales increases generated by the 9-ending prices. By means of experimental data, Schindler and Kibarian (1996) revealed a sales increase of 8 percent. Based on store panel data, Kalyanam and Shively (1998) reported increases between 12 percent and 76 percent, while Mace (2012) asserted that retailers may register increases between 9.8 percent and 23.7 percent. Nevertheless, these findings depend on the research context and cannot be generalized to the pricing practice of every retailer.

Recent research accomplished by Mace (2012) uncovered various determinants of the effectiveness of the 9-ending pricing. Findings call for attention due to both the broad array of studied determinants and the research scale (thousands of items within 10 categories in 83 stores of a grocery chain). The analysis of scanner data and a simulation underlined that 9-ending prices may generate either losses or sales increases depending on the context. The main determinants of the 9-ending impact were: characteristics of the stock-keeping-unit (price, maturity, market share, promotional 9-ending practice), product category (price, share in the household budget), pricing practice of the brand, intensity of the 9-ending pricing practice of the store and characteristics of the store area clientele (education level, working women, income). Sales increases were identified in the case of small brands, items with low market share or low prices, newly introduced products, categories with low prices or low budget shares and low-price stores. Nine-ending prices may lead to sales losses in the case of premium brands. Stores witness low effects with intense 9-ending practices.

This research direction that focused on the effects of odd prices on demand and sales has not always led to conclusive results. Further research may clarify the relationships between a broader range of determinants and the 9-ending price impact on demand and sales.

***Salience of odd prices***

Salience is a term found in various fields of research, such as pricing, consumer behavior, cognitive psychology, policy making, etc. However, the use of the term did not lead to a clear and generally accepted definition of the concept of price salience.

According to Kim and Kachersky (2006), there are two major perspectives of salience in the research literature focused on fields other than pricing. The former is focused on attention (respectively a person's attention is captured by one aspect of a situation, which is more prominent and noticeable than others). The latter is centered on memory (the salience of a topic being related to the amount of information a person holds about that topic, salience being a process that increases the probability of storing a piece of information in memory).

Relative to the multi-dimensional prices, four dimensions of price salience were identified: visual, semantic, computational and magnitude (Kim & Kachersky, 2006). Hereinafter, these dimensions are analyzed (not necessarily from a multidimensional perspective).

**Visual salience of odd prices**

A visually salient price attracts consumers' attention. They will not ignore such a price. An example of research on the visual salience of odd prices is the study of the direction of price digits. The concept of digit directionality consists in the left- or right-facing orientation of the price digits. The perception of digit directionality refers to the consumer perception that these numbers are "pointing" or "facing" a particular direction.

According to Coulter (2007), the use of truncation encoding strategies depends not only on the left-to-right processing of the price digits, but also on the direction of digits and the resulting eye-movement bias. He tested the digit-directionality assumption (that digits 1, 2, 3, 4, 7, and 9 face to the left, digits 5 and 6 face to the right, and digits 0 and 8 appear symmetrical and may be considered 'neutral'). The hypothesis of the directionality of the digits 2, 3, 6, 8, 9 and 0 was confirmed. In another experiment, subjects were exposed to six advertisements for a fictitious snowboard brand. Each ad contained one of the following prices: \$888.98, \$888.58, \$855.88, \$899.88, \$887 or \$886. The price \$888.98 was more likely to be rounded down than \$888.58. The subjects were significantly more likely to round down a price of \$887 to \$880, than a price of \$886. According to the findings, greater (lesser) degree of attention paid to a price digit results in more (less) accurate recall of that digit and consequently decreases (increases) the likelihood that consumers exhibit a price truncation behavior (the right-facing digit 5 facilitated accurate price encoding and recall, while the left-facing digit 9 led to a price truncation strategy).

There is a lot of room for further study of the visual aspects of odd price salience.

**Semantic salience of odd prices**

Researchers studied consumers' perceptions and symbolic signals of odd prices. In essence, according to the theory of consumer behavior, perception consists in

the process by which stimuli are selected, organized and interpreted (Solomon et al., 2010). Through information processing, consumers assign meanings to the price stimuli.

In 1991, Schindler noted both the perception of deception by the seller and the perception of the presence of discounts. On one side, consumers may realize that odd and even prices are equivalent and may consider that sellers tend to mislead them by means of odd prices. On the other side, odd prices may signal the presence of discounts and cost savings, while even prices may signal higher levels of product quality.

Practice shows that prominent retailers with a relatively classy image, such as Neiman-Marcus, Nordstrom and Macy's, tend to use round-number prices that end, for instance, in the digit 0 and to avoid the digit 9. In contrast, retail chains such as Wal-Mart and Target, which are more focused on mainstream buyers, show a propensity towards odd-ending prices (Stiving, 2000).

Numerous research studies explored the association between price and quality. Pricing experts consider that a buyer tends to use price as a cue for quality when he does not have information on other salient attributes of the offering.

The quality-price inference was also identified among young buyers (18–25 years old) from Taiwan, in the case of mobile phones and notebooks (Tsao et al., 2005). According to the research findings, there is a positive relationship between the perceptual belief and the inferential belief about the price – quality association. This link is stronger when the perceptual belief is based on direct purchase experience (the case of mobile phones) rather than on advertising. In the absence of a direct purchase experience (the case of notebooks), buyers tend to rely on advertising to form their inferential belief.

The findings of a controlled experiment organized by Schindler and Kibarian (2001) make retailers aware of the two-fold effect (positive and negative image) of odd prices presented in advertisements. The study focused on the reactions of middle-income women from the suburban environment to a set of advertisements that prominently displayed a price with either a 99 ending or 00 ending. The results underlined that the 99 ending may communicate a favorable image that products are on discount without any unfavorable association of low quality. In the case of retailers with a higher-perceived quality, advertisements that display 99 price endings may decrease the image of customers relative to the merchandise quality and retailer's classiness.

Further research by Schindler (2006) explored the 99 price endings as a signal of a low-price appeal for consumers. The findings, based on 2,292 price ads, indicated the existence of a quite strong relation in the marketplace between the use of 99-ending prices and the presence of cues for a low-price appeal. According to the research results, this appeal is determined by the tendency of retailers to supplement a low-price claim with any available means to make the price actually appear low and get the attention of consumers. Due to repeated exposures to such ads, consumers learn the association between 99-ending prices and cost savings.

Choi et al. (2014) recently coined the concept of "odd-ending price justification effect" (OPJE). According to this new concept, the discount image that consumers

associate with an odd price diminishes the anticipated guilt felt by them when considering the purchase of hedonic items. The OPJE is present at an unconscious level and disappears when other factors diminish the guilt. The justification effect increases the purchase likelihood in the case of hedonic products as compared to utilitarian products.

### **The computational dimension of salience**

Computational salience increases with the decrease of computational complexity. Estelami published the results of two studies relative to the computational effect of price endings in multi-dimensional-price advertising (1999). There are goods and services advertised with a variety of dimensions that require computation in order to know the final price. Mail-order companies advertise separately the product price and the shipping/handling costs. Prices are often multi-dimensional in the financial sector or in the retailing of durable goods.

The research findings showed that computation difficulty is a function of both price endings and arithmetic operations required to compute the price. The computational effort reflected by the response time may increase up to ten times in the case of non-rounded endings (e.g. \$154), compared to the round format (e.g. \$100). When consumers have to make multiplications, the computational effort may increase four times compared to situations when only addition is needed to calculate the final price.

The use by sellers of endings in multi-dimensional prices and calculations with a higher degree of complexity may result in lower accuracy of consumer's price perception. Consumers may perceive as more fair and attractive the prices presented in a simple manner.

### **The magnitude dimension of salience**

Magnitude is another dimension of price salience. The prices that exceed the top of the reference range could be salient.

The practice of 9-ending prices pushes the upper limit of the price range (Kim & Kachersky, 2006). However, research carried out by Schindler and Kirby (1997) provides evidence that supports the underestimation effect rather than the perceived-gain effect. The research was based on 1,415 sampled selling prices ranging from \$.34 to \$3,900,000, included in print newspaper advertisements from major U.S. metropolitan areas.

Findings showed that consumers underestimate the actual price as they spare the effort of processing the last digit. A price of \$799 may be truncated to \$790 and thus may fall within the reference price range. A rounding to \$800 will surpass the upper bound of the reference price range. Consumers tend to translate non-round numbers into round numbers if retailers do not provide round-number prices. This information processing results in the underestimation effect, according to which the price perceived by the consumer is lower than the actual price. The high cognitive accessibility of the round numbers leads to an overrepresentation of the 9

endings in price advertisements and explains the overrepresentation of the 0- and 5-ending prices.

Due to the underestimation effect, prices become salient as consumers perceive them as lower than the displayed prices. Several questions may be added relative to the potential impact of the product, brand and competition over the consumer information processing.

### ***Other specialized research directions***

Besides the study of the effects of odd prices on demand and the odd price salience, research efforts were also deployed in several specialized research directions. Examples are the use of odd prices in sectors such as restaurants and tourism, the effects of odd prices in specific countries/cultures and the application of odd prices to specific customer segments.

### **Research on the use of odd prices in specific economic sectors**

Lately, the perspective about consumer response to odd prices was enriched with research findings that refer to the intangible services offerings. Besides retailing, odd prices may be found in the hospitality sector, in restaurants and hotels.

A relevant example is the study of Parsa and Naipaul (2007). The results of a mail survey on a sample of fine-dining restaurants and quick-service restaurants provided empirical support that restaurant operators intentionally use odd-even pricing to send pre-purchase signals of quality and value. The authors formulated the price endings and consumer behavior model (PCBM) with hypotheses confirmed by research. Thus, fine-dining restaurants signal quality by means of 00 price endings, while quick-service restaurants signal high value with 99 price endings. These price endings provide an equilibrium solution in the restaurant sector.

An analysis of restaurants from France, Spain and Italy, and a subsequent comparison with U.S. and Taiwanese restaurants, showed differences in terms of odd-pricing tactics (Hu et al., 2006). The researchers classified the restaurants in three categories: (1) high-end, fine-dining restaurants with menu prices of €18 or higher; (2) mid-priced, casual-dining restaurants with menu prices between €7 and €17; and (3) quick-service restaurants with menu prices of €6 or less. As regards the rightmost single digit, 0-ending prices dominated the menus of the European restaurants (99.66 percent of the menu items in the high-end restaurants, 92.38 percent in the casual-dining restaurants and 85.98 percent in the quick-service restaurants). The 5- and 9-endings had a lower occurrence. Price-ending practices in Europe differ from those applied in the U.S. and are more similar to those in Taiwan. Relative to the two rightmost digits of the price, the researchers identified that in the high-end European restaurants, the 00-ending prices were predominant (80.48 percent of the menu items). The 50-ending and 80-ending were also used (11.52 percent and 3.37 percent respectively). In the mid-price restaurants, 00, 50 and 80 were the most applied endings (25.36 percent, 16.77 percent and

10.47 percent respectively). In the quick-service restaurants, the most commonly used two-digit price endings were 50 (20.48 percent), 00 (15.63 percent) and 80 (9.86 percent).

Another study that opens a specialized perspective of the odd-ending prices is the research designed by Kleinsasser and Wagner (2011). The study refers to the impact of odd prices on consumers in the hotel sector and the moderating effects of personal involvement and price interest in this relationship. The research findings showed that price endings influence price perceptions. The part-worth utilities of different price endings decrease with increasing prices. The survey evidence supported the hypothesis that highly involved consumers are less sensitive to the image effects induced by price endings, compared to less involved consumers. The respondents highly interested in price seemed to prefer prices ending in 9, while respondents less interested in price did not prefer 9-ending prices. Thus, findings demonstrated that consumer involvement and the price interest have a moderating effect on perceptions of price endings.

Schindler et al. (2011) surveyed the beliefs relative to price endings of 112 upper managers from a diversity of restaurants located in the U.S. Many of those managers believed that consumers attach the meaning of good value to just-below prices and respectively of high quality to round prices. The findings show that hospitality managers do not apply just-below pricing when they anticipate negative consequences such as unfavorable perceptions relative to product quality, difficulties in developing an upscale image, generating the perception of being less honest and straightforward with consumers, inconveniences in price calculation and communication.

### **Odd prices in specific countries and cultures**

Most empirical research relative to odd prices focused on the practice of companies in western countries, especially in the U.S. During the last decade, the interest of researchers was also directed towards other markets, for example Europe and Asia.

An example is the study of Suri et al. (2004) that contrasts the effectiveness of 9-ending prices in the U.S. with Poland. The findings revealed that 0-endings were the most popular in the Polish ads and 9-endings in the U.S. ads. Odd prices were perceived as a gain by a higher percentage of the U.S. respondents compared to the sample of Polish respondents (89 percent compared to 55 percent), the difference being statistically significant. As regards the fair price estimate, Polish consumers tend to associate odd prices with an overall loss, while U.S. respondents associate them with a small gain. Polish respondents perceive odd prices as less fair, sales offers with such prices being less valuable and more likely to deceive them.

Holdershaw et al. (2005) explored the effects of odd pricing on demand in China. A stated-preference choice modeling experiment was organized for three commonly used products: detergent, thermos bottle and peanut oil. Research findings were consistent with results of studies carried out in western countries. The 9-ending prices generated greater-than-expected demand for each of the three products, while 5-ending prices generated this effect for two products (thermos

bottle and peanut oil). From the researchers' perspective, the effects of odd prices on demand have a biological rather than a cultural explanation. The experiment showed that the higher the odd price, the greater the effect on demand.

Another direction of research refers to the analysis of odd pricing within a cultural framework. Nguyen et al. (2007) explained the variances in the practice of odd and even pricing in western versus non-western countries on the basis of high context (HC)/low context (LC) culture constructs. Their approach was based on the theory of the anthropologist Edward T. Hall (1976), according to which LC cultures attach more importance to the explicit message and to the meaning of the message rather than to the context in which the message is conveyed. On the opposite side, HC cultures care about the implicit, non-verbal cues of the message. Nguyen et al. conducted a survey of prices posted on the web mainly in local online shopping malls, for a sample of 10 countries (China, Hong Kong, India, Japan, Brazil, Argentina, U.S., Australia, Norway and Italy). The research findings showed that consumers in HC non-western cultures are less inclined to associate odd prices with cheaper items or gains compared to consumers from LC western cultures. In HC non-western cultures, odd prices may very likely offend consumers. In these cultures, 9-ending prices may be less successful than even prices ending in 0 or 8 (for the Cantonese Chinese, the number 8 means luck and for the Japanese consumers it symbolizes prosperity). Western companies should not transpose the odd pricing tactics from their country of origin to markets with HC culture. If they still intend to use odd prices, conveying a gain that is more real is recommended (e.g. 3.90 instead of 3.99).

### **Odd prices and specific customer segments**

Most studies have considered consumers as a homogeneous mass. A relatively new field of investigation is related to the perception of odd prices by specific consumer segments.

One of the few attempts to investigate the response of market segments to odd prices is the research of Harris and Bray (2007). The goal of the study was to identify in the U.K. the consumer groups that are more likely to choose odd-ending prices versus round-ending prices. The research findings revealed that men are more likely to respond to round-ending prices and women to odd-ending prices. However, respondents are not exclusively focused on one type of ending. Consumers over 60 years old preferred round-ending prices.

Damay et al. (2011) examined how children between 6 and 12 years old attribute and select product prices according to their presentation (price format and ending). The research findings revealed that children tend to prefer round prices. These preferences are expressed especially for high-priced products and increase with the education level and age. When required to select prices from a predefined set, the propensity to round prices extends to all products, not being limited to high-priced items. Children also prefer to choose 0-ending prices when prices are presented in a decimal form. The level of price knowledge does not affect children's preference for 0-ending prices. Another research achieved by Damay et al. (2014) revealed that children chose, more frequently than adults, endings other

than 0, 5 and 9, in the case of high-priced items (more than €10). In contrast, for low-priced items (below €10), the distribution of children choices of 0, 5 and 9 endings was comparable to the distribution of adult choices.

## **Conclusions**

Researchers investigated the effects of odd prices during almost eight decades. However, the findings of the empirical research on odd prices are sometimes considered inconclusive, contradictory and scarce. The opinions of researchers are split.

A significant feature of this overview is the focus on the diverse and dynamic body of knowledge consisting in odd-pricing research results. The paper is not substantiated on “carved-into-stone” statements about “already-known” aspects usually presented in marketing textbooks. The aim was to explore research endeavors that are sometimes limited in terms of approach and findings but which contribute to academic and managerial advancement.

This paper provided a systematic analysis of major research contributions and introduced three building-blocks of the scope of the research on odd prices: effects on demand/sales, salience of odd prices and other specialized research directions.

This analysis answers the question raised in the introduction. Even if odd pricing practice is more than one century old, research on odd price topics has a long way to go in the clarification of major aspects of interest to practitioners and to an increasing number of researchers.

## **Managerial implications for innovation in pricing**

Researchers still study the effects of price endings on consumers and sales. Clear dos and don'ts for marketing professionals have not emerged. Additional empirical evidence is required because the possibility to generalize the results of the available research studies is limited. However, several aspects to be considered when setting prices are presented hereinafter.

Odd-ending prices may positively influence buyer behavior, generating greater demand than a slightly higher even price, at least in markets such as the U.S. Managers and professionals might consider applying such prices that are common practice among retailers. Consumers could more positively react to odd prices in the case of lower-priced food items. The prices ending in 9 or .95 or .99 are widely applied. However, 9-ending prices sometimes generate lower sales than the immediate upper round-ending price.

To increase the effectiveness of odd prices, managers and professionals must think about the visual, semantic, computational and magnitude salience of these prices. From the visual salience perspective, consumers may more accurately recall right-facing digits (like 5) and may round down the prices with left-facing digits (such as 9). From the semantic perspective, the symbolic signals of odd-price endings may impact consumer demand. The 99-endings could generate cues for a low-price appeal to potential buyers. However, for retailers with a classy image or high-quality positioning, consumers may negatively perceive the display (at least in the advertisements) of 99 price endings. As regards the

computational salience of odd prices, rounded endings and less arithmetic operations make prices more salient. However, if the objective is to make comparisons with competitive offerings more difficult, higher complexity may lead to lower accuracy in consumers' perceptions of multi-dimensional prices. With regard to magnitude, prices that overpass the top of the reference range could be salient.

The use of odd prices evolved not only in retailing, but also in the hospitality sector. Managers and professionals from this field must consider the existing mental associations of odd prices with a specific level of quality and value, perceptions that were probably forged by the price setting practice itself. In the USA, the managers of fine-dining restaurants that want to project a high-quality image could use 00-ending prices, compared to the case of quick-service restaurants that could use 99-ending prices that convey a high-value image. The price-ending practice differs in Europe from the U.S. In almost all categories of restaurants from European countries, such as France, Spain and Italy, 0 is often the rightmost single digit of the menu prices. The two rightmost digits of prices that predominate in high-end European restaurants are 00, while in mid-price restaurants they are 00 and 50 and in quick-service restaurants they are 50 and 00. As regards the tourism sector, for example in Austria, companies that focus on customers that are less involved in the buying decision could apply 9-endings that are preferred by such consumers that are very interested in prices.

The decision-makers from companies with an international presence should be aware of the differences in business practices and consumer perceptions among countries. For example, 0-ending prices are more suitable in Polish ads, compared to 9-ending prices in the U.S. In Poland, it is advisable not to apply odd prices because consumers perceive them as less fair and deceptive, compared to U.S. consumers that associate odd prices with a small gain. In addition, odd prices are not recommended in high-context non-western cultures where most consumers feel offended by odd prices and where there is no image effect of cheaper items or gains. However, instead of 9-endings, managers may use 8-ending prices for the products addressed to the Cantonese Chinese consumers (that associate the digit 8 with luck) and to the Japanese consumers (for which the digit 8 means prosperity).

The preference for odd prices differs by age groups. A manager targeting primary school children cannot achieve positive results with odd prices, as they prefer round prices. There is evidence that consumers over 60 years old prefer round-ending prices.

Is odd pricing a relevant and profitable strategy for companies present in business-to-business markets? The empirical evidence refers to the impact of odd prices on consumers rather than on businesses. In principle, in business-to-business markets, odd prices could not impact significantly the organizational buying behavior as companies are rational rather than emotional in their purchasing decisions. Nevertheless, individuals make organizational decisions and one may hypothesize that their consumer behavior and mental associations could transgress the "corporate boundaries."

When balancing the pluses and minuses of odd prices, managers and professionals should be aware of "the other face of Janus." There are multiple warnings

not to be overlooked. First, the use of odd prices by many brands within a category may deter the impact upon consumers. Second, the impact of odd prices on sales volume is rather difficult to quantify in a market characterized by various competitive influences. Third, odd prices are associated by several groups of consumers with low quality or with misleading retail practices and could negatively affect high-end brands focused on performance and service or with a classy position.

## **Recommendations**

A distinctive feature of this chapter is the formulation of recommendations for further innovation in research on odd prices. The agenda for future investigations may be centered on two pillars – the research scope and the research design. For the former, two areas may be considered: (1) consumers' perception of and response to odd prices and (2) supplier's odd pricing practices. For the latter, new choices of methods and approaches are possible.

First, the analysis of the odd pricing tactics of vendors is important considering the hypothesis of the potential of such practices to shape the purchasing behavior of consumers. Not only marketing managers, but also macro-policy makers and consumer protection decision-makers might be interested. The following aspects may draw the attention of researchers:

- occurrence of odd prices in different economic sectors;
- specific features of odd pricing in various countries/cultures;
- types of price endings applied to various product categories;
- range of effects on sales generated by odd prices in the case of retailers of fast moving consumer goods and of service providers;
- managerial beliefs relative to consumer behavior and natural cognitive tendencies;
- perceptions of managers relative to the effectiveness of odd prices;
- reasons why managers apply/avoid odd prices, etc.

Second, most of the future innovation in the research on odd prices might be related to the study of consumers' perceptions and response. The following directions could be considered:

- magnitude of the demand increases generated by odd pricing in the case of various price endings and demand curves;
- insights into the information processing of price endings by consumers (also in relation to various factors such as the time pressure on purchasing decisions and the multi-sensory stimuli from the retail environment);
- odd prices and the effect of complexities in multi-dimensional prices on consumers' computational effort;
- perception of consumer segments (based on age, familiarity with the brand/product, lifestyle, involvement in the purchase decision, price sensitivity, etc.) relative to odd prices and reasons of specific behavioral responses;

- influence of cultural values and norms on consumers' reaction to price endings and symbolic meanings of price endings in different cultures;
- effectiveness (in terms of consumers' response) of odd pricing in relation to various determinants, such as product types, categories, quality level, brand image, store type, pricing policy of the store and market status.

Third, another area of innovation in research on odd prices is the identification of research methods able to enhance the validity of results. Experimental designs consisting in real buying decisions could bring additional clarifications compared to controlled laboratory experiments. However, both have limitations. Field trials may lead to inconsistent results due to the numerous marketing factors that are not controlled by researchers within the market environment. Such factors are competitive actions and marketing communication. The results of face-to-face interviews about the propensity to buy and about the preferences relative to price endings may be questionable due to the pressure placed on consumers and because the statements of consumers may not lead to actual purchases. The often-used laboratory studies have as the main drawback their inability to accurately reflect the real purchasing situations. More sophisticated research methods may be considered. An example could be the hybrid approaches of the conjoint analysis, in order to estimate the utility of more attributes and attribute levels in relation with the odd pricing tactics.

Fourth, besides research methods, the innovation in further studies may target research approaches. Cross-category, cross-brand and cross-cultural analyses will provide additional insights into the research scope. Comparisons among product categories relative to odd pricing effects may guide the decisions towards increased effectiveness. Analysis of similarities and differences between the effects of odd prices on the brands within a specific product category may lead decision-makers to better choices and lower losses caused by inappropriate pricing tactics. Approaches based on contrasting the effects of odd prices in high-context and low-context cultures may provide support to managers for the adaptation of their pricing tactics to the local markets or for the extension of the pricing decisions from the country of origin.

The above-mentioned directions of innovation in the research on odd prices are only some of those that will evolve in the near future. It is not innovation for its own sake. Finally, the utility of all the future endeavors in this field will be validated by marketing practitioners interested in enhancing business profitability and in expanding the presence of their companies on the global market.

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**Part VI**

**The next frontier**



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# 25 The next frontier of the pricing profession

*Kevin Mitchell*

## **Introduction**

Over the past 50 years, pricing has evolved from a topic purely related to economics and academic research to a very practical and powerful instrument to drive profitability in firms. The pricing function has also evolved, especially in the last two decades, with the development of a strong marketing discipline and the creation of the 4Ps in which price, the only “P” that is not an initial marketing expense, plays a critical role. Today, as pricing becomes a more published topic in economics, marketing and management literature, we also experience some barriers to making the pricing function and the profession as a whole a true managerial discipline. Compared to other disciplines, such as innovation, continuous improvement and supply chain management, the pricing function is not fully breaking through to the next level. The pricing discipline stands at an existential crossroads. Trade organizations, such as the Professional Pricing Society (PPS), and academics have been strong and passionate contributors to bring the pricing discipline to the forefront of the marketing and finance field, but these groups cannot do this alone.

In this concluding chapter, we will reflect on where we come from as a profession as well as where we need to go to bring pricing where it deserves to be. We will examine the next frontier of pricing and call for much innovation in the pricing field to generate excitement and interest for the discipline and profession as a whole.

## **Where we come from**

The pricing discipline has come a long way. There has been a series of evolutionary changes in the last few decades. The most critical change has been the role that pricing has played within the firm: from what was a “gut decision” made by a vocal senior manager in marketing or finance, to a more specific clerical or bookkeeping function who maintained a written price list (strictly on a “cost-plus” basis, most likely) to finally become a more strategic function with decisions made at the highest level of the organization.

### ***Pricing as a clerical function***

An early pricing practitioner may not have even known that she or he was exercising the pricing function or was in charge of pricing activities in their firm. Perhaps

this person was an outcast in the marketing or accounting department with limited upward mobility or gravitas within their company. As no pricing-specific classes were offered in colleges and universities beyond perhaps a few chapters in Introductory Marketing courses, skill sets and training were difficult to define or locate. Limited power and limited information would mean that our proto-practitioner's work would exist only at the mercy of a cross-functional menagerie that likely had very different goals and ideas. Corporate desires for market share or sales volume targets would (and often still do) greatly outweigh aims to improve specific margins or profits, so pricing goals would have been nebulous. Our proto-practitioner would quickly learn about situations where higher ups would decide that big deals would not be lost because of price.

This administrative employee probably had very little interaction with customer purchasing departments and would have been at a supreme disadvantage in the rare situations when there was customer contact. Then (and now) buyers would have had better data, better systems, stronger motivations and better training, at a minimum. If price became a sticking point, a customer could rely on the sales department to pull rank and make the deal outside of pricing targets.

### ***One evolutionary step: becoming tactical***

Increased focus on pricing's potential as a profit lever for the firm led to greater knowledge of and emphasis on our practitioner's goals. Those within the pricing discipline were gaining a framework of the importance of their jobs and had opportunities to increase their skill sets. Pricing managers could block some unprofitable deals (leading to the common joke of the pricing department being the "sales prevention department") and perhaps even had options to move up in their firms, although still lacking the career progression of more glamorous fields. Some industries had pricing software options available to further level the field in dealings with customers' purchasers. Marketing research used tools like conjoint analysis to provide better data and estimate elasticity. There were even whole textbooks (Monroe, 1990; Nagle & Holden, 2002) on pricing – first and foremost, not just subsets within other marketing books.

As the pricing discipline advanced, practitioners learned the value of their daily tasks and could communicate gains made by advising senior management about bottom line gains. Consulting companies created pricing practices whose primary concern was to help clients improve their pricing structure and processes. Eric Mitchell began publishing *The Pricing Advisor* newsletter in 1984 and *The Journal of Professional Pricing* in 1991. Pricing conferences, networking options and literature began to grow and flourish.

### ***Pricing as a strategic function***

Further advances came as corporations looked to leverage pricing power and value propositions to improve profitability. Many companies expanded pricing departments and created vice president level positions in pricing. Some practitioners (Reid, 2010) have called for the further expansion of the CPO – Chief Pricing Officer – position and Wall Street analysts began to look beyond same-store sales and other volume measures in favor of pricing metrics. In 2010, billionaire investor Warren Buffett even placed pricing power above management acumen in evaluating the worth of a company. Along with management focus, special pricing projects and longer-term corporate goals became commonplace and organization charts and reporting structures elevated pricing's status within the firm.

Several top business schools (Wharton, Stanford, University of Chicago, and others) have made pricing education a cornerstone of their executive education programs and some business schools (notably, University of Rochester) have developed concentrations in pricing. Advanced training options and professional designations, such as the Certified Pricing Professional, have allowed pricing practitioners to escalate their skills and demonstrate extra learning within the discipline. Pricing has become a topic of discussion in many boardrooms, executives' suites and team meetings in medium and large enterprises.

So pricing has made some great progress in becoming a function that is now more and more accepted in the organizational fabric of firms. In the last 20 years, pricing has been placed on the map and has demonstrated its potential impact with best-in-class marketing organizations. Our question becomes: Where do we go from here? How do we bring pricing to the next level and to reach its next frontier?

### **The next frontier**

Our reflections have led to the identification of six critical elements for the future of the pricing profession.

#### ***Greater use of technology***

As with other professions, pricing is benefiting from great advances in technology. From powerful computers to the more advanced version of analytical software, the pricing function has gained in analytical skills, speed of execution and quality of team interactions. Over the past three years, we have seen great advances in the science of pricing, especially in the fields of price optimization and dynamic pricing algorithms. Technology is transforming the way pricing professionals work on a daily basis and accelerating pricing decisions. These pricing decisions are taken with more scientific support, more team interactions via video conferences or other collaboration tools, and a greater ability to be tested in the field with customers. Feedback and data can be received in real time via enterprise resource

planning (ERP) or customer relationship management (CRM) platforms. In short, it is just the beginning. The technological developments we have witnessed in the last few years can only offer immense possibilities for pricing experts. Working closely with IT departments, pricers can have access to the best communication and analytical tools to make the best decisions.

### ***The increasing importance of pricing software and data analytics***

Over the past 10 years, we have witnessed the emergence of robust and modern pricing software that allow firms to systematize and optimize their pricing activities. These software platforms (price optimization, pricing analytics, Configure – Price – Quote (CPQ) systems) have made great inroads with Fortune 500 companies and are very relevant in the pricing sphere. The next generation of pricing software is being created as we speak. The cloud-computing environment offers many opportunities for smaller firms to benefit from pricing software at a fraction of the costs without a long and difficult implementation process. Companies will be able to rely on proven, systematic and robust platforms instead of Excel-based, internally designed, static tools and methods. The increased adoption of software also benefits the pricing profession as skills and competencies can be transferred from firm to firm, creating opportunities for advancement. But the last two years have also shown that software cannot work without integrated data lakes. Pricing data, when combined with other data, can offer great opportunity to move pricing in the predictive mode to help decision-makers anticipate pricing behaviors and formulate pricing responses to changing trends. The combination of systems, data and algorithms offer tremendous opportunity to move the pricing function further into the digital age.

### ***More coordination and professionalization of the pricing function***

The transformation of the pricing profession in firms requires the combined positive impact of the five elements, which are shown in Figure 25.1 (Liozu & Hinterhuber, 2011).

### ***More academic research***

Generally speaking, there is a need for more robust and systematic academic research in the areas of value and pricing management to support the proliferation of new pricing knowledge in the marketing construct. Recent academic research undertaken at Pennsylvania State University's Institute for the Study of Business Markets and at Georgia State University's Center for Business and Industrial Marketing (Ulaga, 2001) is critical for the pricing profession to create knowledge, to bring documented and tested evidence of their positive impact on firm performance and to educate practitioners.



Figure 25.1 Framework for transformation

### ***Systematic academic curriculum***

Tomorrow's marketing leaders should be equipped with the most relevant and rigorous academic knowledge on pricing. Pricing should become an integral and systematic part of the marketing curriculum; currently, only about 9 percent of business schools offer a course that has a significant emphasis on pricing (McCaskey & Brady, 2007). We are making slow progress in academia but things are moving. Over the past couple of years, dozens of pricing books have been published. More academic papers cover the fields of segmentation, value management, value-based pricing and value-based selling. Progress is slow but it is tangible and it makes a difference in establishing the credibility of the pricing function.

### ***Greater levels of innovation in pricing***

Pricing is evolving in certain areas, such as revenue management, yield management and mostly in the service, e-commerce and software sectors. We need to see more innovation, experimentation and new training methodologies in

business-to-business (B2B) pricing. Experimentation is an important requirement for the internalization of new pricing concepts, strategies, language and overall theories. B2B pricing may be more static in nature. By creating more excitement in the pricing field, we can attract the best minds and researchers in the field. And one way to make these connections is to branch out with other emerging theories and concepts. Recently, we have witnessed the development of models and concepts tied to business model innovation and to SaaS-based business models. Pricing experts can team up with other gurus in other fields to put pricing on the radar.

### ***Collaboration among academia and practice***

The profession requires a coordinated and collaborative profession-wide transformation process that involves academia, practitioners, consultants and professional associations such as the PPS. This dialog and collaboration among these parties leads to the definition of a research agenda and common goals for the profession.

### ***Professionalizing the pricing function***

Joe Podolny, former dean of the Yale School of Management, states: “An occupation earns the right to be a profession only when some ideals, such as being an impartial counsel, doing no harm, or serving the greater good, are infused into the conduct of people in that occupation” (Podolny, 2009). The professionalization of the pricing function requires the establishment of a code of ethics for the pricing community; the development of capability matrices and of formal entry requirements for pricing professionals; pricing governance mechanisms and dedicated career paths for pricing professionals in companies; and emphasis on continuous formal learning. Some of these activities are already underway; much, we feel, remains to be done for pricing to become a true profession.

### ***Pricing in the C-suite***

The next frontier for the pricing profession also involves the elevation of C-suite positions such as Chief Pricing Officer and Chief Value Officer representing the pricing and value management functions. The Chief Marketing Officer (CMO) and Chief Commercial Officer (CCO) positions have been more widely accepted over the past decade. While the role of CCO is relatively new, about 200 CCOs have been appointed worldwide since the role emerged (Abele & Stevenson, 2009). Similarly, the number and presence of CMOs is accelerating around the world. In 2006, Spencer Stuart identified more than 30 CMOs in FTSE top 50 companies. In the U.S., among Fortune 100 firms 23 had a CMO as the head of marketing in 2008 (Grewal & Wang, 2009). The acceptance of the role of Chief Pricing Officer (CPO) and Chief Value Officer (CVO) has a long way to go. First of all, in most companies, the pricing and value management function receives limited attention. Data from the PPS, the world’s largest organization dedicated to pricing, reveal that fewer than 5 percent of Fortune 500 companies have a full-time function exclusively dedicated to pricing (Mitchell, 2011).

### ***The mid-market opportunity***

Who manages pricing in the millions of small and medium business around the world? The Small Business Administration reports that 99 percent of businesses are small in nature and create the vast majority of GDP. As a profession, how do we carry the pricing and value messages to the millions of marketing, sales, and finance professionals involved in pricing strategies and tactics? One opportunity to reach them is to start publishing pricing knowledge in mainstream media and to partner with larger associations, such as the American Management Association or the American Marketing Association. Here the frontier might be difficult to reach. But we have to start somewhere and create an “army” of pricing evangelists spreading the good word on the power of pricing excellence.

### ***The skills of the future***

Last but not least, we project that the pricing skills of the future are going to evolve. With the advent of pricing software, pricing big data and greater access to technology, pricing professionals will have to show a combination of hard and soft skills. Pricers will be required to gain organizational and behavioral skills to accompany firms through their transformational activities. Soft skills, such as change management, emotional intelligence and communication intelligence, will be needed more and more. How then do we equip pricing professionals with these skills? Firms will have to create more balanced profiles to be able to speak with computers and software for data analysis but also to lead humans through tough and sometimes tenuous transformational journeys.

## **Conclusions**

The pricing professional is evolving and will continue to do so with the increased role of technology. PPS is staying ahead by embracing megatrends and by preparing the way for the next transformational steps. We are planning for the future by embracing technology in our training programs but also during our numerous industry meetings. We are embracing academic research and have welcomed thought leaders in our future thinking. The road ahead is bright and challenging. We can achieve great things as a profession as long as we all work together and lead the profession to reach this new frontier. Join us in this journey!

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*Vartan Vartanian, President, Industrial Market, Regional Sales and Service of SKF, Sweden*

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*Nnaoke Ufere, CEO, iServiceX, Inc., USA*

'Companies spend vast amounts of resources in R&D, engineering and marketing while, most of the time, neglecting their pricing and value strategies. This book shows that pricing is a critical dimension of marketing strategies and that pricing innovation can bring the best out of these strategies. It also emphasizes the multi-dimensional nature of pricing which requires innovation, creativity and breakthrough thinking.'

*Andreas Ising Schulze, CEO, Advanced Polymer Technology Corp., USA*

Pricing has a substantial and immediate impact on profitability. Most companies, however, still use costs or competition as their main basis for setting prices. Product or business model innovation has a high priority for many companies, yet innovation in pricing received scant attention until the first edition of this groundbreaking book.

This new edition of *Innovation in Pricing* builds on the success of the first, examining the ways in which pricing innovation can drive profits through cutting-edge academic research and best practice case studies from leading academics, business practitioners and consultants in pricing.

The second edition has been fully revised and updated according to the latest developments in pricing, with:

- revisions to all chapters
- new chapters, including a chapter on business model and pricing model innovation
- a new introduction that makes explicit just what strategic pricing can do for your organization.

This book is the only book dedicated to innovation in pricing and is an essential read for business executives, innovation managers and pricing managers wishing to treat innovation in pricing as seriously as they treat product, service or business model innovation. It is also valuable supplementary reading for advanced students of marketing and sales.

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