PROFESSIONAL PRICING SOCIETY™

The PRICING ADVISOR

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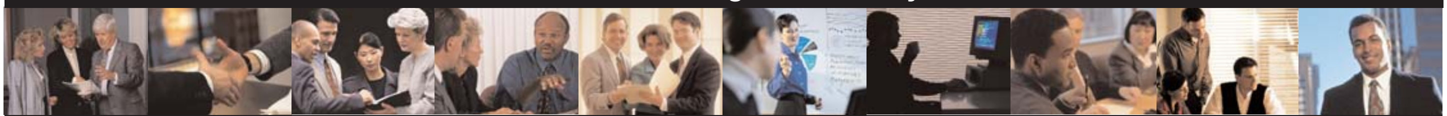

February 2006

Companies make substantial investments in more effective pricing strategies and then fail to reap the expected return on that investment because they didn't sufficiently invest in implementation which requires targeting specific undesirable behaviors and devising a detailed plan to change them. This article, by Tom Nagle and John Hogan, outlines the three ways to affect these behavioral changes. Tom Nagle can be reached 617-252-2720 or tom_nagle@monitor.com. E.M.

Making Your Pricing Strategy Stick

As any experienced marketer knows, developing strategy is one thing-managing the change process to embed that strategy in the organization is quite another. All too frequently, companies make substantial investments in more effective pricing strategies and then fail to reap the expected return on that investment because they didn't sufficiently invest in implementation.

The truth is that implementing effective pricing strategy involves changing the expectations and behaviors of all of the actors involved in the sales process. Customers must learn that they will be treated fairly and that abusive purchase tactics will not be rewarded with ad hoc discounts. Sales must learn that they will be rewarded for closing deals that increase firm profitability rather than using price as a tactical lever to increase sales volume. Finance must learn to look beyond cost as a determinant of price to better understand the tradeoffs between price, cost, and market response.

Successful implementation of pricing strategies requires targeting specific undesirable behaviors and devising a detailed plan to change them.

In This Issue:

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"In ten days, Napoleon said, we will be in Paris!"

Not quite in 10 days but on June 14th, 2006, PPS will open it's 3-day Summer European Conference, an event eagerly awaited. As this year's plenary speakers PPS is delighted to present **Stephan Butscher**, Partner, Simon-Kucher & Partners, London, **Paul Hunt**, President of the Pricing Solutions Division at The Advantage Group, **Tom Nagle**, CEO of The Strategic Pricing Group Inc., Partner with The Monitor Group and author "The Strategy and Tactics of Pricing," and **Bernard Demeure**, Head of pricing practice for France, Mercer Management Consulting.

Mark you calendars, and register yourself and your staff for our 'Pricing in Paris' Conference, Wednesday, June 14 - Friday, June 16, at the Le Meridien Etoile Hotel for another great experience.
For more details, please go to www.pricingsociety.com.

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Financial incentives are, without question, one of the most powerful levers for behavioral change among salespeople.

Our experience has shown that there are three main ways to affect these behavioral changes:

1. Provide effective incentives.
2. Set appropriate expectations.
3. Develop the necessary organizational skills.

Provide Effective Incentives

When actor/playwright/composer Noel Coward said, "If you must have motivation, think of your paycheck on Friday," he might well have been talking about how to motivate salespeople to move to a value-based selling approach.

Financial incentives are, without question, one of the most powerful levers for behavioral change among salespeople. When faced with a choice between working harder to sell value to gain additional price or closing an additional deal at a lower price, most opt to close the additional deal because they receive far more commission for the additional, albeit less profitable, volume.

It is nearly impossible to get salespeople to work harder to get higher prices without changing their commission structure so that total compensation is more closely tied to profitability. Making those changes, although often difficult, is a crucial first step toward more effective price negotiations.

Just as salespeople need appropriate incentives, so, too, do customers. Strategic pricing requires convincing customers to change deeply ingrained behaviors that have been reinforced by years of ad hoc discounting, poor pricing discipline and poorly communicated value messages. Some customers will be asked to start paying for value received or accepting a lower value alternative. Other customers must be convinced to limit usage of high-cost services or else begin to pay for them. Still others may be asked to change purchase timing or volumes, or meet other conditions to qualify for continued discounts.

Convincing customers to change behaviors like these requires discipline and thoughtful design of appropriate incentives. Fortunately, marketers have many tools available to get the job done. For example, pricing policies can be used to encourage service "abusers" to reduce their usage of high-cost services or to begin to pay for them by aligning price paid with value received.

Marketers in distribution, manufacturing and retail frequently use this technique to control delivery and logistics costs by offering a free minimum delivery option and then adding a metric that increases price for additional delivery guarantees.

Another tool that pricers can use to induce more profitable behaviors by customers is discount level. Consider the telecommunications manufacturer that had been giving costly support services away to match a major competitor's offering. The practice was highly unprofitable because the company could not price for the services for fear the competition would not follow and, like most services, they were costly to deliver. Because the company could not change customer usage by increasing prices, it looked to discounting instead. A simple financial analysis showed that the company would improve profitability by offering a 5% product discount for every customer that opted to accept a restricted service package in which they had to use online support to solve technical problems. Price-sensitive customers found the package appealing, in part due to the lower price point but also because they could purchase personal support for an additional fee if needed.

As these examples illustrate, there are numerous opportunities to create incentives for more profitable behaviors.

Set Appropriate Expectations

It's a truism that individuals will change only to the extent that change is expected of them. Unfortunately, in many companies, precisely what those expectations are is unclear. Pricing managers often receive mixed messages from senior management about the types of behaviors they ought to pursue.

Pricing discipline cannot be viewed as an oxymoron in your organization. Senior management must therefore specify clear, consistent business objectives and provide the necessary resources for managers to achieve them. This can be one of the most challenging aspects of strategic pricing because it forces managers to explicitly consider the long-term costs of pricing actions.

It can be incredibly tempting for a sales or pricing manager to approve a pricing exception to close a deal with a new account that has been negotiating aggressively, but doing so can have significant long-term costs. First, it teaches that account that you are not serious about getting paid for

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Consistent policies communicate that it is impossible to "game the system" by shopping within the company for the best deal.

your value and that they can win concessions by being aggressive.

Second, and oftentimes more importantly, it can place your relationships with long-time customers at risk if they find out that they are paying a higher price than a first-time purchaser. Finally, competitors are likely to copy this approach if it wins market share in the short term, with the result that overall industry price levels start to decline and profits shrink for everyone.

Failing to have a consistent message to customers that they will have to pay for value received sets the expectations that they can "win" by negotiating aggressively or simply waiting you out to until the price comes down. Instead of setting prices based on short-term needs, companies need to set polices designed to enforce price discipline and send a clear message to customers that they cannot win special treatment through clever tactics.

Ideally, policies are transparent and consistent. With transparent policies, customers need not engage in threats and misinformation to learn the tradeoffs you are willing to make. Consistent policies communicate that it is impossible to "game the system" by shopping within the company for the best deal.

Develop the Necessary Organizational Skills

Creating incentives and setting appropriate expectations are necessary but not sufficient to change individual behaviors. Even when customers and company personnel are willing to change, the key question is whether they have the knowledge and skills that make them able to change.

In negotiated environments, all of the work to create a proactive, profit-driven and value-based pricing strategy comes to fruition when the deal is signed and the final price is set. Too much is riding on the outcome to simply admonish sales to "sell value" and defend price.

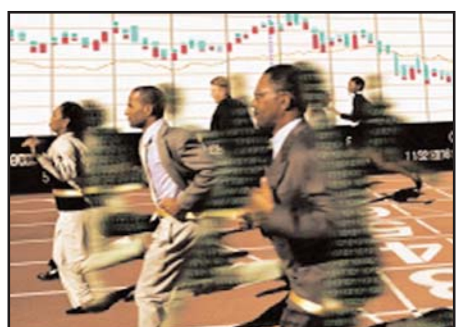
Harvesting the fruit of your pricing labors requires teaching salespeople how to change from a fixed offering/variable price approach to the more profitable fixed price/ variable offering approach to negotiation. Training alone is often not enough; success requires developing tools to help customize and communicate the value message in a way that makes it relevant for customers.

Salespeople aren't the only ones in the company that need new skills to implement strategic pricing in the organization. Product managers must learn how to collect the data necessary to estimate economic value, analyze relevant costs, and set profit-maximizing prices. The first step to develop these skills is education.

However, true skills development requires putting the concepts to work on real products on multiple occasions. As we have already noted, strategic pricing is challenging, and many companies do not have the level of commitment necessary to make the transition. That's good news for those companies that persevere to develop the skills needed to change, because it means that pricing can become a source of competitive advantage that delivers incremental profits over time.

Communicating the rationale and benefits of a value-based pricing strategy is one of the most critical steps to convincing customers to change how they set prices. Customers must understand that the prices they are paying are fair and that other customers are not getting better deals through the use of aggressive price tactics. This communication happens through the use of transparent pricing policies that clearly define the ways in which customers can earn lower prices.

Companies must also explain to customers that they will benefit from more choices about the types of offerings and ways that they engage with you. When customers receive high value or increase service usage, they will be expected to pay more. But strategic pricing does not equate to higher prices for all customers-low-value customers or those that are willing to purchase in a way that reduces costs may receive lower prices. Understanding these options is essential to setting the stage for a new pricing approach.



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The distribution industry is generally one of tight margins. Imagine being a distributor of thousands of products with a substantially lower market share than either of your two main competitors and with no unique market position. On the other hand, each of these two competitors has established unique strategies and together controlled over two-thirds of the market. John S. Harrison reveals the challenges and solutions in gaining market acceptance and encouraging new technology uptake. He is the President of Harrison Pricing Strategy Group and can be reached at 416-218-1103 or by email at jsharrison@harrisonpricing.com E.M.

Price Leverage: Forget Gold - Go For Platinum!

The distribution industry is generally one of tight margins. Imagine being a distributor of thousands of products with a substantially lower market share than either of your two main competitors and with no unique market position. On the other hand, each of these two competitors have established unique strategies and together controlled over two-thirds of the market.

This was the case facing a distributor for several years. As well, its market share had progressively eroded so much that in some markets, it held even less market share than its regional competitors.

To counter this declining market position, the company had recently acquired and developed a unique set of technology tools permitting more efficient management of inventory. A key issue for the supplier was how to use price to leverage the new technology to improve its competitive market position.

While the savings through use of the technology were potentially significantly higher than they were for their competitors' offerings, the problem was that their two main competitors could easily demonstrate cost savings through more conventional approaches.

As in many cases relating to the uptake of a new technology, the distributor faced a number of challenges in gaining market acceptance and encouraging technology uptake.

These included:

1. Undemonstrated field-tested benefits
2. Uncertainty with respect to the size and timing of the benefits
3. Personal risk presented to the decision-maker by choosing a new offering
4. Relating cause (i.e. use of the new technology) to effect (benefits/ cost savings realized)

In addition, from the distributor's perspective:

5. Creating ongoing incremental savings beyond the first or second years becomes increasingly difficult

To develop a pricing strategy that would incent customers to take up increasing amounts of technology, the distributor considered two factors, the elements of a deal that would:

1. Provide value to a customer
2. Add value to the distributor

Chart 1: Dimensions of the Segmentation Space

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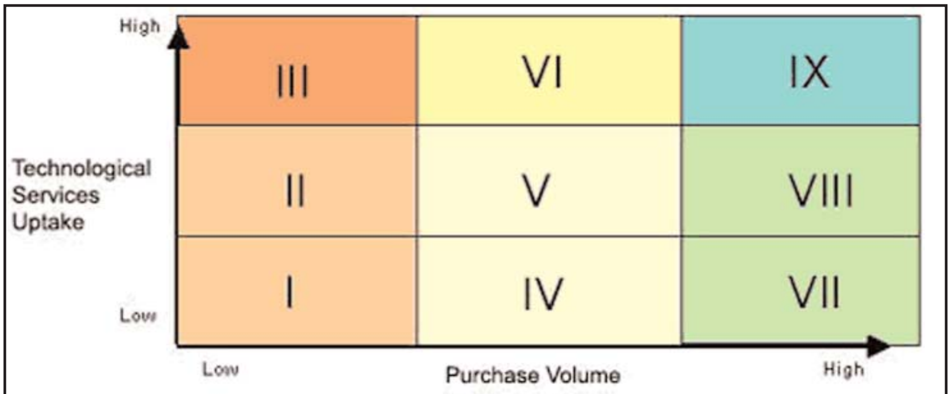

Chart 2: Segments

To do this, the two dimensions of thenew offering, volume and technology, were used to segment the market. See Chart 1.

Consequently, there were also two pricing elements; the first, relating to volume of distribution, and the second, the extent of technology uptake. Further, it was felt that smaller customers with lower purchase volumes would likely place different value on volume and technology relative to customers purchasing higher volumes. As a result, the market space was divided along the lines shown in Chart 2.

Based on this, the lowest prices were offered to customers in Segment IX given their high volumes and high degree of technology uptake. The highest prices would normally be for customers in Segment I with the lowest technology uptake and lowest volumes.

However, the key question became how to encourage customer movement both to the right (increasing volumes) and up along the technology uptake axis. To do this, the distributor carefully analyzed its customer value-chain as well as its own value-chain relative to the benefits that would be provided by the technology employed. It found that as technology increased, it was able to provide significant operational savings both for its customers and for itself. These savings could then be shared; the question then became, how should these savings be shared?

Because customers were under intense pressures to justify expenditures through tight ROI guidelines, the distributor decided that there would be two components to the pricing equation:

1. Overall price charged for distribution and technology
2. The savings that would be shared, or effectively "deducted" from the overall price.

To reduce risks to customers while providing incentives to take on technology, the sharing of savings was broken further into two components:

a. Guaranteed savings to the customer
b. Further potential savings that the customer could obtain through use of the technology.

Overall, the costs and benefits to both the customers and distributor are shown in Chart 3.

Current costs of the offering included product costs and distribution costs. With the new technology, savings accrued through better ordering, inventory management and other customer efficiencies.

In order to incent customers both to increase their product volumes sourced from this distributor as well as the degree to which advanced technology was taken up by customers, this distributor developed an algorithm whereby the percentage of the savings accruing to the customer increased with both volume and technology uptake.

Depending on this distributor's objectives with respect to different segments and customers, the algorithm was adjusted to reflect the relative importance of volume or

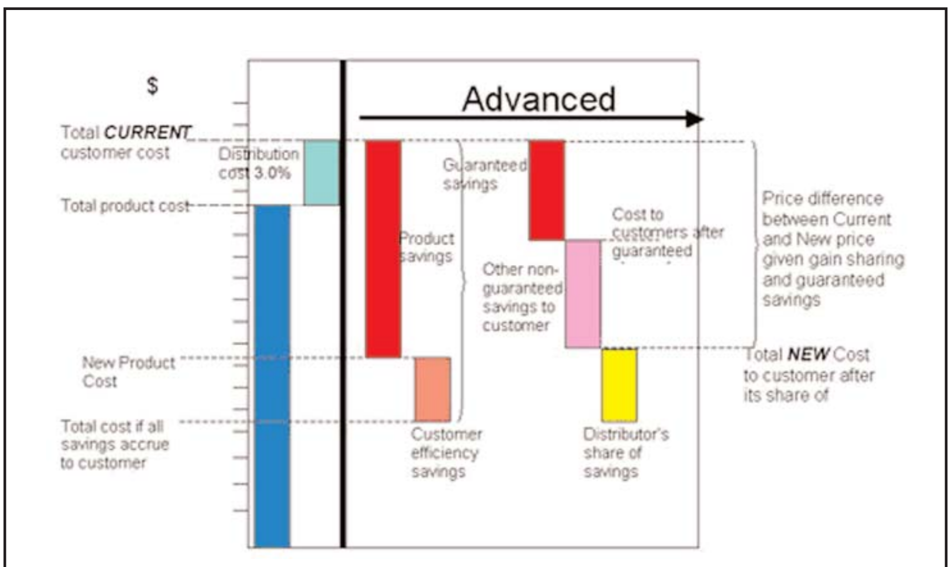

Chart 3: Savings Distribution

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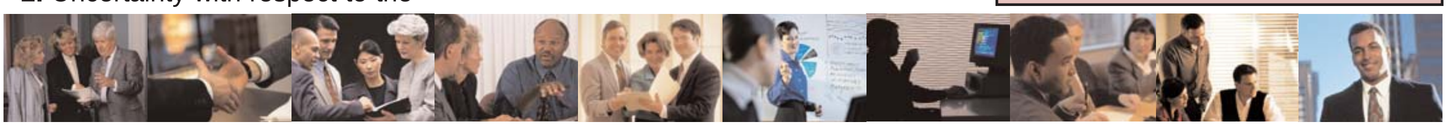
technology uptake. While the percentages to the customers increased with volume and uptake, this distributor still benefited given that both volume and technology uptake also provided increased savings to it. Both parties won, and this distributor successfully overcame the resistance to technological uncertainty.

While its competitors were panning for gold, this astute distributor discovered the value of platinum and effectively used it to dramatically benefit both itself and its customers. Through this pricing approach, customer uncertainty and risk were minimized because a certain level of savings were guaranteed. This form of gain-sharing, overcame customer resistance due to:

1. Undemonstrated field-tested benefits-
2. Uncertainty with respect to the size and timing of the benefits
3. Personal risk presented to the decision-maker by choosing a new offering, and;
4. Relating cause (i.e. use of the new technology) to effect (benefits/cost savings realized

Differentiation is critical in the increasingly price sensitive purchasing environment. Unless a distributor has unique capabilities making it the lowest cost provider (of which there can only be one), other differentiators are critical. Current rapid technological advances make this possible. But, resistance to new technologies with less certain benefits make it more difficult to compete on this basis. Gain-sharing based pricing can be used to overcome this resistance. The key is to share savings in a manner that provides customers with effective prices.

The distributor found that as technology increased, it was able to provide significant operational savings both for its customers and for itself.



Without laying a proper foundation, it's doubtful that any pricing leader could be successful. The following article outlines practical pricing requirements and what's involved in creating them. Michael Calogridis, Senior Pricing Director/sales Operations with Philips Medical Systems, writes a practical, plain text that gets right to the basics. Any pricing professional that has implemented a pricing strategy for their organization will identify with the basic needs in this article. Michael can be reached at 425-487-7689 or by email at calogridis@philips.com. E.M.

What Are The Minimum Requirements To Enable A Successful Pricing Strategy?

There are certain minimum requirements before you can even begin to understand the how's and why's of pricing for a particular company.

Executive Leadership

Executive Leadership must support the general idea that the company's pricing strategy requires change

Why? Pricing has historically been part of the marketing function with cost & margin impact analysis coming from finance. Additionally, sales has a big stake & interest in product pricing and pricing strategy also, but more so from the standpoint of always wanting more aggressive price points and discounts.

If the companies' leadership has a desire to wrap their arms 'around price', then all the parts of pricing would need to be consolidated in one person or at minimum, one person who will act as the central strategist.

That said, roles will have to change and 'culture' does not adapt overnight. It is unlikely that, without strong executive support, any person or organization would be able to effect enough support in Sales, Marketing and Finance to empower any one individual or group of individuals with the core pricing function. So the first step is to have that senior leader who wants to improve the pricing function.

Hiring the Pricing Professional

Many companies either bring in consultants to assess their pricing strategy or hire a full-time pricing professional. Either way, its highly unlikely that any company will have a steadily working pricing function without someone who carries the title 'pricing expert'.

Dividing pricing responsibilities between the marketing and finance teams never works. It is too fragmented of an approach and never leaves either side comfortable that the process works.

So, who do you hire? The top-notch consultant? Or do you advertise for a pricing professional? Do you work with an executive recruiter? The answer depends on the 'moneys' available in your organization.

These days it's frequent for companies (mostly consumer products) to want to hire top-notch consultants. Why leave so important a process as pricing to a so-called 'executive recruiter' or HR, which will both just scour Internet job search pages. Why not hire the consultant full time who you know has done this before?

However, when a highly-compensated former consultant as pricing leader is not viable in your company, its best to utilize an executive recruiter. Its extremely difficult to find someone with both a marketing and finance background who has worked in a day-in and day-out capacity with sales. Lastly, wouldn't it be nice if they also had industry experience.

Those issues aside, pricing is a rather new discipline so be prepared for a long search if you're trying to find a top-notch candidate.

In all probability you won't find someone with the 'perfect' skillset. One skill that stands out above all others as necessary is being a 'good business' person; help the organization make solid business decisions.

That said, once you've made your hire, its time to get to work. Pricing is at its best, a roll-up-the-sleeves daily grind in looking holistically by product and also deal by deal. If your pricing person isn't a roll-up-the-sleeves person, you'll have problems.

Second, while creating another incremental FTE is always an expense, resist the urge to staff the position as an individual contributor. Constant meetings and the sometimes & frequent data extraction issues make it extremely difficult for one person to do 'everything'.

Think of the pricing process as 'fine-tuning' an automobile; you wouldn't just fix one part of the car.

Once executive leadership supports the establishment of a pricing function and that pricing leader is in place, then the 'practical' foundation aspect to pricing will begin.

This aspect will take two forms: (1) the analytical/strategic piece and (2) the alignments 'down the leadership line' that need to occur to sell the strategy.

A workable pricing strategy can be drafted into a format not unlike any other type plan. Specifics around what needs to happen and who needs to make it happen are vital. Simply hiring someone, good intentions aside, won't get you much.

What I've labeled 'data' includes the 'analyses' piece. The only effective way to conduct pricing analysis is by using data, either historical, market share or competitive.

Data Essentials

- Market Research
- Competitive Intelligence
- P&L
- Historical Data
- Sales Discount Programs

Market Research (Conjoint Analysis)

- Market Research effectively 'survey's' the customer base that the company has & doesn't have to assess buying patterns and reasons for those buying tendencies.
- Assessing the marketplace 'we don't have' is as important as the marketplace currently enjoyed by that customer.
- You'll need to know what customers value about your products (Conjoint Analysis) so you can gage the worth of those product attributes.

Competitive Intelligence

- You will need to assemble a database of competitive intelligence in order to gage your price vs your competitor(s).
- These types of databases take time to accumulate and are another example of a 'role up the sleeves' process.

Pricing is at its best, a roll-up-the-sleeves daily grind in looking holistically by product and also deal by deal.

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Historical Data is crucial when looking at price trends.

- In many industries there are very specific legal constraints on who/how to collect competitive intelligence. Healthcare, for one, says that you cannot leverage price issues when people's health is at stake.
- Governmental agencies such as the VA, DOD, Etc keep on record invoices from recently purchased items for all competitors so this can be a good manner of collecting intelligence. Its open to the public.
- However, by far the most effective way to gather intelligence is to seek out (in a legal fashion) the people who deal with customer's day in and day out. Anecdotal surveys of the sales force are perfectly legal in trying to understand customer-buying patterns.
- Its important to note, though, that the most effective manner of surveying a sales force is to do so in separate conversations (one on one) over a wide geographic area and involving different selling channels. Lastly, don't just always include the sales reps, utilize managers and above. In that manner, trends will emerge independent of one another and carry more weight in deciding the right answer.
- I've always lived by the rule 'that if you hear and see the same price trends over large geographies and populations of people, the more true it usually is.

P&L

- Knowing whether or not your products and contracts are within profit guidelines is a key issue. You'll need to know the profitability and you'll have tons of questions about what does/does not hit the p&l.
- Price i.e. Revenue is obviously a large component of the budgeting process. However, since there are different immediate goals here, its never advisable to think that your pricing people can also provide you with your revenue forecasting.
- Lastly, when supplying data or such to marketing and/or the sales on price performance you need to ensure that the data you are providing is correct and ties to the P&L. Big issue!

Inter-Company Historical Data

- Historical Data is crucial when looking at price trends (list, net and discounting). You can't talk opinions. You'll need this data and in a time series format. Prices & discounts fluctuate over time so you cannot just look at one or two months.
- While most recent history is key, going back to see the month over month trends over a 2 year period will enable to incorporate trends into your pricing analysis. However, don't ignore the most immediate history if clear pricing trends are visable.

Alignments

There are 3 basic alignments that will define the day in and day out:

1. Sales
2. Marketing
3. Finance

Alignment with sales will for the most part be around transactional type pricing as well concern/interest in whether their pricing is market competitive.

Additionally, a sales force will require a compensation plan that matches the pricing strategy, otherwise they will not be motivated to achieve their revenue plan. Pricing analysis isn't done in vacuum; you're not going to go off in a room somewhere and create price points.

Marketing will have a very strong interest in the price points created. In fact, in most companies, in one way or another, marketing product managers owned the pricing analysis.The alignment with marketing is going to be the most 'sensitive' of the key alignments that I've discussed.

Realistically, you're going to have to accept a certain working style and relationship with the marketing department. There is also going to be a certain amount 'tension' as the product managers are really never going to like someone else having ownership of the actual price analysis.

Policies & Procedures

Lastly, A formalized set of Pricing Policies & Procedures will be required in order to document your pricing 'rules' both for internal use and auditor examination.

You will also need to communicate in formalized manner to a very wide audience which will include, in addition to your pricing management (who will not, most probably, read a set of P&P), all the sales operations folks who make a sales back office hum.

Lastly, for revenue assurance and integrity, your accounting department will require a set of policies and procedures. What I've outlined is only the foundation, the building blocks. However, all business plans and strategies are built off of solid foundations and pricing is no exception.