VOLUME 18 ● NUMBER 2 ● SECOND QUARTER 2009

The Journal of Professional Pricing

A Professional Pricing Society Publication

EDLP and Trade Promotion ROI: Measurement and Capability Development
by Joseph Jang, Ph.D

Why Pricing Strategies Fail
by George E. Cressman, Jr

Rocket Plan
Mark Burton and Steve Haggett

Pricing Policy: A Tool to Implement Corporate Strategy or a Reaction to Market Pressure
by Robert C. Maddux

The World's Only Association Dedicated to Pricing Management

The World's Only Association Dedicated to Pricing Management

The Journal of Professional Pricing

VOLUME 18 • NUMBER 2 • SECOND QUARTER 2009

ADVISORY BOARD

MR. ERIC MITCHELL
Founder and Chairman of the Board
The Professional Pricing Society

MR. JEROLD BERNSTEIN
President
The Price Improvement Team LLC

MS. JANELLE BRECHON
Director of Global Pricing
Eaton Corporation

MR. XAN CHAMBERLAIN
Global Pricing Manager
Hitachi Data Systems

MR. MARTIN COALSON
Asst. VP, Product Development
& Yield Management
Union Pacific Railroad

MR. JIM GEISMAN
President
Market Share, Inc.

DR. SCOT HORNICK
Vice President
Oliver Wyman

DR. RICHARD LANCIONI
Professor of Marketing
Temple University

MS. LAURA PRESLAN
Industry Director
Microsoft Corporation

MR. GARY RITZERT
VP, Retail Consulting
AC Nielsen

MS. STACEY SCHAEFFER
Director, Price and Offering Management
SAS Institute, Inc.

PUBLISHER & PRESIDENT

KEVIN MITCHELL
PROFESSIONAL PRICING SOCIETY
MARIETTA, GA

ADMINISTRATIVE STAFF

CHRIS BUCKINGHAM, Director of Sponsor Relations

HELEN CAUTHEN MITCHELL, CMP, Meeting Director

LATONIA DUGGER, Membership Associate

STEPHANIE HUDSON, Meeting Planner

WYNETTA JONES, Membership Associate

FABRICIO LOPEZ, Vice President of Marketing

JULIE R. MARTIN, Certification Program Director

KATRESE PHELPS, Director of Membership

DARNELL SHEPHERD, Project Coordinator

JOAN TERRY, Meeting Planner

REBEKAH WORTMAN, Marketing Publications Editor

PROFESSIONAL PRICING SOCIETY

3535 ROSWELL RD., SUITE 59
MARIETTA, GA 30062
PHONE: 770.509.9933, FAX: 770.509.1963
E-MAIL: info@pricingsociety.com
URL: www.pricingsociety.com

The Journal of Professional Pricing™ is published quarterly by Professional Pricing Society; Publisher Kevin Mitchell. All Rights Reserved © 2009. Professional Pricing Society accepts no responsibility in connection with any liability that might develop as a result of material published; opinions expressed are those of the authors and do not necessarily represent the publisher. No part of this publication may be reproduced in any form by microfilm, xerography, or otherwise, or incorporated into any information retrieval system, with-out the written permission of the copyright owner.

aptitude
50%

We know what it takes to be a Tiger.

What separates high performers from lesser competitors isn't just talent. It's the way they fuse their capability and mindset. It's what we call performance anatomy and it's one key finding from our groundbreaking research into the world's most successful companies. For an in-depth look at our study of and experience with high performers, visit accenture.com/research

• Consulting • Technology • Outsourcing

accenture

High performance. Delivered.

©2007 Accenture. All rights reserved.

Finally…

A pricing book the whole company can use.

Available now at Amazon.com

and Barnes and Noble.com

www.HoldenAdvisors.com 978-405-0026 **Holden Advisors**

From the Publisher

by Kevin M. Mitchell

These are certainly interesting times for pricers. Whether we are relatively new Pricing Analysts or well-experienced Chief Pricing Officers, we face questions without easy answers. Is the recession bottoming out or do we still have a further descent before things turn around? Are we seeing the first signs of recovery or economic optical illusions? Where should our pricing be reevaluated and what will be our customers' and competitors' responses?

To paraphrase a sentiment that I have heard in meetings, presentations, informal networking, and deep discussions with those of us who know first-hand, pricing can be a tough job. Some of us are at the intersection of sales, marketing, finance, and operations and we may have "dotted line" connections to even other business segments. To make matters even more challenging, our compatriots across the table (or phone line or e-mail) in Purchasing and Supply Chain are often very well connected with their peer networks – so a special concession granted to one customer can become a free-for-all almost instantaneously.

In spite of all of this, I know someone who concludes emails with the mantra "Pricing is Fun."

The Professional Pricing Society (PPS) was founded 25 years ago to connect its members with others that have chosen this fun career. PPS is the world's only professional society dedicated to pricing management. Our mission is to nurture a growing community of professionals committed to disseminating pricing expertise throughout the business world. We provide current research, market trends, strategies, and resources from today's leading pricing experts and technology providers worldwide.

PPS Conferences offer the perfect forum for peer networking with pricing thought leaders, practitioners, and experts with the widest range of presentation topics and discussion points possible.

Because pricing is such a dynamic field, up-to-date training is especially important. The PPS Board of Advisors designed the Certified Pricing Professional (CPP) designation to support, educate, and elevate the pricing professional. You can earn CPP Credits at our Conferences and Workshops or with our new Online Courses, where you can learn at your own pace without having to travel or spend time away from the office. Here is a partial list of PPS Online Pricing Courses available now:

- **Core Pricing Skills** – Stephan Butscher & Mark Billige
- **How to Achieve Pricing Excellence** – Jim Saunders & Avy Punwasee
- **From Pricing Management to Value Management** – Brian Sharp & Kevin Lemke
- **Implementing Price Strategies in Competitive Markets** – Richard Lancioni
- **Pricing During Turbulent Times** – Paul Hunt
- **Avoid the Commodity Trap: Pricing Services in a Recession** – Reed Holden
- **Bundling's Impact on Profits** – Tim Smith
- **The Psychology of Buying at Higher Prices in a Down Market** – Scott Sorrell

Our website www.pricingsociety.com features a Pricing Technology Directory and a Pricing Experts Directory for those who are considering using outside resources to assist with their business opportunities. PPS Members have access to many additional tools, such as an archive of several hundred pricing articles covering almost every conceivable topic. Members can also search for job postings, access free on-demand Webinars, review thought-provoking White Papers, and visit the PPS Experts Blog via our website.

We build PPS offerings based on our members' feedback, so please do not hesitate in letting us know what your membership association can do for you.

Please check out our Calendar of Events for a list of upcoming opportunities for you to connect, network, and train with fellow pricers, the people who can understand your career's fun complexities.

I hope that you enjoy this quarter's edition of *The Journal of Professional Pricing*.

Sincerest thanks,

Kevin M. Mitchell
President
Professional Pricing Society

THE JOURNAL OF
PROFESSIONAL PRICING

CONTENTS

10 **EDLP and Trade Promotion ROI: Measurement and Capability Development**
Joseph Jang, Ph.D
Trade promotion investment constitutes one of the largest investment items in the P&L for many Consumer Packaged Goods (CPG) manufacturers, and research suggests that CPG companies can achieve up to a 10-20% increase in bottom-line profit through improved trade promotion efficiency.

18 **Why Pricing Strategies Fail**
George E. Cressman, Jr.
Often the key to successful pricing strategy lies in understanding the underlying organizational activities that preclude successful implementation. If the business unit has articulated a value based pricing strategy, failures are often not a strategy problem.

26 **Rocket Plan**
Mark Burton and Steve Haggett
The majority of new-product launches fail. However, it is seldom the technology itself that's to blame. A rigorous pricing approach can improve customer adoption rates, grow profitability, and increase return on investment.

32 **Pricing Policy: A Tool to Implement Corporate Strategy or a Reaction to Market Pressure**
Robert C. Maddux
When a manufacturer does not have a clear, current, executable, and logical pricing strategy it leaves to chance and market forces the fate of its brand and its future. In many cases, in order to achieve their long term vision, manufacturers need to coordinate their trade promotional policies (cost) and retail pricing policies (price) into a cohesive effort.

For change agents seeking profit nirvana, please note: effective pricing is your most powerful lever to get to the top! At Pricing Solutions, we have helped many companies in many industries take the exhilarating ride to the top; to take price increases, reduce needless discounting and grow their businesses. If you agree that every penny counts and you want to drive pricing improvement, give us a call or visit our web site.

PRICING
solutions

ASSOCIATED WITH THE ADVANTAGE GROUP

| PEOPLE & ORGANIZATION – PROCESS & CHANGE MANAGEMENT – RESEARCH & ANALYTICS – TOOLS & SYSTEMS

WWW.PRICINGSOLUTIONS.COM – LONDON **+ 44 (0) 20 7323 5059** – FRANCE **+ 33 1 4602 6032** – SPAIN **+ 34 91 572 6821**

NORTH AMERICA **1-888-771-8326** ext. **169**

access
analyze
act

QL2 is the leading provider of demand-driven data access, aggregation and delivery services, providing reliable, up-to-date pricing information that positively impacts your price optimization and revenue management strategies.

QL2 helps you make sense and derive value from the sea of pricing data available on the web and from other structured and unstructured digital data sources. Data on pricing, competitive intelligence and product mix are delivered directly to you when you need it, for informed, strategic pricing decisions that impact your business.

Visit **www.QL2.com/proof** to sign up for our Prove It! Program. Try our proof of concept where we'll show you how we can deliver the information you need for better price intelligence, pricing optimization and revenue management.

800.750.8830 • sales@QL2.com • www.QL2.com

Copyright © 2008 QL2 Software, Inc., All Rights Reserved

EDLP and Trade Promotion ROI: Measurement

Trade promotion investment constitutes one of the largest investment items in the P&L for many Consumer Packaged Goods (CPG) manufacturers, accounting for an average of 13-20% of revenue or 67% of total marketing investment. Research suggests that CPG companies can achieve up to a 10-20% increase in bottom-line profit through improved trade promotion efficiency. Author Joseph Jang, Ph.D, a Consultant with Accenture Marketing Sciences, Accenture Ltd., addresses the ROI measurement of EDLP in relation to other types of trade investments and key success factors for institutionalizing ROI process in an organization. Jang can be reached at joseph.jang@accenture.com.

Trade promotion investment constitutes a single largest investment item in the P&L for many Consumer Packaged Goods (CPG) manufacturers, accounting for an average of 13-20% of revenue or 67% of total marketing investment.[1] Industry experts estimate that over $300 billion dollars are spent in trade and retail promotions each year.[2] Of the trade promotion investments, many CPG companies spend 30-40% of their entire trade fund on buying down prices everyday ("Every Day Low Price" – EDLP) or extended price reductions. With the growth in Walmart and recent retail phenomena of everyday price reductions to cope with slowing economy, the EDLP investment figures are only to grow.

The measurement of promotion effectiveness and efficiency continues to be recognized as one of the most critical issues faced by CPG companies.[3] Research suggests that CPG companies can achieve up to a 10-20% increase in bottom-line profit through improved trade promotion efficiency.[4]

Unfortunately, even with much advancement in the trade ROI measurement, processes, and technologies, many CPG companies are still struggling to understand the return on EDLP (Everyday Low Price) and other types of trade promotion investments. To make matters worse, utilizing traditional measurement of ROI without fully accounting for investments made on everyday price management could lead to misguided decisions.

This article addresses the ROI measurement of EDLP in relation to other types of trade investments and key success factors for institutionalizing ROI process in an organization.

What is EDLP and Hi-Lo Pricing Strategy?

EDLP pricing strategy is a retail practice of charging a constant, low everyday price to consumers without any temporary price promotions. Often times, the practice is supported by manufacturers making trade payments to retailers in the form of off-invoice allowances. Hi-Lo pricing strategy, in contrast, charges consumers relatively higher prices everyday, but runs frequent promotion discounts below the EDLP level.

EDLP pricing strategy could help manufacturers reduce product volatility and save supply chain cost from a more steady and stable demand, while also saving retailers the time and expense of periodic price markdowns. In contrast, Hi-Lo pricing strategy could attract price sensitive switchers and build store traffic during the temporary promotions while generating higher revenue from loyal consumers on an everyday basis.

Walmart, Food Lion, and Cub Foods are a few examples of supermarkets that employ EDLP pricing strategy, while Kroger, Safeway, Albertson's and Meijer are examples of Hi-Lo operators. In recent years, however, the distinction between EDLP and Hi-Lo operators has become rather blurred. There are hybrids of pricing strategy where EDLP operators like Walmart run temporary price roll-backs and occasional discounts while Hi-Lo operators also run extended temporary price reductions (TPR) that are more than a few weeks long.

Regardless of whether the pricing strategy is pure EDLP or extended TPR, it is critical for CPG companies to have a good understanding of return on these investments. With an accurate and consistent trade ROI measurement, CPG companies can improve trade efficiency by re-allocating trade funds to promotion tactics, products, retailers, and geographies that generate better returns on investment.

What is the right ROI measurement?

Developing an organizational ROI capability involves many factors working in concert, including strategy, process, technology, and change management. These factors will be covered in the later section, but the ROI capability building starts with defining an accurate and consistent ROI measurement that is sanctioned by key stakeholders. A generic definition of ROI is often expressed as a percentage:

ROI = (Return – Investment) / Investment
= (Return/Investment) -1

However, there are many variations of the definition of ROI depending on what measure of return is being used. Commonly

used measures of return are the following:

1. Volume
2. Revenue
3. Net Sales
4. Gross Profit or Margin
5. Gross Profit After Trade Investment
6. Operating Profit
7. Contribution Margin (recommended)

Depending on the need, one can argue for using any one of the measures listed above, but if ROI is to reflect true profitability of an investment, we recommend using contribution margin as a measure of return. It excludes any fixed expenses (e.g. fixed production cost, SG&A, etc.) that will be incurred regardless of the investment. The key is to understand the "incremental" profit from the investment that you wouldn't have gotten without the investment.

Consider a product with the following simplified P&L:

The hypothetical product generates $5.00 revenue and $0.80 operating profit after fixed expenses are allocated across expected total units. However, each additional unit sold beyond the total expected units contributes $2.80 directly to the bottom-line profit ($2.80 = $5.00 - $1.50 - $0.70). In this example, any additional investment that generates incremental unit sales and that costs less than $2.80 per unit will be considered a profitable investment. If the measure of return used was operating profit, the investment decision would have been too strict, not allowing investments costing greater than $0.80 per unit, while it would have been to lenient if the revenue measure of return were used.

Now, let's consider a trade promotion investment decision. Suppose that the product was promoted to $4.00 net price to retailers after $1.00 trade investment was applied to each unit sold during the promotion, and that the promotion generated total of 100,000 units instead of typical 60,000 base units without promotion. In this example, the trade investment generated a benefit of 40,000 incremental units or $112,000 incremental contribution to the bottom-line ($2.80 CM * 40,000 incremental units). The true profitability measure of ROI is calculated as follows:

A Simplified P&L for a Hypothetical Product	
Revenue	$5.00
Variable COGS (labor, materials, etc)	$1.50
Fixed COGS (production overheads, etc.)	$1.00
Gross Profit	$2.50
Trade Investment	$ –
Gross Profit After Trade	$2.50
Variable Operating Expenses (distribution, etc.)	$0.70
Fixed Operating Expenses (SG&A, etc.)	$1.00
Operating Profit	$0.80
Contribution Margin (CM)	$2.80

ROI = ($112,000 Incremental CM) / ($100,000 Trade Investment) - = 12%

Note that the total trade investment is $100,000 instead of $40,000 because the trade dollar is spent against each and every unit being sold on promotion.

What is the ROI of EDLP investment?

Now that we have established an accurate measure ROI, let's consider the ROI of EDLP investment. Conceptually, it should be as simple as calculating the ROI as follows:

ROI of EDLP = [(Incremental units due to EDLP * CM)/(EDLP Investment)] -1

However, the challenge is not in the calculation of it, but in the estimation of incremental units due to EDLP investment. Suppose $5.00 price to retailer was already net price after applying $0.20 of EDLP investment on an everyday basis. Then what is the incremental unit generated from the EDLP investment? The question is a non-trivial one for most decision makers, but price elasticity information helps estimate the benefit from the EDLP investment. The price elasticity is defined as follows:

Price Elasticity = (% change in units)/(% change in price)

This measures how sensitive consumers are with respect to price changes. Let's assume that the price elasticity for this product is known to be (-1.37). Then the base units without the $0.20 (or 3.8%) reduction from $5.20 can be calculated as follows:

-1.37 = (% change in units) / (-3.8% change in price) or % change in units = 5.3% = (-1.37)*(-3.8%)

We now know that the 60,000 base units are due to 5.3% increase in base units from 57,000 units and that the incremental units due to EDLP spending are 3,000 units. The question then is whether it was a profitable investment. The ROI of the EDLP investment is calculated as:

ROI of EDLP = ($2.80 CM * 3,000 incremental unites due to EDLP)/ (60,000 * $0.20)-1 = -30%

Thus, the EDLP investment in this example was not profitable.

There may be many valid reasons for CPG manufactures to engage in the EDLP program. Some examples include retailers' pricing strategy requirements, cost savings in production and supply chain economics, and gaining everyday share positions. However, understanding the profitability of EDLP investment will help redirect the investments to other better performing tactics and products for both manufacturers and retailers.

What determines a profitable EDLP investment?

The answer is conceptually simple. The incremental unit from the EDLP investment should be "large" enough to justify the reduction in price on an everyday basis. How large is large enough and what is the break even point? In the previous example, the EDLP ROI would become positive if the incremental unit generated from the EDLP investment was more than 4,286 units.

With the knowledge of price elasticities, companies can determine profitability of EDLP investment before the investment is made and reallocate funds to profitable ones.

Breakeven Incremental Unit
= EDLP Investment/ Contribution Margin
= $120,000/$2.80 = 4,286 units

Note that the break even point depends on the contribution margin. The less the contribution margin is, the more the incremental units are required. Another important factor is how sensitive consumers are with respect to everyday price changes. Recall that the price elasticity measures consumers' sensitivity to price change. It is a critical element of ROI analysis involving EDLP investment.

In the previous example, the price elasticity of (-1.37) suggests that consumers were not sensitive enough to the price change generating only 3,000 incremental units from the EDLP investment. To generate the breakeven incremental units of 4,286, it would have required price elasticity of (-2.00) or larger in absolute value.

With the knowledge of price elasticities, companies can determine profitability of EDLP investment before the investment is made and reallocate funds to profitable ones. One caution is that price elasticity is not a simple calculation of price and volume relationship because it requires factoring out seasonality, trends, and other market activities that influence the volume change while price is being altered. There are econometric techniques readily available to accurately measure price elasticities. Given the magnitude of trade dollars spent in EDLP and upside on the bottom-line profitability, it is strongly encouraged for CPG manufactures to obtain retailer specific price elasticities to determine ROI before an important investment decision is being made.

Incorrect ROI and Erroneous Decisions

As noted earlier, the retail environment is becoming ever more complex and there are hybrids of everyday price management practices. In these incidences, utilizing traditional ROI measurement without fully accounting these investments for everyday price management could result in misguided investment decisions.

For an illustration of a misguided decision, let's go back to the earlier example where the product was promoted to $4.00 that generated incremental 40,000 units. Now, let's assume that the 60,000 base units already included EDLP investment of $0.20 and that the investment boosted the base volume from 57,000 to 60,000. What is the ROI of the $4.00 promotion that is run on top of the EDLP investment? Is the $4.00 promotion a right decision?

Recall that the promotion generated $112,000 incremental contribution, but total investment would be $120,000 compared to $100,000 in the earlier example because it would cost $1.20 ($1.00 on promotion and $0.20 on EDLP) for each of 100,000 units sold during the promotion. Without fully accounting for the benefits of EDLP investment, one could erroneously calculate the ROI as:

Incorrect ROI = ($2.80 CM * 40,000 Incremental Units)/($120,000 Total Investment) -1 = -6.7%

With the incorrect ROI measurement, the $4.00 promotion does not seem to be a profitable investment. The total ROI calculation below captures the benefits of both EDLP and the $4.00 promotion investment during the weeks of promotion:

Total ROI = ($2.80 CM * 43,000 Inc Units)/($120,000 Total Investment) -1 = 0.3%

Total ROI calculation suggests that this investment is only marginally profitable. However, if a decision maker is interested in deciding whether to run the promotion on top of EDLP program rather than on the ROI of total investment, he or she should consider the following promotion ROI calculation:

Promotion ROI = ($2.80 CM * 40,000 Incremental Units due to Promotion)/($108,000 Incremental Promotion Investment) -1 = 3.7%

The promotion ROI calculation factors out EDLP investment cost and corresponding benefits from it and focuses on incremental benefits of running the $4.00 promotion and incremental investment cost. Whether to use total ROI or promotion ROI calculation depends on what type of decision is intended. If the intention is to understand ROI of total investment and comparisons across multiple retailers, the total ROI calculation is recommended, while the promotion ROI calculation is recommended if the intention is to compare alternative promotion tactics.

Building Organizational ROI Capability

For over a decade, improving trade spending efficiency has been one of the top priorities for CPG companies. Much advancement has been made in this field and there are tools and processes now available to help improve trade investment efficiency.

While most CPG companies still lack organizational ROI capability, a number of leading companies are beginning to utilize ROI as an integral part of trade promotion planning, execution, and evaluation.

Research and experience in working with numerous CPG companies indicate key success factors in developing organizational ROI capability. These factors include strategy, process, technology, and people.

Strategic Focus: Understanding and improving trade ROI can be a significant competitive advantage for many CPG manufacturers. By identifying and minimizing events that do not provide a profitable return on investment, companies can better allocate trade funds to support events that not only increase top-line sales, but also bottom-line profits.

Unfortunately, increasing profit is often not one of the reasons for trade promotion investments. According to Nielsen's trade promotion practice survey[5], only 24% of the manufactures surveyed quote increasing profits as one of their reasons for trade investment, while 82% cited increasing sales and 63% cited generating market share as the main reasons for trade investment.

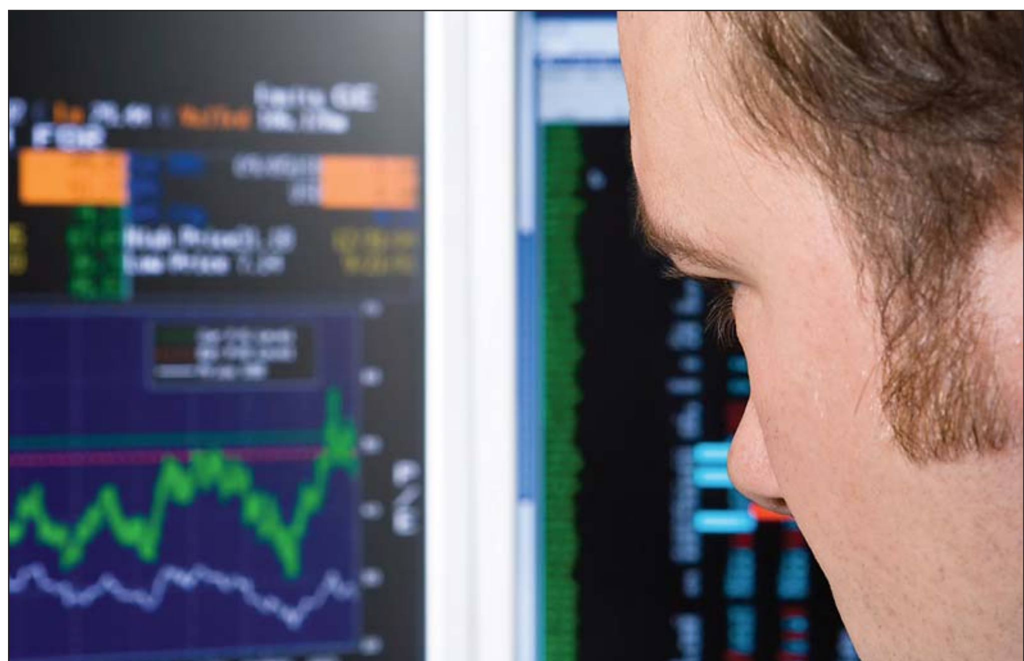
In the current economic environment where every investment is scrutinized, trade investment should not be viewed as a cost of doing business or a necessary evil to maintain goodwill with retailers. Leading companies are tracking promotion performance with rigor, focusing on both execution and resulting profits. In order to institutionalize ROI successfully, it is imperative for executives to put forth a strategic focus on making ROI one of the key performance indicators in driving investment decisions.

Closed-Loop Process: We have seen many ROI initiatives fail, not because of lack of tools and technology, but because they are treated as one time ROI analysis projects. Often times, many trade ROI programs become an exercise of generating insights from reviewing ROI of past promotions. Unless ROI process becomes a part of existing trade management process, the outcome of the ROI initiative is only one of the dusty binders on the bookshelves of marketing and sales managers.

To successfully institutionalize an ROI initiative, it is critical to involve key stakeholders upfront and map out business process steps involving ROI evaluation and trade investment decisions. The key is to insert ROI measurement as an integral part of the closed-loop trade management process including trade budgeting, fund allocation, promotion planning, execution, and continuous ROI evaluation to make necessary course corrections.

Technology: The measurement and calculation of ROI is relatively straight forward, but conducting ROI analysis for thousands of events can be a formidable task requiring much time and dedicated resources unless the ROI calculation is automated. The main obstacle is the fact that ROI measurement requires data from multiple, often disparate, data sources, including trade event data, syndicated data, financial data, as well as account specific price elasticities to accurately account for EDLP investments.

Fortunately, there are tools and technologies available to alleviate the time and resources required to calculate and track ROI in an automated fashion. Leading companies are beginning to leverage technology solutions that allow them to measure ROI automatically before and after a promotion is run and gain insights into drivers of performance from a database of event specific ROI.



To successfully institutionalize an ROI initiative, it is critical to involve key stakeholders upfront and map out business process steps involving ROI evaluation and trade investment decisions.

One common misbelief is that technology alone will automatically deliver organizational ROI capability and improve trade efficiency. There is no such thing as "right out-of-the-box" solution and the technology needs to be carefully configured to meet company specific business process and IT infrastructure requirements.

People: A successful ROI program always involves a structured change management approach to transitioning people and business processes from a current state to a desired future state. It starts with clearly defining roles, responsibilities, and accountabilities surrounding ROI evaluation and investment decisions.

Experience suggests that a successful change management approach requires sponsorship, organizational alignment, communication and training to function in concert.

- Sponsorship must create the executive alignment and commitment for the importance of the profitability of trade investment and relentless pursuit to improve return on every trade investment being made.
- Organizational alignment must ensure that individual goals are aligned with business goals. An ROI initiative will not succeed unless there is an organizational alignment and reinforcement that "profitable" trade investment is critical and corresponding incentive structure is in place.
- Communication should be directed to all individuals impacted by the ROI program to build awareness and to foster desire to participate and support the required change.
- Training must build in the required capabilities that individuals need to perform in the changed environment, including using new processes and tools.

Conclusion

CPG companies spend billions of trade dollars on managing everyday prices each year, and these investments will only grow with the current economic environment. Many CPG companies recognize that that improving return on these investments has a significant impact on both top-line and bottom-line performance.

The journey of trade efficiency starts with having an accurate and consistent ROI measurement that is management-sanctioned and adopted by individuals making investment decisions. Technology is one of the key enablers that facilitate the use of ROI measurement in the closed-loop trade management process including budgeting, fund allocation, promotion planning, execution, evaluation, and course correction.

Leading companies are beginning to harvest both top-line and bottom-line gains from on-going, rigorous reviews of return on their trade promotion investments. As with many other organizational capability developments, the ROI capability is not acquired over night. Improving trade efficiency is a long journey that requires involvement from many aspects of business operation. An accurate, consistent ROI measurement is an essential tool that will serve well in that journey.

Endnotes

[1] TPMA Trade Promotion Benchmark Survey 2007

[2] Accenture, Cannondale, Aberdeen Group 2007

[3] Nielsen Trade Promotion Practices Survey 2007

[4] Accenture Industry Experience and Trade Promotion Study, 2007

[5] Nielsen Trade Promotion Practices Survey, 2007

Recognize this company?

There is a good chance that insights and solutions from Simon-Kucher helped create the pricing strategy for the:

- raw materials to build its factory
- machines running in that factory
- raw materials that go into those machines
- ERP software
- chips that enable that software
- labels on the products
- ink on those labels
- courier that ships the products
- trucks that the courier uses
- fork lifts in the warehouse
- tires on those fork lifts

Are you sure that you have the right prices for your products and services?

SIMON ✦ KUCHER & PARTNERS

Strategy & Marketing Consultants

www.simon-kucher.com

WHY WATCH, WAIT AND HOPE?

For many organizations, this is an all too familiar feeling when the end of the quarter rolls around. Watching, waiting and hoping that deals will come in, margin guidelines will be realized, inventory will be available and revenue targets will be attained can turn even the most sophisticated organization into a frenzied pressure cooker of last second heroics.

CHANGE THE GAME

Get the forward-looking visibility you need to proactively plan and respond to changing business and market conditions. Synchronize and align your business across key functions to enable proactive responses to intra-period changes. Symphony Metreo has helped leading organizations meet their financial goals with innovative forward-looking solutions that align and synchronize top-down planning with bottom-up execution by focusing on the strategic levers of Price, Volume and Cost. Call us today at 650-935-9400, or visit our website at www.symphony-metreo.com.

Copyright ©2008 Symphony Metreo, Inc. All Rights Reserved.

UP AND TO THE RIGHT

GET BACK ON TRACK WITH VENDAVO

IMPROVING PROFITS ACROSS INDUSTRIES

HIGH TECH

MANUFACTURING

CONSUMER GOODS

MILL PRODUCTS

PROCESS

SERVICES

DISTRIBUTION

Leading Provider of Price Management and Optimization Solutions for B2B Companies

Vendavo Headquarters 1029 Corporation Way, Palo Alto, CA 94303 | **Phone** 877.836.3286 | **Fax** 650.962.0645

European Headquarters 3rd Floor 24 Chiswell Street, London EC1Y 4YX, United Kingdom | **Phone** +44 (0) 208 133 0744

Email info@vendavo.com | **Web** www.vendavo.com

Why Pricing Strategies Fail

Effective pricing strategy is essential to profitable performance. But when firms face difficulties in managing pricing policy, the problem may not be the pricing strategy. Often the problem lies with providing the "implementation infrastructure" that enables the business to pursue the pricing strategy, on which this paper focuses. Author George E. Cressman, Jr. is the Founder and President of World Class Pricing, Inc. and can be reached at George.Cressman@WorldClassPricing.net.

Managers are under increasing pressure to hold and even increase current price levels. The current economic conditions make this most difficult, with recessionary and customer stresses pushing prices down.

As challenges to price management mount, managers are paying much more attention to the development of pricing strategies. Effective pricing strategy is essential to profitable performance. But when firms face difficulties in managing pricing policy, the problem may not be the pricing strategy.

In any corporate effort, well defined strategy is critical, and this is especially so with pricing strategy. Developing pricing strategy is a necessary precursor to profitable performance, but the key to successful performance is not strategy development. Rather, the key to successful performance is the effective implementation of a well founded pricing strategy.

As difficult as development of pricing strategy is, the real work in building pricing policy is in providing the means to implement the strategy. There are two major components of the implementation means:

1. Providing the "implementation infrastructure" that enables the business to pursue the pricing strategy.

2. "Selling" the pricing strategy to the organization: that is, motivating the organization to implement the strategy.

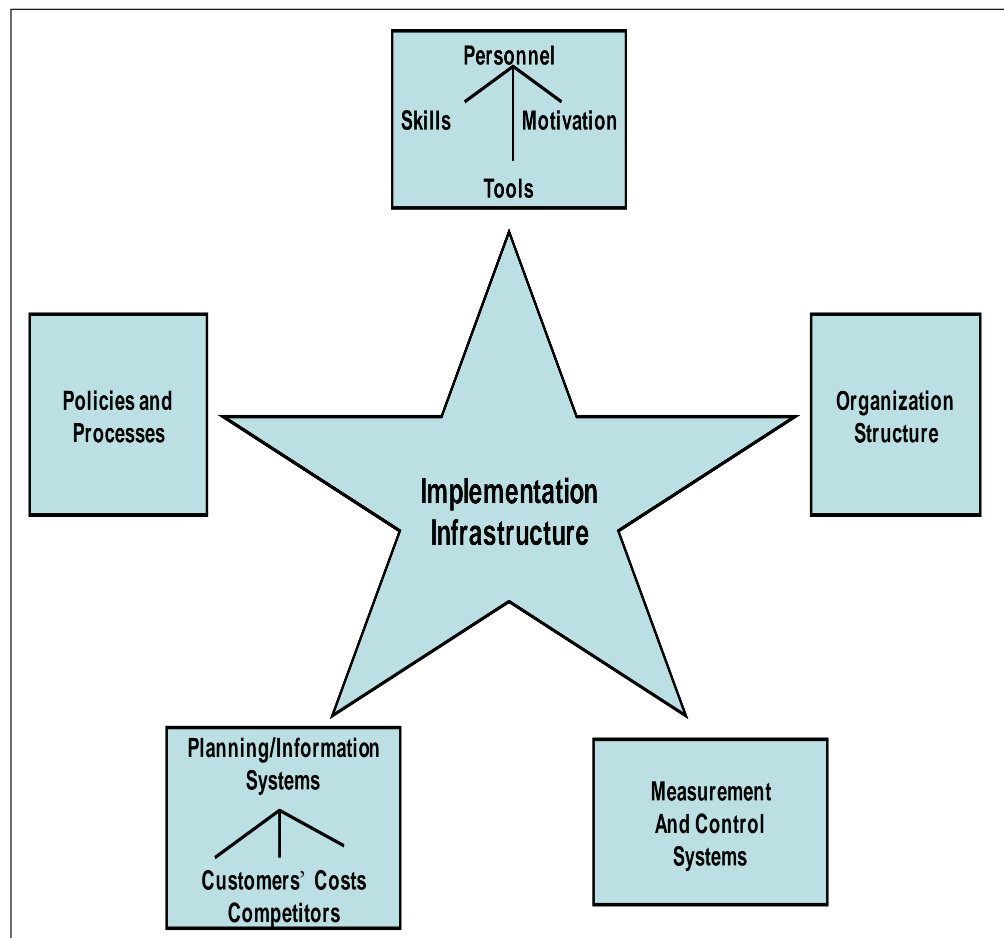
The focus of this article is the implementation infrastructure.

Pricing Strategy Implementation Infrastructure

Enabling the business to implement a pricing strategy involves the creation of an implementation infrastructure. The elements of the infrastructure – shown in Figure 1 – are the building blocks that make it possible for the business team to successfully carry out the aim of the pricing strategy.

Why is it critical to pay attention to the implementation infrastructure? Pricing strategies can fail in many ways, and the roots

Figure 1: Implementation Infrastructure Elements



of failure are often buried in organizational processes, systems, and tools. Practices disguised in organizational activities can create significant pricing problems (see, for example, "Fixing Prices"[1] for a discussion of how some of these "hidden" organizational practices can impact profitable pricing policy). Rather than allowing poor practices to creep into business practice, managers should consciously focus their effort on creating the infrastructure necessary for pricing strategy implementation.

Active management of each of the implementation infrastructure elements in Figure 1 (on previous page) is critical to successful – and profitable – management of pricing strategy. When managers experience challenges to their pricing strategy, diagnosis should include a review of these implementation components.

Control Systems

Many firms have a healthy dose of financial controls. While absolutely necessary, the challenge is, of course, that these financial controls (e.g., period income or average realized price) often reflect systemic pricing performance without direct reference to actual pricing practices. This can leave the management team scrambling to discover underlying pricing problems.

Inadequate pricing control metrics are often exacerbated by a lack of planned pricing performance reviews. For example, a client had the system capability to develop price dispersion, price by sales territory, etc. And, when senior management asked about pricing issues, performance plots were examined. The problem with this ad hoc review system is the "out of sight-out of mind" phenomenon. Undetected pricing problems escaped management's overview, and could have impacted profitability for a long period of time – until senior management asked another question!

What is needed is a regular, routine review of fundamental pricing metrics. As a minimum, management teams should routinely review:

- **Realized price**-volume plots for major products. The focus of a review of these plots is to develop understanding if customers are exploiting their bargaining power to leverage lower prices. Where there is little correlation between price and volume, negotiating processes are suspect.

- **Realized price by market.** This plot should be used to foster a discussion about why various markets have different price points and an assessment of individual market attractiveness. In addition, observing different market price levels should drive the management team to consider how they will "fence" markets to prevent migration of customers to lower price points.

- **Realized price levels by sales territory.** This plot should be used to identify where additional sales training and/or incentives are required.

- **Price Waterfalls.** These plots show the various discounts customers are granted. The management team should use these plots to develop a discussion around discounting policies and the effectiveness of individual discount practices.

Organizational Structure

A major challenge to profitable pricing practices is that pricing authority is widely diffused across the business. It seems that everyone has a position and view in the pricing process. This diffused pricing authority often leads to conflicting goals and piece-meal implementation of pricing strategies. Perhaps most troubling with this diffused pricing authority is the granting of price discounting policy to the field sales organization. Studies[2] have shown that when price authority is granted to the sales team, price levels tend to migrate to the floor price the sale team may allow. But, there is much more to the price concession game!

> Perhaps most troubling with this diffused pricing authority is the granting of price discounting policy to the field sales organization.

Price concessions are a deadly game because they have a tremendous impact on profits: for the average firm, a 10% price cut drives bottom line profits down 50%! But, price cuts do drive sales. Price concessions are powerful motivators for customers; they often get the sale.

But what happens when a firm cuts price? There are three deadly consequences:

1 The customer learns that price aggression is rewarded. They discover the more price demands they place on their supplier, the lower their price. It's entirely reasonable, then, for customers to demand more price concessions – they "win" with little effort.

2 So, price aggressive customers become more and more price sensitive. They realize that only price is important – not what they get from the supplier.

3 Suppliers who "successfully" negotiate price concessions find their customer discussions are focused only on price – and consequently have to spend more time in price negotiations to realize lower and lower price levels!

This is a "self-reinforcing" cycle: the more a firm negotiates price, the more it must negotiate price. And, of course, price levels continue to decline with each succeeding price negotiation. And, profits continue to decline along with price levels. And, the beat goes on! The more "successful" a firm is at negotiating price, the lower its profits. Not a good recipe for business success!

Managing the discounting process through centralizing pricing authority is key to successful implementation of pricing strategies. A sole source and responsibility for the development and execution of the pricing strategy is a foundation stone for managing the pricing process.

Of course, there are multiple options for the structuring of this centralized pricing authority:

- **At the business unit level.** This form has the advantage of connecting the pricing authority directly to the profit center. This makes it easier to see the influence of pricing on business unit profitability. In corporations with many individual business units, however, this organizational form may prevent recognizing and spreading pricing "best practices."[3]

- **At corporate level.** This organizational form facilitates standardizing on best practices across the entire corporation. The challenge to this organizational structure is that business unit leaders may feel they are distanced from pricing management – that pricing decisions are beyond their control.

There are clearly advantages and disadvantages regardless of which organizational form is chosen. The key is to establish more centralized control while removing control for price concessions from field authority.

Personnel Skills, Incentives, and Tools

Skill development is a critical element in building a profitable pricing practice. The most effective pricing strategy is value based, but value based strategy requires a very different set of implementation skills than do cost based or competitor based pricing strategies.

As with any organizational effort, effective personnel management must look at both capability and motivation. Assuming the marketing and sales team is aware of the desired pricing strategy and the goals of its implementation, individuals can be in one of four action states (this is based on the "situational leadership model"[4]):

Ability	Unable	Able	Unable	Able
Motivation	Unwilling	Unwilling	Willing	Willing
Leadership Style	Telling or Directing	Selling or Coaching	Facilitating or Counseling	Delegating

When a marketing or sales team member is:

- **Both Unwilling and Unable** – Managers must define the tasks this person must accomplish, and continually monitor for compliance. If a person remains in this state for a long time, managers must seriously consider whether employment should continue; the productive manager cannot afford to do both his or her job as well as the employee's job.

- **Able, but Unwilling** – Managers must attempt to motivate, or sell, the employee to do that which the employee is able to do. Again, if an employee remains in this state for an extended time, managers should consider continuing employment.

- **Willing, but Unable** – Here the manager can train the employee to do that which they are willing to do. The manager's role becomes that of facilitating to ensure the employee gains the required skills.

- **Both Willing and Able** – In this situation, the manager stands aside and empowers the employee to achieve objectives.

The critical assessment then becomes the state of readiness – seen as both ability and motivation – of the marketing and sales team.

When ability is the critical concern, skill development is best done in the "on the job context." Here skill development is conducted using the specifics of the marketing and sales teams' day-to-day jobs using real customer and market problem cases. The marketing and sales team are trained in value based pricing strategy development and implementation while practicing on projects that are part of their everyday work lives.

Motivation involves a mix of financial and non-financial incentives. Marketing and sales teams should be incented for driving profitable, not necessarily large, sales. Non-financial incentives should include appropriate use of recognition venues like corporate meetings, sales meetings, newsletters, etc.

A cautionary note: Senior management actions speak much louder than words. For example, consider this scenario: a client whose senior management espoused the use of value based pricing processes. A sales team had spent six months preparing for a negotiation with a customer who was known for their demands for price concessions. The sales team had built a powerful negotiating position, forcing the customer to give up really valuable offering components if they insisted on price cuts. When the customer refused to accept a lesser offering in exchange for a lower price, the sales team walked away from the negotiation. The customer's president called the client's president (who had supported the negotiation posture), arranged to play golf, and somewhere on the back nine a lower price deal was cut. The sales team was, of course, thoroughly discouraged; how could they ever again insist customers pay for delivered value?[5]

Sales teams should not be tasked to sell value to customers if the appropriate value management tools are not in place. These tools must be developed by the marketing team, and include:

- Definition of customer targets, selected on the basis of the

firm's ability to deliver differential value at competitive advantage.

- Value delivery analysis for target customers.
- Offering definition, including a "menu" of offering options (see the "Price Menu" paper by Gary Ottley[6]).
- Value communication messages and selling script development.
- Definition of negotiation processes that force customers to shift from negotiating price to negotiating offering delivery.

Processes

Along with diffused pricing authority, many firms suffer from confused pricing processes. There are two aspects of this confusion:

1. Lack of a clear process for setting price levels.
2. Lack of a clear process (and authority) for changing price levels.

Consequently, in many businesses pricing is managed on a situational basis.

Effective pricing processes are value based. That is, they start with definition of target customers and development of offerings that deliver value based on the target customer's business model. Customer targets are selected on the basis of a supplier's ability to deliver differential value at competitive advantage. In this context, value is defined as economic impact on the target customer's business through increasing the customer's revenue flow and/or decreasing the customer's cost of doing business.

There are then two issues in choosing target customers:

1. **The ability to deliver differential value.** Differential value is unique value, value the customer cannot get from a competitor. Delivering differential value is the key to achieving premium prices, as well as negotiating with customers in a way that forces the customer to acknowledge and pay for the value (customers are forced to trade off offering elements that carry differential value if they insist on lower price).
2. **Competitive advantage.** Competitive advantage involves the productive use of the organization's resources; firms with competitive advantage are more productive than their competitors in use of their resources. An effective customer targeting process results in customer choices where differential value can be delivered at competitive advantage.

As customer targets are selected, a value based pricing strategy then looks to understand the target customers' business models. Specifically, customer business models are examined in depth to understand how the customer chooses its customer targets, goes to market, defines its offerings, and achieves competitive advantage. In short, the value based firm develops an understanding of its target customers' business economics.

The next step in the value based process involves quantification of value delivery. In this step, the supplier learns how much it increases the customer's revenue flow, and/or decreases the customer's costs. Based on this understanding, the value based firm then develops an array of offerings (combinations of products and services) that allow the customer to make offering choices that best fit their business model. The implication, of course, is that offerings are designed specifically for the target customers' business models.

The value based pricing process then examines the quantified value delivery of each offering in its choice array. The question managers must address in this step is "how much of the delivered value will we capture with our price points?"

Firms with effective strategy implementation efforts have a clearly defined process for how they will evaluate value delivery, how they will price based on this value delivery, and who has authority for making these decisions. These processes are documented in policies, which are not negotiable. Pricing decisions are not determined by who the customer is; they are determined by corporate policy.

Discount decisions are made in a similar fashion. All discounts should drive business the firm would not otherwise achieve. Discount levels are set by clear rules about how customers qualify for discounts and how the discounts are granted. Again, discounts are not driven by customer negotiating power; they are driven by clear rules that apply across the customer base.

Data Systems

Another challenge for many firms is a lack of on-purpose collection of customer, competitor, and cost information. The problem here is that much market information is stored in the minds of individuals in the business team, and is consequently not tested and validated. The result is a lack of consensus about the drivers of business success, and disjointed interactions with customers and competitors.

Purchasing organizations have discovered the power of integrated data systems. For example, suppliers selling into the automotive sector have found that offering a price deal in a specific geography can have almost instantaneous impact in all regions. Increasingly suppliers are hearing "I want the product delivered in Western Europe, but I want the price you offered in China."

Data that is not validated across the entire market place can drive dangerous actions. For example, a marketing team hearing from a sales person that a competitor has cut price is likely to respond with its own price cut if it does not test the competitor's move across its entire market. Testing for the reality of a reported competitive price cut, and if real, whether it is a strategic or tactical move, is a prerequisite to making profitable pricing decisions.

The implication is that managers need a centralized, validated competitive intelligence data base. The competitive data must be routinely reviewed and its validity assessed. Assessment should be done using both managerial judgment (based on analysis across the entire customer set) and routine inputs from third-party assessments.

Marketing and sales teams also need a centralized customer data system. The customer data system should include analysis of customer business models and quantified value delivery models. This

provides a starting point for development of negotiating packages as well as the basis for identifying potential new offerings.

Finally, the marketing and sales teams need a thorough cost data base. This data base provides the context for making profitable customer targeting and offering design decisions. Some marketing teams argue they don't want the sales team to understand costs because they are likely to negotiate away all profit margin. The cure is obvious: don't grant price negotiation authority to the sales force. What the marketing and sales teams should understand is which offerings are more profitable to sell, and which customers to sell to. This requires these teams have complete cost information.

Conclusion

Often the key to successful pricing strategy lies in understanding the underlying organizational activities that preclude successful implementation. If the business unit has articulated a value based pricing strategy, failures are often not a strategy problem. The real problem is often a failure to adequately develop the means – the implementation infrastructure – to successfully execute the strategy.

Endnotes

[1] "Fixing Prices," by George E. Cressman, Jr., *Marketing Management*, September-October, 2006, pp. 32-37.

[2] See, for example, "Delegating Pricing Authority to the Sales Force: The Effects on Sales and Profit Performance," by P. R. Stephenson, W.L. Cron, and G. L. Frazier, *Journal of Marketing*, vol. 43, no. 2, 1979, p. 21.

[3] Of course, the danger of failing to capitalize on best practices may be mitigated to some extent through establishing a central coordinating function or committee. Still, the "my business unit is unique" phenomenon may make capitalizing on best practices difficult.

[4] See *Management of Organizational Behavior: Utilizing Human Resources* by Paul Hersey and Kenneth H. Blanchard, sixth edition, Englewood Cliffs, NJ: Prentice Hall, 1993.

[5] There was much more to this case. The customer took our client's price cut to a competing supplier, and used the price deal to leverage a lower competitive price – and then place the order with the competitor!

[6] "Value Based Pricing Strategy in Practice: The Price Menu," by Gary Ottley, *Journal of the Professional Pricing Society*, Spring, 2002.

"We know exactly what goes into the cost of each of our goods and services."

"Our sales force is focused on deal profitability."

"A 10% increase in the price of our premier product would lead to a 3% increase in revenue…with no net effect on market share."

We can help you develop the support for such statements – and help you organize the data to back them up, too.

Contact us to learn how.

usdeloittepricing@deloitte.com

www.deloitte.com/us/pricing

Deloitte.

Audit.Tax.Consulting.Financial Advisory.

www.deloitte.com

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Copyright © 2008 Deloitte Development LLC. All rights reserved.

Don’t Just Take Our Word For It

Don’t Just Take Our Word For It
Don’t Just Take Our Word For It

“This professional services firm (eClerx) specializes in data analytics and provides a combined services and technology ‘solution’ for the pricing process. Its focus is on data collection, process management, data mining and analysis with dedicated software development to support the pricing process. eClerx provides a customized analytics solution and wraps services around it, including process re-engineering, and data acquisition and validation. It…differentiates itself…by focusing on rapid pricing process re-engineering so that enterprises can implement a new process paradigm within a few weeks, achieving more agility.”

The Yankee Group

“By leveraging eClerx to manage the more tactical aspects of our business, our pricing teams have been able to tackle bigger, and more strategic issues. One of the most positive and unexpected benefits of our relationship has been increased job satisfaction of the pricing analysts on my team.”

Source: Large Texas – based electronics manufacturer

If you are truly interested in how eClerx can help you increase your revenue and margin through a well founded pricing program, give us a call at 512-252-4482 or visit our website (www.eclerx.com). Spend a few minutes with us and reap a lifetime of business rewards.

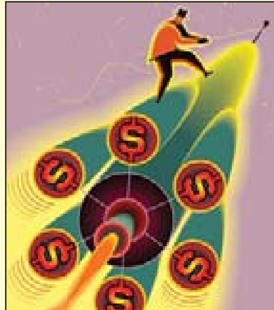
eClerx
virtual team

Pricing in The Cloud.

SaaS solutions for
Pricing Analytics, Price Negotiation, and Sales Optimization.
www.mimiran.com

MIMIRAN

Rocket Plan



The majority of new-product launches fail. However, it is seldom the technology itself that's to blame. A rigorous pricing approach can improve customer adoption rates, grow profitability, and increase return on investment. Companies can fuel success, as the authors outline in this article, with an approach that measures customer value, the innovation's nature, and the product category life cycle stage. **Mark Burton is vice president of Holden Advisors in Concord, Mass., and may be reached at mburton@holdenadvisors.com. Steve Haggett is a client manager for Holden Advisors and may be reached at shaggett@holdenadvisors.com.** **This article is reprinted with permission from Marketing Management, published by the American Marketing Association.**

Innovation is the fuel that drives growth. Any good sales executive can tell you that the quickest path to revenue growth is through new product innovation rather than fighting for share in existing markets. Innovation offers immediate differentiation and the chance to command a premium price. Yet the risks of failure are high. Consider this statement from Eric von Hippel, a professor of the Massachusetts Institute of Technology (Harvard Business Review, January 2007): "Recent research shows that the 70% to 80% of new product development that fails does so not for lack of advanced technology but because of a failure to understand users' needs."

A new-product launch enjoys many proud parents: the development team that followed a rigorous staged development process, the manufacturing organization that trained Six Sigma black belts, the marketing team that developed creative promotions and toured with industry trade shows, the public relations team that built a compelling publicity campaign, and the sales team that enthusiastically extolled the product's virtues to customers. So why are there high failure rates?

Many companies' innovation efforts are inwardly focused. The results are billions of dollars wasted developing offerings that have little to no appeal to customers. In business-to-business markets there are three principal reasons for that:

Failure to connect customer needs to value: financial, competitive, and strategic benefits to the customer. PictureTel was an early innovator in the videoconferencing industry 20 years ago, developing a breakthrough technology enabling live videoconferences. Its product launch focused on its leading performance and truly impressive technical capabilities.

Yet after PictureTel's great investment and product differentiation, the market did not beat a path to its door. The early value propositions failed to translate the cost of the system into clear value for customers: revenue benefits of reaching more customers or cost savings from travel. In 2000, PictureTel lost $100 million; in 2001, a smaller and more profitable rival purchased it.

Use of product-based value propositions centering on technical ability over market needs. Iridium was a triumph of rocket science. In 1987, the wife of a senior Motorola technology leader fumed because she couldn't call home from a boat in the Bahamas. Eleven years and more than $2 billion later, Motorola had successfully launched a necklace of 66 satellites linking $3,000 phone sets for $7-a-minute calls. However, cell phone customers wanted increasingly small units, not 1-pound "shoe phones," and the market for people who needed a dedicated satellite system for $7 a minute was tiny. In 2000, the network was sold for around $25 million—about a penny on the dollar for Motorola's investment.

Overemphasis on the role of pricing in driving customer adoption. Petrocosm launched as an oil industry transaction platform with a $100 million investment from Chevron and top leadership from the oil equipment industry. It offered a cheap source of high-technology drilling equipment. But in an industry requiring billion-dollar offshore platforms poised over explosive hydrocarbon reservoirs, replacing the trust and experience that trained sales and service representatives offer with a low-cost transaction failed to gain a customer base. The customer base didn't want cheap; it wanted cost-effective. Petrocosm faded away.

The good news is that the pricing process is straightforward and will improve the returns on investment in innovations. Most successful innovators follow a few simple rules:

- Define the financial benefits that customers receive from adopting the new solution.
- Align price levels with financial and psychological drivers of customer value.
- Align pricing strategy with the specific nature of the innovation and the product category life cycle status.
- Create outstanding launch programs—taking the emphasis off price by mitigating perceived risks for customers.

Companies that adhere to those principles enjoy significant benefits over their competitors, including (1) a more effective screening process that enables them to focus resources only on those innovations that provide significant value to the customer, (2) compelling launch programs that communicate the business value of innovations, and (3) a coherent pricing strategy that prevents panic discounting to drive sales. Taken together, those benefits translate to greater success rates for new offerings and better pricing for those that make it to market.

The Value-on-Innovation Paradox

In B-to-B markets, technological possibility often drives innovation, not defined customer needs. Living on the uncertain edge of technology, it should be less risky to focus on what's possible rather than invest money in less-certain research based on customer wish lists—trusting in Moore's Law rather than Murphy's Law. (Moore's Law is the observation that the number of transistors on an integrated circuit for minimum component cost doubles every 24 months, described by Intel cofounder Gordon Moore. Murphy's Law states that anything that can go wrong, will.) But the results show the drawbacks of a technology-driven approach.

Often, market research is focused on projections of market size and growth based on customer intent-to-purchase studies. Although this information can be important, it overlooks the most fundamental issue of whether an innovation will be successful: Is there a compelling business reason for customers to go through the upheaval of changing how they do things—to get the potential benefits of adopting your innovation? In short, what value does the customer expect to get, and how does value compare with the costs of switching? That question sets a much higher standard for research. To address it, companies need to focus on the six areas in Figure 1.

Figure 1: Customer Value

Define customer objectives	• How do customers make money? • How do they plan to grow? • How do they differentiate their offerings? • What are their greatest challenges?
Define current solution	• Which business processes support critical customer objectives? • What is the current work flow? • Who are the process owners and what are their priorities?
Define problem solved	• How does our innovation improve performance against key customer objectives and performance of critical business processes? • What is the impact of solving the problem defined? Is it significant enough to go forward?
Define financial impact	• How does our innovation affect revenues and costs relative to current solutions?
Define barriers to adoption	• What and whom in the customer buying group would our innovation affect? • What are the switching costs? • Is our innovation compatible with customer processes and supporting technology? • What is the organizational or political impact of our innovation?
Define likely adopters	• Who will benefit most from a change to our solution? • Who has the power to push for the change?

Great innovators use the answers to those questions to draw a map of where innovation will have the greatest impact—at both the market and individual customer level. Not until they understand (1) the customer value their innovations create, (2) the barriers, and (3) enablers of adoption do they finalize specifications. These same insights are used to define high-impact value propositions and to establish pricing models and price levels.

Defining barriers to adoption and identifying likely adopters are critical. Companies commonly misread how their innovations change the buying center dynamics. Existing customer contacts might not be the right targets for an innovation when relationships with new decision makers and influencers need to be cultivated. Companies often call on the same old contacts and fail to anticipate that those contacts will not have the power to drive change and/or are very much invested in the status quo. When that happens, they find that those relationships actually impede their ability to sell innovations to their current customers.

The smartest road to profitable returns on innovations starts with an understanding of the customer; technology comes second.

Using Value Insights

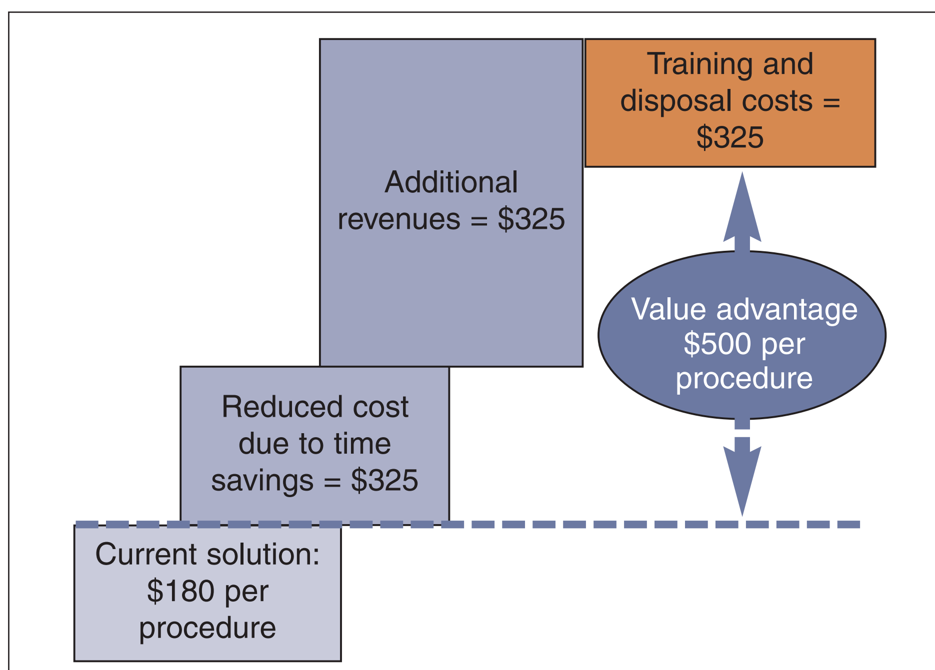
Translating the results of customer value research into effective pricing for innovations requires answering some challenging questions about value to the customer. Importantly, it is not necessary to exhaustively answer these questions at the start of your customer research and innovation development processes.

In fact, one defining characteristic of many leading innovators is that they are comfortable with a certain amount of ambiguity to start. The key is that they continue to (1) ask hard questions about customers and value and (2) refine their views on offering specifications, value positioning, and pricing. They do it early and they do it often.

Figure 2: Preparing for Effective Launch Pricing

> 24 months	18-12 months	< 12 months
Baseline analysis	Refine value analysis	Complete launch strategy
• Customer problem defined • Target specifications • Competitive solutions analyzed • Customer revenue and productivity improvement targets defined • Preliminary estimates of market uptake	• Statistical analysis of financial impact date • Product functionality testing conducted • First generation sales tool created • Initial sales team training • Specifications updated	• Product specifications finalized • Pricing finalized • Launch plan finalized

Figure 3: Use Customer Value Data to Determine your Price



A leading manufacturer of dental equipment (disguised), which has built its business by entering new markets with innovative offerings, does exactly this. Figure 2 shows a summary of its process.

It is tempting to look at the timeline and say "Our product life cycles are too short for this to be practical." But the fact is that all windows of innovative advantage are shortening. For all companies, it is critical to do value homework and get launch pricing right. Although your business might require far more compressed timelines, the process of establishing and refining your view of value to the customer is the foundational element for successful introduction, pricing, and positioning of innovations.

When the manufacturer was able to employ new technologies, to replace reusable dental instruments with disposable ones, it knew it had a potentially valuable innovation to bring to market. Through direct customer interviews and operational studies, it determined that such a device would improve procedure-room utilization by reducing cleanup time. The device also provided a market opportunity for oral surgeons seeking to differentiate themselves by advertising that they use the safest and most advanced equipment.

Using this information to establish a range for pricing is a three-step process: Determine the total costs to the customer of his current solution options, define the financial benefits that your innovation delivers over and above current alternatives, and identify the switching costs for customers who want to move to your solution.

In the case of our dental equipment manufacturer, that meant determining the following:

- the cost per procedure of current solu-

tions—by amortizing the total lifetime costs of current and reusable equipment over the number of procedures performed

- the cost savings due to greater procedure-room utilization
- the increases in revenues from patients brought in through oral surgeons advertising use of the new equipment
- switching costs (in this instance, disposal and training costs)

Its findings are summarized in Figure 3, on the previous page.

The results of customer value research yield a band of customer value and establish upper and lower boundaries for price range. Using that information about financial value, the manufacturer was then able to set an initial price that captured a fair share of the value created for customers. To do that, it first defined its value advantage over existing solutions: in this case, $500 per procedure. Next, it added the cost of the current solution to define the maximum range of price options available: $180-$680 (the $180 cost of the current solution plus the $500 value advantage).

To narrow down the range, the manufacturer analyzed the psychological elements of value from the customer's perspective. That included negative perceptions (e.g., risk from adopting the new technology, concerns about moving from the comfortable old solution to something new) and psychological benefits (e.g., pride in being on the cutting edge). Finally, the manufacturer needed to set a price that offered some incentive to purchase. At the end of the process, it decided on $400 per instrument. Although that was at the lower end of the possible range, it ensured a significant profit and gave customers a reasonable incentive to switch.

How do companies best select the right price within the range of customer value? Let's turn to that by looking more closely at pricing strategy.

Pricing Strategy Selection

To really refine the pricing decision, evaluate price ranges against a defined pricing strategy for your innovation. This is an iterative process of checking (1) pricing strategy against market research data and (2) possible price points against your pricing strategy. The best way to get your arms around the pricing strategy element is to think about the following two variables.

What is the nature of the innovation?

Is it a minor improvement, such as an interim software update? Is it a major one, such as the introduction of flat-panel TV sets? Or is it disruptive, such as the current move to solid-state flash memory for applications previously covered by high-speed disk drives?

Understanding the nature of the innovation defines the degrees of freedom that the innovator has in selecting a pricing strategy. Minor innovations (e.g., line extensions) are often necessary, but they do little to create advantage over the competition. As such, they provide little to increase pricing power. Innovations that are recognized as major breakthroughs present much greater flexibility in choosing a pricing strategy. This is because companies can keep prices high to skim value until the market develops—and then bring prices down to drive growth.

With disruptive innovations, the decision is a bit trickier. In the groundbreaking article "Disruptive Technologies: Catching the Wave" (Harvard Business Review, January 2005), Clayton M. Christensen points out that such innovations fall into one of two categories.

Some, such as flash memory, offer significant performance advantages for niche markets (e.g., aerospace applications) but are too expensive for mainstream applications (e.g., laptop computers). The best approach for these products is to go upmarket and use a skim pricing strategy—until costs and complementary technologies make it possible to enter mainstream markets.

Alternately, some offer inferior performance on many key attributes but offer clear benefits in one or two areas for some customers. That was the case with 3.5-inch disk drives when they were introduced. In that instance, the best approach is to go down-market and use a penetration pricing strategy with prices set below established alternatives.

Understanding the nature of the innovation defines the degrees of freedom that the innovator has in selecting a pricing strategy. Minor innovations (e.g., line extensions) are often necessary, but they do little to create advantage over the competition.

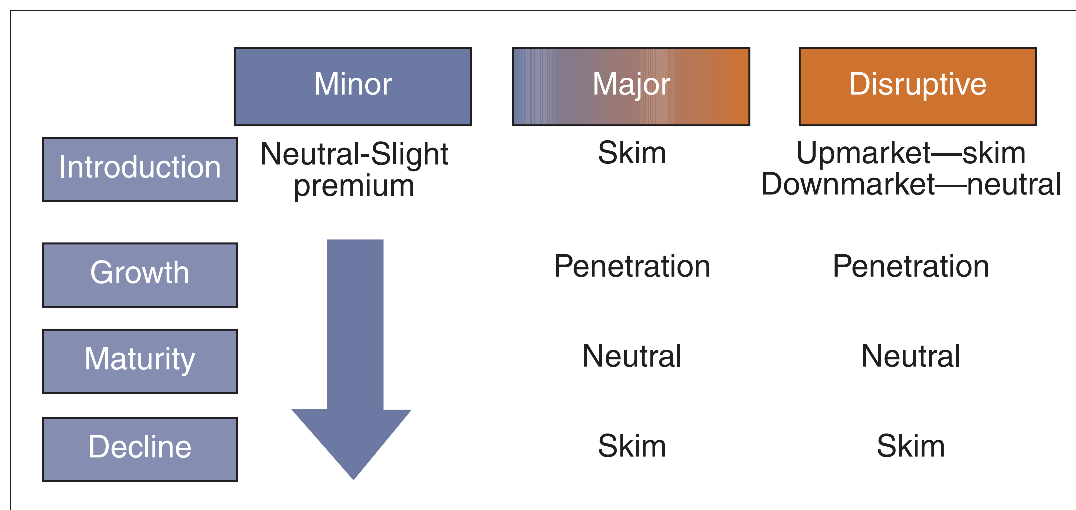
In what stage of the life cycle is the product category?

This element is critical but often overlooked. Failure to consider the life cycle dimension can result in disastrous financial consequences. That happened with flat-panel TVs. Early entrants initially played the game well. Prices for the early sets were high, reflecting both costs and the value that enthusiasts placed on them. As process technologies improved, prices dropped precipitously and customer adoption took off.

Unfortunately, as the market started to show signs of maturity, most manufacturers were slow to take their feet off the pricing gas. The result has been terrible margin pressures due to low prices and overcapacity—at exactly the time that consumers are becoming sophisticated enough to value and actively seek out differentiation.

Taken together, those two variables point to default pricing strategies for each combination type and stage of the product category life cycle.

Figure 4: Pricing Strategies Change with Market Conditions



Driving Customer Adoption

In addition to doing their homework on value to frame initial prices as fair and reasonable, great marketers take the focus off price by targeting the right customers, working to mitigate the risks of adopting a new technology, and making it easy for customers to see the value for themselves (as Figure 4 shows).

When rolling out a true innovation, marketers are often focused on identifying and converting early adopters. Those customers are desirable because they become references for later adopters. The motivations for early adopters run the gamut from (1) exploiting the latest technologies to get ahead of the competition to (2) desiring to satisfy the emotional need to be on the cutting edge. Regardless of the specific motivation, early adopters are traditionally less price-sensitive. However, they are still concerned about the potential challenges in adopting an innovation; even the most motivated aren't completely careless about how much risk they will take on. And if the price is too high for an unknown product and its unproven benefits, then the product might never get off the ground.

To address those concerns, marketers should build their launches on what does drive adoption of new technologies. And they should use that knowledge to support sales. Key drivers of customer adoption include the following:

- compelling advantages over existing technology
- the ability to observe and measure the impact of those advantages
- the complexity of the new solution
- compatibility with existing processes and technologies
- the ability to try out an innovation before making a full commitment

Note that price is not on the list. What the list represents is customer desire to mitigate the risks inherent in adopting an innovative new technology. Too often, companies fail to take into account these drivers of adoption when launching an innovative new offering. Instead, the approach is: "Our specifications are set. Our product is so innovative that it's hard to prove value or understand risk until we get it into customers' hands. Once they have it, they'll see the genius of what we have created."

Consider how Azul Systems addressed adoption drivers in the launch of an entirely new server for handling Java applications. In addition to being a new player in the business, Azul's product did not replace any existing customer equipment— further squeezing already tight information technology budgets. Yet it enjoyed a successful launch. Here's how:

- an economic advantage program: "A free, private consulting engagement helps customers quantify the financial gains their organization will realize through a computer pool deployment." (See www.azulsystems.com for more information.)
- integration of its technology that required changing only one line of code
- a relationship with IBM to provide global support, services, and spare parts to address customer concerns about ongoing support and maintenance
- documented adherence to widely accepted industry standards for interfacing with existing platforms
- a no-cost 45-day evaluation program for qualified accounts

Successful introduction of new products is challenging, but some simple things can be done to greatly improve your chances. More than anything, companies need to understand what ease of adoption will mean to their customers.

An alternative method of enlightening customers is often absurdly low introductory price deals. That compounds the perception of risk by leading customers to think: "If this technology is so good, then why do they seem so desperate for customers?" Price dealing to get those early "reference accounts" can also dramatically affect future revenues. Once low prices are out on the street, it is very difficult to raise them.

Pricing for Success

Price strategy can be the lever that maximizes return on the risky investment or the velvet rope that bars customers from your service. Get it right and your company enjoys a commanding market position, increased profits, and well-earned confidence across the team. Get it wrong and your company limits both sales and profitability and suffers from a weakened market position, financial performance, and team capabilities.

Lessons from successful new-product launches demonstrate an

effective process for innovation price strategy.

First, implement a customer-value measurement process as rigorous as the technology development process. Answers to the questions posed in Figure 1's six customer value areas will enable the company to (1) offer a quantified value message as compelling as the technology and (2) estimate a price range corresponding to customer value. Without a solid understanding of quantified customer value, the launch process is unnecessarily risky.

Second, within that range of customer value, set prices based on the interaction of the innovation's nature (minor, major, or disruptive) and the stage of product life cycle (introduction, maturity, growth, or decline). This simple matrix allows companies to plot a price point that maximizes both adoption and profitability.

The rules laid out here offer a guideline of where to set a price for a product or service innovation. That process can help companies overcome the long odds of new-product success— and fuel growth in both revenues and profitability.

About the Authors

Mark Burton is vice president of Holden Advisors in Concord, Mass., and may be reached at mburton@holdenadvisors.com.

Steve Haggett is a client manager for Holden Advisors and may be reached at shaggett@holdenadvisors.com.

Pricing Policy: A Tool to Implement Corporate

In many cases, in order to achieve their long tern vision, a manufacturer needs to coordinate their trade promotional policies (cost) and retail pricing policies (price) into a cohesive effort. To develop these two strategies in isolation is to not fully utilize the cost-price arsenal. An excellent example is the implementation of discounts, promotions and other pricing policies without significant research into the effectiveness, purposes or profitability of these strategies. Author Robert C. Maddux examines several of these promotions tactics and gives insight into how and why they can be counterproductive to revenue and growth goals.

Pricing is one of a company's most important and perhaps most neglected strategic resources. However, decisions on pricing need to be considered as the utilization of vital corporate assets. It is imperative that a manufacturer have an integrated, well planned pricing policy that penetrates all levels of their distribution channel. When a manufacturer does not have a clear, current, executable, and logical pricing strategy it leaves to chance and market forces the fate of its brand and its future.[1]

Pricing is often one of the most complex and contentious decisions facing a company. It often creates conflict between various divisions within a company. It is also one area of business research that is often overlooked by both managers and academicians, even though it is the only element of marketing that is directly related to revenues and profit.

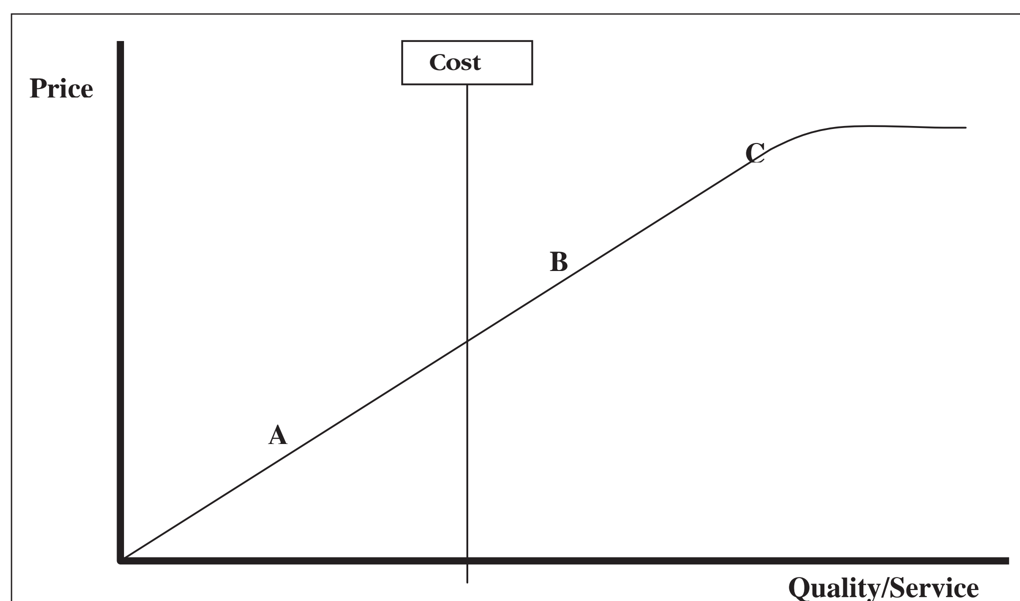
Pricing decisions in a company are often left to mathematicians who have derived complicated formulas. In many cases these mathematicians are more concentrated on producing a certain margin over what a product costs than with determining the product's actual value in the marketplace. The reason for studying and manipulating price should be to maximize value and profit.[2]

If the goal of pricing is to maximize value and profit, the cost of the product is not the starting point in a pricing strategy. The starting point is determining what a customer is willing to pay. Cost becomes a factor once market value has been determined. The goal is always to maximize profit; cost therefore is always a factor. But once market value has been determined, then cost may be affected by what the market demands.

It is possible that a manufacturer needs to raise or lower its cost based on what the customer wants. A customer may demand additional quality or service requiring a higher cost and selling price. Or, the customer may desire a lower quality or service requiring a manufacturer to cut their cost in order to reach the customer's price demands and still maximize profit.[2]

Looking at the graph below, most customers' "wants" lay somewhere on the Price/quality continuum. The higher the levels of quality and service they demand, the more they are willing to pay.

If the customers' "wants" lie at point C on the chart below, the company may need to raise their costs in order to provide that level of quality and/or service. However, if the customers' "wants" lie at point B, the company may need to reduce their costs with a resulting drop in quality and/or service in order to maximize profit. Finally, if the customers' "wants" lie at point A, the company may need to produce a new product or look at an alternative business model.



Strategy or a Reaction to Market Pressure

Pricing Promotions

Given that a manufacturer wants to maximize profit, why would they implement promotional pricing? Manufacturers use a number of pricing tools either to implement corporate strategy or react to market pressures. Among these tools are trade promotions, trade discounts, special discounts, volume discounts, suggested retail price, minimum advertised retail price, and minimum allowable retail price. In many cases, the reason why a manufacturer either did or would implement one or more of these tactics is not fully understood, long forgotten, or both, by the people in the company responsible for strategic management.

Exactly what is considered a "promotion" in today's market place often is unclear. For the purpose of this discussion, a promotion will be any additional discount off a manufacturers' "true" selling price (MTSP) to its primary retailers. Many manufacturers have numerous discount schedules and often play games with different discount structures and price lists. Manufacturers have wholesale price lists, distributor price lists, stocking dealer price lists, non stocking dealer price lists and more.

In this discussion, what we are referring to when we discuss the manufacturers' "true" selling price to its primary retailers is that price which the majority of retailers receive on a consistent basis. For example, if a manufacturer has a "wholesale price list" and 90% of the retailers in the market receive 20% off the wholesale price list as a standard procedure, then 20% off is not considered a promotion. It is considered the manufacturers' "true" selling price (MTSP) to its primary retailers. If 15% of the retailers receive 25% off for some qualifying reason, then that additional discount is considered the promotional discount. In addition, any discount or rebate that a reseller receives that is a factor of their purchases will be considered a promotion.

Discounts and Promotion:

It is important to understand why a manufacturer would want to have a promotional price. All manufacturers try to maximize net profit. It is therefore imperative to find the correct balance between price and quantity. Why would a manufacturer not just set what they believe is the optimum price and attempt to maximize profit dollars? Most of the reasons usually concern competition and market forces.

The following are two of the key reasons why manufacturers offer trade discounts and promotions:[4]

Capture maximum retailer inventory dollars: Most retailers have a certain amount of cash flow that is usually moderately fixed by their business activity. As the business grows or shrinks, this amount may vary, but for most typical retailers it is a fairly stable and constant variable. It is therefore in the manufacturer's best interest to try to capture as much of a retailer's total inventory dollars as possible. One key objective is to deny those dollars being spent with a competing manufacturer.

Capture maximum retailer inventory shelf space: As with inventory dollars, most retailers have a limited amount of space to store and display inventory. Capturing limited storage and display space can be of vital importance to a manufacturer. Consumers often purchase items they see or that are available at the moment. If a product is not on the shelf, in the line of sight or immediately available consumers are much less likely to buy it. Shelf space therefore becomes a high priority for many manufacturers, and the more visible the space the greater its importance. Therefore, manufacturers offer discounts and programs to capture a prominent place on the shelf.[3]

Types of Discounts and Promotions[1, 4]

Over the last twenty years manufacturers have created a number of types of discounts. Many of these discounts were developed in reaction to some type of market or competitive force. Regardless of the type of discount program, the two reasons stated above still appear to be the main intentions for having a discount or promotional program.

The numerous discount structures and types of promotion in use today can divided into the following nine basic types:

1. Quantity – Discount Schedules

A discount based on a quantity purchased is perhaps one of the oldest forms of promotional discounts and one of the earliest attempts of manufacturers to affect channel-coordination issues.[3] Basically these schedules reward retailers who buy greater quantities of inventory. Either through "quantity over time" or through "specific order size" a retailer is rewarded for buying specific quantities of inventory. There are also some circumstances in which a retailer can "double dip" on these promotions and purchase products with both types of discounts in effect.

It is evident that some manufacturers did not understand the long term consequences of these types of programs when they put them into effect. At first glance, it would appear logical to reward resellers with greater discounts the more inventory they purchased. This would certainly seem to be an excellent method

Many manufacturers have products that sell best during certain times of the year. A manufacturer wants to make sure that the right mix of products is on the limited shelf space at the correct selling time.

to gain retailer loyalty. However, in the absence of some type of retail price structure, which in many cases is illegal, this will also allow the strong reseller to get stronger and the weak to perish.

Furthermore, some manufacturers, when they implemented these discount programs, may not have realized that they were creating a situation that would allow for the growth of one regional retailer that was able to control the market and sometimes control the manufacturer. So how can this situation also affect consumer welfare? In a market with a large number of retailers of different sizes and strengths, a larger retailer, with multiple locations, can afford to function at a break-even or in a loss situation, in one location, for a sufficient period of time that could cause a smaller retailer to become insolvent. Once competition has been reduced or eliminated, the large firm is free to raise its price to a level higher than was currently in the market, or a level that might be controlled by a manufacturer's Retail Price Maintenance (RPM) agreement. Thus the manufacturer's discount structure, absence of RPM has allowed for the elimination of competition and the lowering of overall consumer welfare.[5, 6]

2. Time Sensitive Promotions (Push certain products at certain times)

Many manufacturers have products that sell best during certain times of the year. A manufacturer wants to make sure that the right mix of products is on the limited shelf space at the correct selling time. Therefore they often offer special promotions on the items that they want sold during these times, e.g. grass seed or deck stain at the beginning of summer.

3. New Customer/Growth Promotion

Many manufacturers offer some type of promotional buy for a retailer who is new to their line of products or to a current customer who wants to add an additional location. Most manufacturers want to grow through new outlets. In order to assist a retailer in opening an additional outlet or to entice a retailer to add their products or replace a competitor's products, an enticement in the form of a promotion is often given.

4. New Product Promotion

When a manufacturer introduces a new product it is imperative to have those products displayed and promoted. Therefore manufacturers often offer promotional buys around the introduction of a new product line. These promotions may have certain stipulations that require the reseller to participate in certain marketing activities. The level of involvement in the marketing activity by the reseller may affect the level of promotion from the manufacturer.

5. Reward for Compliance/Loyalty Discounts

A more recent phenomenon in today's business environment is the advent of manufacturer compliance programs. Today manufacturers are frequently trying to attract new customers and improve customer loyalty by offering a better buying experience. Many manufacturers sell to independently-owned retailers and often have no direct control over the way these resellers conduct business. Therefore they need to influence certain behaviors through monetary rewards. These types of programs can involve many diverse elements including store appearance and set up, personnel staffing levels and training, inventory mix and stock levels. They may also influence advertising programs and even the way the businesses operate concerning ethical practices. In addition, loyalty discounts are often included as part of a compliance program.

6. Segment Driven Promotions

Many companies face markets with a number of distinct and separate consumer segments in which willingness to pay for a product or service (price elasticity) differs greatly. In simple terms, one group of buyers is willing to pay more for a product or service than another group. In order to receive full value for their product from each segment, a company needs to find ways to segment, market, and price to these groups in diverse ways. For instance, the Wall Street Journal sells at one price to a standard household, perhaps a 70% discount to a college student, and a 100% discount to a college professor.

Segment driven promotions become more difficult when a company sells its product through resellers. Manufacturers are often faced with trying to pass a promotion to the targeted end user without passing additional discount to the reseller. When the discount is given to the reseller, it can be difficult to prevent the reseller from passing that discount to all segments instead of only to the particular segment the discount is intended to reach. These types of promotions are often referred to as price tailoring, and

could perhaps be considered price discrimination.

In order to implement profitable segment driven promotions, the following three elements must exist:

- The different segments must have clear, definable boundaries.
- There must be a true willingness on the part of the segments to pay different prices.
- Finally the cost of implementing the program must be less than the sales increase received.[7]

7. Spiffs as Promotions

Manufacturers are beginning to realize that there are many factors, other than the power of their brand, that affect consumer preference. Consumers can be swayed by many factors, one of which is the recommendation of a professional. To the degree that reseller store personnel are seen as experts in a particular field they can have a strong influence on brand preference. Often brand preference can be shifted or modified by store personnel. Many manufacturers understand this "personnel modified preference" for brand selection and work hard to make sure retail store personnel are adequately trained on the merits and features of their products. However, some manufactures, under special circumstances, pay bonuses, usually referred to as "spiffs," directly to store personnel for selling their products. These spiffs have proven to be effective in influencing reseller staff to recommend one product over another

8. Year End "Make the Number" Promotions

What happens when the sales department is in charge of year end promotions? Often year end bonuses are linked to total sales for the year. When those sales are short of goals there are often last minute efforts to make these goals. Ad hoc promotions designed to make year end numbers can be the least effective and most costly promotions utilized. Usually these types of promotions do not increase yearly demand, but only move demand for one period to the next.

Experience has shown that in many cases the timing of a purchase by a retailer may be affected by a promotion, but the overall yearly purchases are not affected, creating a periodic but un-sustained peak in sales. These periodic swings in sales, production and inventory level are known as the "bullwhip effect".[1] What makes this particularly costly to manufacturers is that this peak demand often causes increased production cost on goods that are selling at a significant discount.

9. Promotions as a Tool to Reduce Manufacturing Cost

In many cases it actually costs a manufacturer more to generate products during a special promotion phase than it does to make them during normal demand times. Therefore a manufacturer's profits can be hit particularly hard during some promotional periods.[1] They take a reduction in their normal gross profit and their variable costs to produce the goods increases in order to meet increased demand. Meeting demand during promotional periods can involve overtime, increased warehousing and shipping costs, and even increases in the price of raw materials needing to be expedited. It is definitely in a manufacturer's best interest to try to schedule and plan demand periods. In an attempt to accomplish this, some manufacturers have built programs that reward "planned growth."

Measuring your efforts: Discounts, Promotions and Price Elasticity[7]

It may be surprising the number of companies that use a variety of promotions and discounts to accomplish a combination of the goals mentioned above and never stop to measure if their actions are actually effective in increasing the bottom line. When establishing pricing actions, many companies need to stop and understand the price elasticity of their products. Price elasticity is the most common gauge in use in determining responsiveness to price changes. Understanding that quantity purchased is a function of price charged is the basic tenant of price elasticity. Most business managers do not have a problem understanding price elasticity in a qualitative sense. If we drop or raise prices do we expect demand to go up, hold steady or plummet? The greatest difficulty is trying to quantify what effect our price changes or promotions will have on demand.[6]

In simple terms, price elasticity is the ratio of percentages that expresses the responsiveness of demand to a small change in price. Price elasticity can be divided into two major demand functions. These two demand functions are referred to as linear and constant. In the first case of a linear demand function, the slope is constant but the elasticity is not. Slope is the change in quantity when price changes slightly. Elasticity is the percentage change in quantity caused by a small percentage change in price. For a linear demand curve, the percentage change in quantity (elasticity) changes with price. [7]

The second case of a constant demand function describes a demand curve with a constantly changing slope. The demand conditions in this scenario are the opposite of the linear demand curve. The slope changes at every point while the elasticity remains constant. A constant elasticity demand curve assumes that a small percentage change in price will cause the same percentage

change in quantity. The value of the initial price is unimportant. The rate of change in quantity versus price is equal to a constant throughout the curve. This constant which is expressed as a ratio of percentages, is the elasticity.[7]

For the purpose of quantification, price promotions can be divided into two broad categories;

- Temporary price reduction
- Permanent features of pricing structures

In order to quantify the value of temporary price promotions it is valuable to divide sales metrics into two key components: baseline and incremental. A company's baseline sales are those sales that would have been achieved in absence of any promotion or pricing action. A company's incremental sales are those additional sales caused by any such action. The incremental sales increase is also referred to as the "lift" associated with the promotion.

It is important to note that time plays a vital element in analysis of incremental sales. If a company only looks at its baseline and incremental sales in a narrow time frame there may appear to be a significant increase over baseline. However, if that same analysis is stretched over a longer period, it could show the incremental sales increase over baseline to be marginal or non-existent with the decrease in price. For a complete understanding of measuring pricing action please refer to chapters 7 and 8 of "Marketing Metrics: 50+ Metrics Every Executive Should Know" by Paul W. Farris et al.[6]

> Until recently, attempts by manufacturers to implement any true Retail Price Maintenance (RPM) agreements have been met by the courts as automatic violations of current antitrust laws.

Is "every day low price" the answer?

Many manufacturers have put into effect a patchwork series of discounts and promotions that have evolved over the years in an attempt to resolve some of the dilemmas created by their poorly conceived mix of discounts and promotions. Often a new promotion solves one problem, but creates another. Over time, pricing and discount policies can become a mélange of special deals, one off programs, and specific incentives that make it difficult for business managers to understand or control their full effect. In an attempt to clean the slate, some manufacturers are investigating the merits of every day low prices (EDLP).

In fact, EDLP will level the playing field amongst retailers. As it has been mentioned, the use of various buying promotions has allowed larger retailers to become larger and stronger at the expense of smaller retailers. In addition EDLP will allow a manufacturer, to a greater degree, to establish a consistent manufacturing schedule that does not have as many peak demand periods and the associated costs of a group of promotional buys.[1]

EDLP probably will solve some of the ills that have been created by inadequately planned discounts and promotions that have been implemented over the years. However, when you remember the two key reasons why discounts and promotions were implemented in the first place, which are to gain more inventory dollars and gain more inventory shelf space, will an EDLP program create a situation in which a manufacturer is losing either of these two vital elements? Just as promotions have created many issues that were not foreseen or expected, one can predict that a fully implemented EDLP will also have some long term unforeseen and unexpected consequences.[1]

Before launching an EDLP program a strategic manager must consider the functions that current promotions are designed to perform. This analysis must consider the effect on subsequent order cycles as well competitive and channel reactions. A carefully constructed "modified" EDLP that includes discounts and promotions built around structured and planned long term goals may be the answer for some manufacturers.

The role of Retail Pricing Policies

Manufacturers have used promotional policy in an attempt to solve myriad distribution and retailer issues. They have also tried to use promotional policies in an attempt to control downstream prices that resellers charge to their consumers. However, these strategies often do not have the desired effect because the manufacturer has had little or no control over prices actually charged to the end user/purchaser by the reseller.

Manufacturers have also attempted to affect downstream prices on their products using a number of retail pricing tools. One of these tools is Minimum Advertised Price (MAP) which forbids a reseller from advertising a manufacturer's product on sale below a certain minimum price. Any MAP policy is as effective as the resolve of the manufacturer to enforce it. Some manufacturers have taken strong stands when dealing with violators of MAP policies. Others have turned a blind eye and their policy is more propaganda then regulation.

Another retail pricing tool that is often employed is manufacturer's Suggested Retail Price (SRP). Many manufacturers have published lists of prices which they use to recommend prices to resellers who are selling their products to retail customers. These prices can be an actual attempt by manufacturers to establish a value level for their products. But in reality these efforts are often ignored by the resellers who are under no obligation to utilize them and manufacturers have no power to enforce them.

A few courageous manufacturers have in fact implemented Mandatory Retail Pricing (MRP) under the Colgate Doctrine, a Supreme Court ruling that allows a manufacturer to enforce a mandatory retail pricing schedule, but only if it is an all or nothing proposition. However, it is a decision fraught with possible negative legal side effects and implementation difficulties.[5]

Until recently, attempts by manufacturers to implement any true

Retail Price Maintenance (RPM) agreements have been met by the courts as automatic violations of current antitrust laws. A RPM agreement is basically a manufacturer's requirement that downstream distribution conform to a set of minimum or maximum prices. Price maintenance agreements usually involve contracts that are enforceable through a set of consequences by the manufacturer if they are violated.

A recent United States Supreme Court ruling has cracked the door open slightly for manufacturers to consider using RPM agreements. However there is still an opportunity for legal action against manufacturers by the state courts. In the recent Supreme Court case, it was argued that RPM prices particularly affected high tech, information-intensive consumer durables. There are also ample examples to illustrate its effect on products that are considered commodities. In many product lines, however, there is a group of consumers that will benefit from higher prices on commodity type items because of the inherent needs of the customer, not the just the differentiation of the product. [5,6]

In a number of market situations, involving differentiated products, including brand names, RPM can actually serve to enhance consumer welfare. This happens when "retail service" becomes a fundamental element in the buying decision as opposed to price being the primary factor. Retail Service is broadly defined as the numerous elements that are a part of the decision and satisfaction fundamentals of a completed transaction. This may include more modern equipment, enhanced displays, product-specific information, improved store hours and locations, retailer certification, additional and superior trained customer service personnel, sufficient inventory, post sale satisfaction, and the list goes on.

The salient argument against Retail Price Maintenance is that it would be logical that retailers who provide these services would attract customers who desire them and Retail Price Maintenance would not be necessary. However this does not happen when a premium service retailer tempts an inferior service provider whose primary selling technique is price competition, to become what the court refers to as a "free rider." A "free rider" is a retailer who takes advantage of another company's assets and steals the customer on price alone. This becomes a vital factor when that customer could not have made the buying decision without the premium service provider.[5]

As discussed earlier, another way that RPM will secure long term overall consumer welfare is that it protects the small retailer from the regional or national entities that have the potential to lower their prices in one market in order to drive smaller competition out of business. A larger retailer can afford to work in a loss situation for a sufficient period of time that could cause a smaller retailer to become insolvent. Once competition has been reduced or eliminated, the large firm is free to raise its price to a level higher then was currently in the market, or a level that might be controlled by RPM. Thus the absence of RPM has allowed for the elimination of competition and the lowering of overall consumer welfare.

There is another factor at play here. It is one that allows certain manufacturers to be able to pick and choose in which markets they will compete purely on price and which markets they will compete on service. Some manufacturers that also have completely vertically integrated retail operations, who only sell through their own stores, can select which markets and customers they will sell products to based on price alone and in which markets they will choose to sell service. To the degree that customer segmentation can be fined tuned so that a manufacturer knows where their "service oriented customers" reside, it can be argued that a vertically integrated manufacturer has a marked advantage over one that relies on second step distribution.

The current question now is what does the future hold for retail price maintenance agreements? Will the Supreme Court decision produce radical change in manufacturers pricing policies? Will manufacturer begin to exercise more courage in developing pricing and promotion policies that work to achieve their long term business goals?

In many cases, in order to achieve their long tern vision, a manufacturer needs to coordinate their trade promotional policies (cost) and retail pricing policies (price) into a coordinated effort. To develop these two strategies in isolation is to not fully utilize the cost-price arsenal. Company leaders may have to review who, within their organization, makes the decisions on reseller cost and retail price issues.

In cases where these strategic decisions are made in isolation from each other it cannot possible yield an optimum solution. If the marketing department is making all decisions on the cost at which products are being sold to resellers and the sales department is making the decision on retail pricing schedules, one can not expect a coordinated perspective that will most effectively support long term corporate strategy. Recent Supreme Court rulings (Leegin Creative Leather Products, Inc. v. PSKS, Inc, dba KAY's KLOSETS...KAY'S SHOES) [8] have definitely opened the door for manufacturers to have greater flexibility in coordinating those efforts.

A fully developed Cost-Price strategy is of greater importance for a manufacturer whose strategic direction is to be a premium service provider as opposed to a low cost leader. According to Z John Zhang, a Wharton marketing professor, "Previous legal treatment of retail price maintenance meant that specialty stores had diminishing incentive to offer informational and other services, since consumers were likely to purchase goods at discounters after tapping specialty stores for data about the goods," he says. "Now, with fewer obstacles to retail price maintenance, more retailers may be encouraged to provide service." [9] It is now up to manufacturers to have the vision and courage to move in this direction if they want to establish their brands as premium, and exemplary service is a key element to that brand offering.

Note:
A special thanks to Dr. Paul Farris (Landmark Communications Professor of Business Administration, University of Virginia, Darden School) for all of his help and guidance in my academic pursuits.

References:

1. Kusum Ailawadi, Paul Farris, Ervin Shames. "Trade Promotion: Essential to Selling through Resellers." Sloan Management Review (1999).

2. Kostis Indounas. "Making Effective Pricing Decisions" Athens University of Economics and Business, Indiana University, Kelley School of Business, HBS BH 211.

3. Paul Farris & Kusum Ailawadi. "Retail Power: Monster or Mouse?" Journal of Retailing Vol 68 #4 (Winter 1992).

4. James Olver & Paul Farris. "Push and Pull; A One-Two Punch for Packaged Goods." Sloan Management Review # 53 (Fall 1989).

5. Kenneth G. Elzinga and David E. Mills "The Economic of Resale Price Maintenance." Forthcoming in Wayne D. Collins, Issues in Competition Law and Policy, American Bar Association Antitrust Section (2008).

6. Marie L. Fiala and Scott A. Westrich. "Leegin Creative Products; What does the New Rule of Reason Standard Mean for Resale Price Maintenance Claims?" The Antitrustsource (August 2007).

7. Paul W. Farris et al. "Marketing Metrics: 50+ Metrics Every Executive Should Know." Wharton School Publishing (Jan. 2007) Chapters 7 and 8.

8. Leegin Creative Leather Products, Inc. v. PSKS, Inc, dba KAY's KLOSETS...KAY'S SHOES. Supreme Court of the United States (2007)

9. "Retail Price Maintenance Policies: A bane for Retailers, but a Boon for Consumers." Knowledge at Wharton. Stephen Laboton. "Century Old Ban Lifted on Minimum Retail Pricing." The New York Times. 29 June 2007.