PROFESSIONAL PRICING SOCIETY

The PRICING ADVISOR

The Pricing Advisor™ is published monthly by the Professional Pricing Society
3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
www.pricingsociety.com
Eric G. Mitchell, Publisher
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A Professional Pricing Society Publication

October 2008

Despite challenging economic conditions, producers of luxury products and companies that serve booming markets (like segments of the farming industry) are thriving. In other sectors, firms which have nurtured strong brands find themselves much better positioned to increase prices to keep up with rising costs. Author Tim Smith, PhD, Chief Editor of The Wiglaf Journal, *examines how smart pricers are successfully meeting the challenges of an unpredictable marketplace. Tim is the author of* Hawks, Seagulls, and Mice: Paradigms for Systematically Growing Revenue in Business Markets. *For more information, you can reach him at: tsmith@wiglafjournal.com.*

The Right Response to Fluctuating Prices

These are exciting times. Prices are in flux. Many companies are raising prices, some easily, others not so much. Still others find price increases unattainable. How to make sense of all this? Or, more precisely, what should a pricer do?

The answer involves making strategic decisions responsive to current global economic conditions, as well as seizing competitive opportunities. Many of the price changes in 2008 have been directly driven by developments in the world economy, which are unlike any we have seen in the past 40 years.

In the U.S., the richest 1% reported 22% of the national total adjusted gross income in 2006—the highest percentage since 1929. This suggests that while the wealthy can increasingly buy high-end and luxury goods, most other consumers face more challenging economic situations. Middle- and low-income Americans are suffering from volatile and decreasing home prices. All Americans are adjusting to higher fuel prices at the pump, though again higher-income market segments are affected less. For the majority of people in the U.S., stagnant wages, losses in the major savings vehicle (the home), and a higher core cost of liv-

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  3. Core Pricing Skills – Mark Billige, Simon-Kucher & Partners, London
  4. How to Build an Optimal Pricing and Discount Structure that Supports Business Strategy across Different Markets – Marc Abels, Deloitte Consulting, Belgium

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ing (transportation and food) encourage a psychological environment of high uncertainty and frugality. From this perspective it can be expected that most Americans will limit their spending to necessary or individually valuable items. Most, but not all.

Globally, developing nations are seeing the ranks of the newly rich swell, producing consumers able to purchase previously unattainable goods. Yet most people in these countries must deal with higher cereal prices cutting into their already meager incomes. (These price hikes are largely driven by the increased costs of oil coupled with a growth in demand as China and much of Africa urbanizes, along with the shift of the new middle class from greens and root vegetables to cereals.)

We see these effects directly in the fortunes of companies serving the higher end of the economic spectrum. Luxury goods makers are reporting strong earnings and gaining high stock valuations.

- Hermes International SA, maker of men's fashion, reported a 10% increase in sales between April and June in the Americas.
- Compagnie Financier Richemont SA, maker of Cartier and Montblanc, reported a 6% sales increase in the Americas for the same period.
- Burberry Group PLC's sales in the Americas climbed 27%.
- Patek Philippe SA, maker of luxury watches, is on track to sell out its entire inventory.

Similar corporate buoyancy is reported in Europe and in fast-growing emerging markets where the ranks of the newly rich are growing. Even manufacturers of somewhat tangible goods for the masses are making moves to capture the upper end of the market. For instance, Nokia unveiled two high-end mobile phones, the N79 and N85, although this may also be mostly fueled by the desire to compete directly with Apple's iPhone.

All of these price actions by luxury goods makers are directly related to the new or sustained wealth of the rich. But for firms serving the common consumer, where most of the economic adjustments come in the form of pain, price changes are far more challenging.

Driving Price Increases to Match Higher Costs

Consumer goods manufacturers, focusing on the masses, have had to boost prices to keep up with increasing commodity prices and energy costs. But companies with strong brands, which serve middle-income consumers, have been able to weather economic fluctuations far better than those with weaker ones.

On the positive side, we find:

- Hershey Co. raised prices 13% on chocolate bars in January and boosted promotional spending. Second quarter revenue increased to $1.11 billion aided by the price hike as well as growth.
- Kraft raised prices 7% and lost only 1% in volume, while achieving a 3.5% jump in net income for the second quarter, partly due to the price increase and expansion.
- Wrigley's second quarter net rose 14%, which was attributed to higher North American prices (despite a 5% decline in volume) and favorable foreign exchange rates on international sales.

Not all price increases were direct. Some came from reducing the product size or otherwise cutting corners in terms of the value of the product.

- General Mills Inc.'s Cheerios price increased to $2.98 from $2.86, while the product size decreased from 10 oz to 8.9 oz.
- Hershey Co. is substituting vegetable oil for a portion of the cocoa butter in some of its chocolates.
- McCormick & Co. is supplying food companies with cheaper spices and new flavor blends.
- General Mills is reducing the number of spice and ingredient pouches in boxes of Hamburger Helper.

Other firms, specifically those with weaker brands or firms dealing in meat and contending with higher grain and feed costs, have not been so fortunate.

- Sara Lee has not weathered the recent commodity cost increases as well as its rivals, posting a profit margin of only 7.7% in the recent quarter (after executing four price increases) compared to 17.5% for General Mills Inc. and 15.5% for Heinz. This is partly due to its holding a weaker brand position.

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- Tyson hasn't yet been able to pass on the high chicken feed costs to consumers, resulting in its net income plunging to only $9 million in the third quarter. CEO Dick Bond anticipates price increases on the horizon.
- CEO Clint Rivers of Pilgrim's Pride encourages Americans to "brace themselves for sticker shock in the meat case over the next 12 months" as he prepares for price hikes on chicken. (Read: concurrent price signaling.)

Outside of the food industry, many firms have seen stagnant prices with declining volumes. For instance, Barnes & Noble Inc. reported sliding sales of 1.6% over the year prior. This outcome, and others like it, can be largely attributed to declining disposable incomes as consumers focus on getting to work and buying food rather than improving their homes and taking care of creature comforts.

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Business Marketers Are Also Affected

The price changes reach beyond the consumer market area. Manufacturers of equipment and supplies that serve the food-producing farms are also seeing a healthy market. Farmers, reaping windfall profits from a global increase in cereal consumption and a misguided corn to ethanol policy, have recently found their pockets lined and are prepared to make new investments. Companies serving these farmers are capturing this demand and enjoying the profits.

- Genetically modified seed maker Monsanto Co., fertilizer maker Mosaic Co., and farm equipment maker Deere & Co., are all seeing rising sales and climbing stock values.
- Deere & Co. particularly anticipates further price rises for 2009 of 7% on tractors, 9% to 10.5% on combines, and 4% to 9% on construction and forestry equipment, while its customers (farmers) enjoy a two-year, grain-price rally.

Strategic Marketing Issue

What are all of these price changes telling us? Much. First, the moves by luxury good makers and companies supplying farmers highlight how pricing power is strongly affected by the economic situation of the target market. Unfortunately, this situation fluctuates constantly and somewhat unpredictably. Thus, pricing power and volume are strongly influenced by chance. Being in the right place at the right time enables some companies to "outperform," while others linger on. (As one mentor told me, being in the game is half of winning.) Making the most of these opportunities is the key management challenge for these fortunate firms.

Second, the moves by consumer food makers demonstrate that companies with stronger brands and more differentiated products have fared the best in the current economic turbulence. Unfortunately, true differentiation requires investment to uncover non-obvious customer needs and to develop new products to meet them. Furthermore, branding isn't a one-shot effort. It takes time. Sara Lee investors hopefully understand this, and CEO Brenda Barnes needs to take further action on this front.

Finally, companies in industries that fail to respond to higher costs by raising prices suffer. Both Pilgrims Pride and Tyson need to further communicate the need to boost prices and then back it up with execution. Time is not on their side, so they must act promptly.

Pricers must make adjustments considering the entire marketing mix. They need to consider external factors such as industry health, economic changes, and competitive moves. They should also factor in strategic issues under companies' control, such as promotion, distribution, and product quality. Many executives will fail to make the necessary adjustments, proving themselves unable to execute except against managerial dictates and no-longer-relevant historic patterns. But the most able leaders will find fresh solutions based upon sound strategic thinking and continue improving with the new opportunities that change brings.

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How Best to Compare Price and Performance for IT Services

Companies assessing whether to outsource IT services should make careful use of cost and price benchmarking studies. Authors Uwe Helmer and Gary Tovey, both Vice Presidents with IT Advisory Services for PricewaterhouseCoopers LLP, point out the potential pitfalls of these tools and offer a blueprint for applying them most effectively. For more information, please contact: uwe.helmer@ca.pwc.com or gary.tovey@ca.pwc.com.

When we're driving and notice a police cruiser in the rearview mirror, most of us instinctively check our speedometer even though we may have checked it a split second before. Business managers similarly feel anxious or defensive when asked about performance measurements due to the ever daunting question of IT performance and, if it is under par, the related outsourcing discussion.

To alleviate this problem, organizations should incorporate best practices by formally educating staff and benchmark participants, including them early in a performance measurement program whose goals and objectives are clearly explained.

Benchmarking, the comparing of existing values/metrics to internal or external values/metrics, is an integral part of any performance measurement initiative in virtually all businesses. While this exercise has been regularly applied to assess financial performance within companies for years, it's only over the last decade that IT organizations have used benchmarking as a management tool. In the early days, it was only utilized in data centers and mainframe shops, but by the mid-nineties, it affected all IT service areas.

Benchmarks allow organizations to understand how they compare to top performers and, in some instances, how to communicate what tangible value their IT services bring to a business. Organizations that perform internal benchmarks and compare the results to external peer groups hope to find areas where they can reduce costs, increase service levels, or improve process performance to meet growing business demands.

IT services benchmarking generally focuses on either cost or price. Both approaches are useful, but their goals and methods differ. Cost benchmarking compares internal IT services and costs of user IT organizations, while price benchmarking compares what vendors charge clients during the delivery of an outsourcing contract. This distinction can be confusing to IT managers trying to choose the most effective method for their environment.

This choice is made even more difficult when both methods are necessary to reach a monetary-based business decision (e.g., during outsourcing negotiations when making an internal cost to external price comparison using price ranges).

Unfortunately, end-user organizations have begun to view cost benchmarking as intrusive and offering limited value. They consider the effort to gather data for a benchmarking exercise onerous and time-consuming. Benchmark results are viewed with suspicion or disbelief, and are often challenged by the organization's "underperformers."

The situation is made worse when internal service structures and service levels are compared against external offerings to determine a market price or base case comparison. In this case, it's difficult to ensure that the collected base data is consistent when most clients differ in scope, complexity and service levels.

Vendors typically dislike price benchmarking exercises because clients automatically assume they will result in contract price reductions. Although this is a possibility, a reduced service price is not guaranteed if a true market comparison methodology is applied.

Despite these challenges, many CFOs are reluctant to commit to a multi-year, multi-million dollar outsourcing deal without a benchmarking clause that measures contract performance during the relationship. This is understandable. After all, would you lease a new car without a warranty?

The relationship between outsourcing clients, vendors and respective benchmarking organizations can best be described as a love/hate relationship. Benchmarking is disliked but perceived as a necessary performance measurement tool and therefore widely accepted and applied.

This article recommends an approach that can benefit end-user IT organizations and vendors interested in exploring the use of cost or price benchmarking.

Using a Cost Benchmark to Determine the Market Price for IT Services

Organizations that outsource regularly benchmark vendors' prices against similar outsourced environments to determine if their deals are still competitive, and how to remediate them if they're not.

Given the high stakes, it is not surprising that controversy exists on the best way to benchmark IT services, includ-

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ing what methodology works best, what results should look like, and who is best qualified to conduct a fair and objective benchmark study.

Benchmarking Cost

User IT organizations should use cost benchmarking to compare and contrast IT services and their delivery against peers (i.e. other IT departments providing similar services to internal business users).

Cost benchmarking should determine:

- How an IT organization's cost compares to that of best practice firms delivering IT services at similar levels; and
- How the organization's cost compares to the "average cost" incurred for similar IT services among all the firms delivering them internally. This comparative analysis must take into account costs for a given service level.

These objectives, combined with a process maturity assessment, can highlight areas where a company can improve its process and reduce costs.

Cost Benchmarking for a Base Case

IT organizations that in-source, typically use cost benchmarks to optimize performance, measure against the competition and learn from other groups that develop best practices.

In certain instances, however, a firm that outsources may find that cost benchmarks can be useful to construct a "base case," positioning the internal IT department for competition.

The base case consists of two elements:

1. The ideal cost of service; and

2. The necessary investment required to elevate an IT organization's internal IT services to a level that an outsourced vendor should deliver.

This second element is critical. Too often, user organizations simply compare vendors against their internal "budget" and the delivery cost at current service levels. A typical vendor usually opens a sales pitch discussion by saying "we can reduce your IT budget by x%."

Clearly, if business units are dissatisfied with their IT services (which may drive the decision to outsource), they should increase the prospective budget so they have the investment required to attain higher service levels. This will establish an "apples to apples" comparison between the customer cost of delivery and the vendor price.

Using a cost benchmark to construct a base case is unusual. In general, base cases should begin with the current budget, adding the necessary investment cost to elevate service levels.

> Too often, user organizations simply compare vendors against their internal "budget" and the delivery cost at current service levels.

In rare circumstances a cost benchmark substitutes the budget in the base case only, for example when a "greenfield" (i.e. newly created) environment is to be implemented and no actual or historical budget numbers can be used.

Benchmarking Price

Many price benchmark studies are executed incorrectly, resulting in misleading results. Few service providers capture outsourcing contracts and proposals on an ongoing basis. Such efforts cannot truly determine a fair market price since they do not consider the full breadth of the user environment.

Research shows that many firms and consultants rely more on readily available cost benchmark information from internal IT departments, and adjust or convert this cost data into an inaccurate market price.

This is typically done through a simple—but faulty—formula, which can have negative consequences on contract negotiations:

Contract price = Cost - Leverage Factor + Profit Margin + Risk.

(*Explanation of formula: Reduce the cost by the percentage of leverage that the advisor assumes the vendor can achieve. Then add the profit margin extracted from the vendor's annual report or another source plus a risk factor.*)

To an objective and knowledgeable observer, it's evident that this formula's success in determining a realistic market price depends on several crucial factors:

1. The vendor's leverage factor against each unique environment must be correctly assumed.

2. The service provider must always bid within the assumed profit margin range.

3. A benchmarking firm needs to consider the scope of services offered by the vendor and select similar (in scope) comparators/peers of the environments the costs are derived from.

The issue with this benchmarking approach is that all the factors used to calculate the answer involve guessing to some degree since vendors do not typically share leverage factors with anyone. In addition, they may not bid according to the expectations of benchmarking firms, speculating about their profit margins.

Although a vendor's goal is to make profit, we often observe these firms offer heavily discounted contracts to achieve other business goals such as market share increases, strategic account penetration

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and short-term revenue growth.

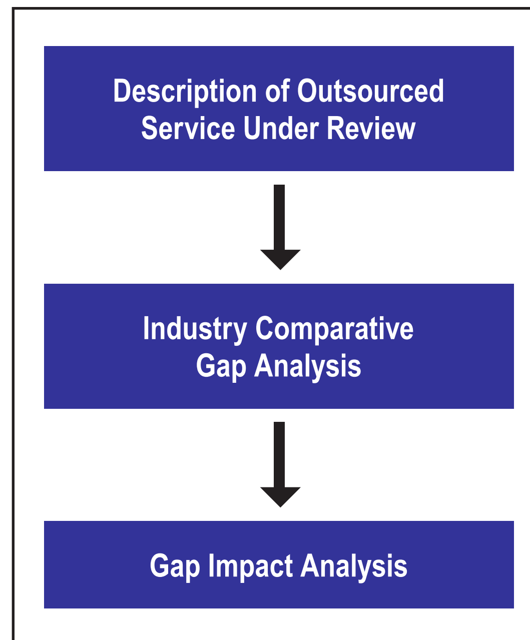
The scope of services in a typical outsourcing agreement is often fundamentally different from those provided by internal IT organizations. A challenge vendors face is demonstrating to customers the savings they can achieve versus the internal solution.

Part of the difficulty is gathering all the appropriate costs from the client organization because many of those costs, known as "shadow" costs, fall outside the purview of the IT department. An example of this is corporate overhead charges, which are not recognized in the IT budget (but should be in a good base case).

Since the information used in cost benchmarks excludes hidden costs, using cost to perform a price benchmark will omit key information and improperly assess the value that outsourcing may deliver. Cost information cannot account for the vast differences in service levels often demanded of vendors over internal services, though it may "declare" them.

Differences in these levels and costs are among the most important factors in determining outsourcing prices. Misstating their impact can distort a benchmarking analysis.

The best way to mitigate errors that may result when cost information is used to calculate price benchmarks is to base the process on price information (outsourcing contracts and pre-contract documents).



This approach enables user organizations to answer more accurately the critical questions: How much does the market charge for these services; and how does that price compare to total potential costs if these services were offered internally?

The Importance of Cost and Price Benchmarking

Depending on the unique operating model and objectives of an IT organization, cost and price benchmarking studies can be invaluable tools when applied appropriately. They help IT organizations:

- Determine the price competitiveness of IT services;
- Identify gaps in service levels;
- Prioritize IT investments and improve return on them;
- Understand processes of best practice organizations that enhance performance and customer satisfaction;
- Avoid lengthy outsourcing evaluations by quickly determining if outsourcing can yield cost savings or improve service levels;
- Save money by providing the intelligence required to negotiate outsourcing agreements effectively; and
- Maintain price and service-level effectiveness by continuing to assess the market competitiveness of sourcing agreements.

Generally, the most effective approach for benchmarking an outsourcing contract involves using comparative analysis. This requires the vendor and the client to jointly use an independent third-party advisor to work through the operational review (benchmarking) phase of the contract. This review is necessary to align price and performance during the term of a contract.

There are right and wrong ways to benchmark IT services. Both comparison "tools" (cost and price) have their clear place and benefits in managing an IT organization, but for different reasons. Although both methodologies are valuable, they are not interchangeable, so seek experienced advice if you are in doubt of what is the right tool to select.

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Can Sellers Make More by Renting or Leasing Their Products?

Rafi Mohammed, the founder of Culture of Profit, a business consulting company, looks at the publishing and automobile industries to examine why firms have made the critical decision to sell rather than lease or rent their products. For more information, you can contact Rafi at: rafi@cultureofprofit.com or visit his website: www.pricingforprofit.com.

Why Certain Publishers Should Adopt the NetFlix Pricing Model

The age-old problem for publishers is that once a student buys a textbook, he can later resell it, used. This resale prevents the publisher from earning profits on the sale of a new book to a future student. A professor friend of mine estimates that roughly 40% of his popular economics class purchases used texts.

I did a little research on the used book market, and the numbers were surprising. **A popular textbook retailing for $100 is being bought back by used bookstores for $31. So, in essence, a student who paid $100 for the book pays $69 to "rent" it for the semester. The used bookstore in turn resells the text for $55.**

The fact that there's a thriving resale textbook market out there clearly demonstrates that some students prefer to rent their books. Instead of ignoring this market, publishers need to embrace their customers' pricing preferences. There's profit to be made by serving both the rental and purchase market.

Publishers ought to consider adopting the Netflix pricing model for their textbooks. For, say, 50% of the list price, students can rent a book. At the end of the semester, they simply return it to the publisher on campus or via mail.

This is a win-win proposition for both students and publishers. For books with a $100 price tag, students can rent their texts for $50 (which is less than it costs to buy a new copy) and resell it to a used bookstore (net cost = $69), or purchase a used copy ($55). Publishers win by continuing to profit from the value of their textbooks.

Just to be clear, I'm not advocating that publishers stop selling books—many students want to keep the copies they have learned on. I'm suggesting the publishers offer the option to buy or rent. This new pricing mechanism would enable them to benefit from the resale market.

Additionally, publishers could offer a variety of other options such as renting a new hardcover, a used hardcover, or a (new) one-time-use paperback (which would be destroyed when returned) at various prices. Offering these alternatives could also be a selling point to entice professors to select a particular company's titles—"we offer your students a variety of pricing options that are better than what rival publishers provide." The only firms that would lose with this strategy are those buying used books from students at a paltry 31% of list price.

My thanks to economist Patrick DeGraba for contributing his ideas to this discussion.

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Memo to the Big Three Automakers: Don't Abandon Leasing

In July Chrysler LLC announced it would stop offering leases through its lending arm, Chrysler Financial. Soon after, the *Wall Street Journal* reported that both GM and Ford were scaling back their leasing efforts. Once considered a key driver of growth, leasing is now on the endangered species list at the Big 3 U.S. automakers.

Leasing is the pricing concept of renting a vehicle for a fixed time period (e.g., 36 months). At the end of the lease period, you simply turn in your vehicle or purchase it at a pre-negotiated price. Leasing companies forecast what the value of the car will be at the end of the lease, and your payments cover this depreciation cost.

Once considered a key driver of growth, leasing is now on the endangered species list at the Big 3 U.S. automakers.

This is what's so interesting about leases…payments have little to do with a vehicle's selling price. Instead, they are based on how much a vehicle depreciates over the lease term. This is why Honda can lease a $25K CR-V for $199 a month, while Ford has to charge roughly double that amount for a similarly priced Taurus. Since you aren't buying a car, leasing payments are usually lower than loan payments. (One web site claims 30% - 60% less).

The crinkle to leasing, of course, is forecasting a vehicle's residual value–there's a great deal of uncertainty. I mean, who could have imagined that gas would reach $4 a gallon when a SUV lease was signed three years ago? The Power Information Network reports that last year, higher gas prices depressed the resale value of pick up trucks and large SUVs by 12% and 11% respectively. In part due to these lower residual values, Ford announced that its financing division had to write down $2.1 billion in Q2/08.

If I were a U.S. automaker, I wouldn't be so quick to abandon leasing (note: no foreign car makers are scaling back their lease programs). A large segment of customers prefer to lease (20% of Ford and Chrysler vehicles are leased compared to 40% of GM's retail sales). Who amongst us is willing to risk losing 20% - 40% of our customer base?

So what's a Detroit automaker to do? They need to hire econometric specialists to improve their vehicle forecasting models. Economists use sophisticated statistical tools to forecast our economy, insurance liabilities, and Wall Street futures prices…I bet they can handle residual car values.

Lease prices will inevitably go up. Ok…so instead of being 30% - 60% lower than monthly payments, perhaps they are now 20% - 40% cheaper. And yes, some customers will switch to foreign car leases because of these price increases. But if the alternative is losing a significant chunk of current customers, if I were the Big 3 ... I'd brush up on my vehicle depreciation forecasting skills.