

Price Optimization: Why it's Important and How it Works

by: Paul Sansom

In this article, the author explains what price optimization is, how it works, how to ascertain if price optimization is right for you, and how to identify the right path to a successful implementation. Paul Sansom (psansom@vendavo.com) is a Denver-based Business Consultant focused on understanding market challenges, building business cases, and driving business value and outcomes for Vendavo customers. Paul has a wide range of expertise in business development, forensic market analysis, CRM management, marketing communications, field engineering, and corporate business strategy. He will be leading a breakout session entitled "Are You Prepared for the AI-Driven Pricing Revolution?" on October 12th at the PPS 34th Annual Fall Conference in Atlanta.



Things have changed **A LOT** since May 2021 when [this article](#) was originally published.

Where Picasso had his Blue period, we should call the last couple of years the Murphy's Law Period. Whatever could happen, did happen: the worst of the COVID-19 pandemic, runaway inflation, exploding interest rates, seeing energy prices, domestic political turmoil, crypto's meteoric rise and catastrophic meltdown, a (still ongoing) land war in Europe, billionaires behaving badly, dangerous and deadly storms, and the list goes on. Hell, a giant boat clogged up the Suez Canal and almost brought the global supply chain to a halt. You see what I'm talking about?

Each of those events alone could have caused issues for business, but all together? AT THE SAME TIME?!

Companies used to annual or biannual price changes were subject to many more than what their organization could handle, and trusted legacy systems and processes began to strain, stutter, and stop under that pressure. It exposed a lack of automation, an inability to quickly or proactively respond to market impacts, and an ever-widening technology gap. In increasing frequency,

Commercial and Pricing Leaders began to ask themselves 2 questions: **What technology is out there and is it right for us?**

These questions invariably lead to another issue, one that I like to call The Three Stooges Effect, named for the scene where Larry, Curly, and Moe all attempt to go through a door together and get stuck. There are many different directions that organizations can go, but are often paralyzed by indecision, competing priorities, and a lack of strategic direction.

One of the first trails that people often tread down is **price optimization**. Two words that, when put together, have taken on an almost-mystic quality in the past few years. Many people use them confidently, but far fewer use them correctly.

Often misappropriated with other elements of the commercial excellence suite, **few organizations start their journey with an appropriate understanding of what price optimization is, how it works, or if it is "right" for them.**

A senior executive at a company with an effective price optimization program once told us that just one person in their

entire organization understood how their pricing solution worked. He then went on to explain, more accurately, there were actually probably two people – each of whom half understood.

This lack of understanding is common among companies. The executive's rationale for being okay with the fact that no one understood the solution was also commonplace. The company was doing well and they were realizing an improvement in profitability. Did it matter that they didn't really know how it worked?

Such a lack of understanding can really limit success. And of course, any knowledge gaps are likely to kill the potential for continued or added improvements over time. **That's why the importance of pricing optimization programs must be understood – and believed in – by everyone who uses them.**

When utilized effectively, **price optimization can be one of the biggest barriers to margin erosion and lost business brought on by market factors.** By understanding your customers' Willingness-to-Pay in a variety of market conditions and placing guardrails

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to prevent any course deviation, your organization can implement a dynamic pricing solution that fits any pricing methodology or commercial strategy.

Within this article, we seek to explain 2 things: (1) what price optimization is and (2) how it works, and as our collective understanding of the subject improves and we realize that SkyNet will not be in control of a company's prices, you will also begin to ascertain if price optimization is right for you and put you on the right path to a successful implementation.

What is Price Optimization?

Price optimization is the practice of deciding upon the most effective pricing for a product or service. It is the process by which an organization seeks to find the optimal price that their customer is willing to pay for a product. Not so high that they risk losing that customer's business and not so low that they sacrifice margin, but just right.

Reliant on crystal clear data, great pricing optimization enables companies to offer their products at the price points that are most likely to be picked up on by customers.

Optimal price points will deliver the best possible profits for

the company and may also be designed to achieve additional goals such as assisting in improving the company's market share or enabling expansion into previously unexplored markets.

What Does Price Optimization Involve?

Price optimization covers a wide range of different factors, and companies looking to ensure that their prices are all fully optimized will be managing a combination of these. The first thing to consider is which pricing areas the company needs to optimize.

1. Starting Prices

The starting price of a product or service is of course fundamental to its success, so pricing optimization is key here. Pricing optimization software will analyze data to reveal the best possible starting prices, taking a wide range of internal and external factors into account.

2. Discounts

Many companies opt to push their products out to larger audiences, or tempt back past customers, with the offer of discounts. Well-managed pricing optimization software can also be used in these instances, to ascertain the optimal price points.

The Benefits of Price Optimization



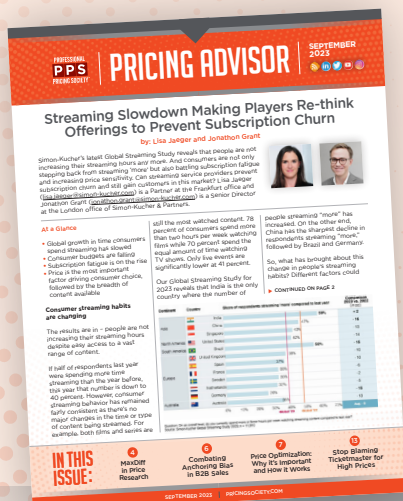
- Measure ROI
- Maximize Profits
- React Faster
- Gather Insights

Pricing optimization brings a multitude of benefits, which are evident throughout the sales process. Take a look at some of the main advantages of pricing optimization strategies.

1. See fast, measurable ROI improvements

With pricing optimization software, it's easy to see how things are improving. ROI can be closely monitored, with all changes available to view in real-time. This data-driven approach enables teams to respond to fluctuations in demand quickly, maintaining the best possible ROI for the company.

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2. Maximize sales and profits

The best possible price points allow companies to achieve their true potential, particularly when it comes to maximizing sales and profits. Customers are more likely to pick up on products and services when they're priced optimally, and companies soon reap the benefits.

3. React faster to market changes

Pricing software makes it possible for companies to react quickly to changes in the market, outsmarting their competitors by offering goods and services at the best possible prices for any given circumstances.

4. Gather insights into customer behavior

The more data a company has, the better it can understand its customers. And with this understanding comes immeasurable opportunities. Data allows companies to offer products they know their customers will love – at prices they're sure customers will respond favorably to.

Price Optimization Models



- Science and Strategy
- Blackbox vs Clear Box
- Simple Rules Engine
- Clever Math Angle

Data is incredibly valuable when it comes to pricing. However, it can fall short if not used effectively. When it comes to

price optimization models, there are a couple of different approaches – each with their own set of challenges:

• **Combining “Science” with “Strategy”**

Remember SkyNet and all the phobias it created? Well, I've got news for you: we are way past that. Algorithms are here to stay, and they control almost every aspect of our digital lives. But as their ubiquity expanded, so too did our understanding of how they work. Therefore, modern optimization systems should give immense control to the users. Gone are the days of letting the algorithm make all the decisions. Now users should be able to combine their business strategy with the unlimited potential of an optimization model, overriding decisions when it makes sense and guiding the system to better outcomes. This should be done within the User Interface (UI) and should not require a data science or coding background.

• **“Black Box” vs “Clear Box”**

Black Box AI refers to an antiquated philosophy where systems take in data and spit out guidance, without any transparency. Historically, this has been a hurdle for many organizations that would otherwise be good candidates for price optimization, as they lack trust in these technologies. When the system does make decisions, it should be completely transparent as to why that decision was made, and that background should be both easily accessible and defensible. This includes all of the math and actions that led to that guidance.

• **Simple Rules Engine**

Business rules enable organizations to set broad and/or scenario-specific guardrails that mitigate any risks

associated with science-based price optimization, such as capping price changes for a customer group. Individually, a rule is easy to understand, but as the number of rules builds up over time, they conflict with each other, which means new rules are then created to fix erroneous combinations. The result is often many layers of conflicting rules which are far too complex to visualize.

• **Clever Math Angle**

Algorithms are used to try to solve the issues that the rules engine creates. While the solution may work, it's difficult to validate at a granular level. Users are asked to simply trust the answer. High-level statistics, operational research, and dictates from a “black box” aren't feasible for most organizations.

The simple rules engine approach is fiendishly difficult to manage, but the “clever” approach is often just too opaque and doesn't deliver real control to the business. **Neither option builds confidence** among the sales team so that they can fully deliver on the promises of the software vendor. Regardless of whatever the black box recommends, it's only the confidence of the front-line sales and deal negotiators that can deliver actual business improvement.

This is where strategy comes into play. While the models above deal with the number crunching, the execution is where real gains can be found. Smarter price optimization solutions allow developments in **algorithm-driven technology** to infuse with the intuition of humans in order to deliver when it counts.

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How to Develop a Price Optimization Strategy



- **Solidify Your Strategy**
- **Know Your Customers**
- **Organize and Analyze Your Data**
- **Measure Value Through Real-Time Insights**
- **Look to AI and Automation**

How a successful optimization strategy looks will vary from company to company. The core ingredients include a strong understanding of the customer base and access to data and real-time insights that ensure teams don't have to rely on guesswork or hunches. All of this can of course be aided by technology.

Here are my recommendations to successfully optimize your pricing.

1. Solidify your Strategy

Listen, I get it. Implementing a price optimization strategy can be a big step, which is why it is crucial to have a comprehensive business strategy that includes value expectations for the new system. What data is necessary to understand differences in price? Do expectations differ from division to division, product to product, or channel to channel? What does your roll-out plan look like? Does your sales team's compensation align with the new strategy? These questions and more should be answered within your business strategy prior to implementation.

2. Know Your Customers

The key to knowing price optimization rests within each potential audience. Users of pricing solutions and **price management software** must have some understanding combined with a relevant level of control. Likewise, teams must have a good understanding of their target customers to achieve the best pricing optimization strategies.

3. Organize and Analyze your Data

Make use of specialist pricing optimization software to organize and analyze data with ease. By keeping a careful eye on the most important metrics, teams can tweak pricing optimization strategies and provide a fully flexible and dynamic service. Tracking transactional metrics, such as both the optimized price and the final invoice price, will give insights into performance and effectiveness and highlight what is and isn't working.

4. Measure Value Through Real-Time Insights

Far too many companies make the mistake of compiling data and only looking at it from time to time. Beat the competition by leveraging insights in real-time. In doing so, you'll put your company in a position where it can respond to any changes in demand at a lightning pace – and profits will soon soar as a result.

5. Look to AI and Automation

Technology has so much to offer here, so keep an eye out for the latest developments in pricing optimization. AI and automation can help companies offer the best possible pricing at any given time. They can also cut down on time spent managing processes manually, freeing up teams to explore even more advanced optimization options.

Price Optimization Examples

It might be helpful to take a look at some real-life examples where price optimization might be impacting your daily lives:

• Car Insurance

Automotive insurers use advanced gathering techniques for both personal and market data, including your loyalty to other service providers and shopping behavior, to arrive at an optimized price. Optimization has been shown to punish the consumers who do not shop around and compare prices.

• Airfare

The airline industry has been one of the most prevalent users of price optimization over the past decade or so. Unlike car insurance, airlines are far more reliant on active aggregation of competitor prices and comparative price elasticity. This is why tickets for most major airlines move in similar patterns. Even "budget" airlines will take advantage of major airlines' higher prices by making themselves more attractive during highly competitive periods.

• Rent

Rental price optimization has drawn major scrutiny recently and is an excellent example of an algorithm running amok. By controlling such a large market share of rental prices, software from a single company drove prices up so high that it pushed away loyal renters, created higher vacancy rates, and drew the ire of the US District Court with alleged price fixing. The point of price optimization is to improve pricing while keeping your customers happy, not drive them into bankruptcy.

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Why Price Optimization Sometimes Fails

Many failed pricing optimization strategies are the result of poor understanding, but there are other aspects of pricing optimization which – when overlooked – can spell trouble. These are the most common pitfalls to avoid.

1. Guesswork

Pricing optimization relies on the clever use of carefully compiled data. If it's based on guesswork and subjective data points, it's doomed to fail. Make sure your prices are fully optimized with the help of consistent, well-managed data to avoid such problems.

2. Data Errors and Inaccuracies

Another issue we often see is the failure of pricing optimization due to errors and inaccuracies in data.

3. Pricing Isn't Value-Based

Price optimization strategies should always take value into account. Value-based pricing is of course vital to the success of any sale, no matter which external factors a brand is taking into consideration.

4. Heavy Discounting

Discounts can be a real secret weapon when it comes to drawing in customers, but heavy discounting can put a spanner in the works of even the best pricing optimization strategies. Instead of discounting products too quickly, or by too much, offer products or services at

the optimal price point for your target market.

5. Overcomplicating the Ask

As with any system or process, added and unnecessary layers of complexity will bog down the optimization and create contradicting guidance. Furthermore, too much granularity in your models can quickly lead to diminishing returns.

10 Tips for a More Successful Price Optimization Project

A price optimization project is a major undertaking for any company. There are often multiple internal stakeholders, and it is likely to affect a wide range of internal systems and processes, from basic product management systems to cost and profit allocation and customer relationship programs. When done right, it can be one of the most profitable activities a company can undertake. But when done wrong, the dangers are equally significant.

Based on my experience, here are some final tips I have for any company that is about to embark on a price optimization project with the target of sustainable improvements:

1. It starts at the top. C-level support is critical.
2. Excel is a great tool for ad-hoc analysis, but not for operational pricing.

3. Distribute central and local responsibilities within a common framework.
4. It is a change management project, not a price list project.
5. Communication is key.
6. Focus on your desired business outcome rather than a specific platform or technology.
7. Set up a well-planned pilot, measure results quickly and comprehensively, then apply learnings in full, rapid implementation.
8. You need the right cross-functional competences on the team, including price management, product sales, business analysis and intelligence, and IT.
9. It is a full-time job. Whoever is running this should be focused on running this project and have few other responsibilities.
10. Create a reference framework in order to understand local and segment differences.

Summary and Key Takeaways

Price optimization can be a powerful tool in your mission to price better, react to market conditions, and keep your customers happy.

But that doesn't mean it's a simple concept to understand, though hopefully this article has helped you gain a better understand of both price optimization and how it works, as well as helped you determine if your organization is a good candidate for this kind of solution.