Pricing Myopia

Executives often suffer from pricing myopia. They don’t see the freedom they have to use pricing to enhance the performance of their businesses and even create competitive advantage. Because of their distorted or limited vision, they underestimate their power to manage pricing, mistakenly believe that their customers are paying the amounts stipulated by their pricing guidelines, passively accept the prevailing approaches to pricing in their industries, or neglect to consider how they could use pricing to change the competitive game.

As a result of their myopia, executives are responding to today’s economic challenges by trying harder to reduce costs, boost asset productivity, and pursue growth. But they often ignore pricing opportunities. Their companies may offer unnecessary discounts, miss chances to improve their competitive position through pricing innovations, and wage destructive price wars.

“I Don’t Have the Power to Manage Pricing”

Many executives lament that forces beyond their control—the sluggish world economy, deflation in major markets, increasing global competition, persistent overcapacity, growing customer power, and the impact of e-procurement and online auctions—have a significant impact on their ability to manage pricing. They insist that they lack the power to manage their pricing and that it’s a huge challenge to maintain prices, let alone raise them. They assert that pricing is a zero-sum game: if they raise prices, the lost volume will negate the effect of higher margins; if they lower prices, the additional volume will not be enough to compensate for the lower profitability of lower-margin business.

The reality is often not nearly so grim. Executives have this misperception because they are overly focused on cost. They have a much more sophisticated understanding of cost than of what customers value, and set their prices on a cost-plus basis.

Consequently, there is often a significant difference between a company’s prices and the amounts that customers are willing to pay or that competitors can afford to charge. Different customers frequently place different values on products and services, as well as on specific components of an offering. In addition, perceptions of prices vary. This is true in virtually every market—even industrial and financial-services commodities. The keys to capturing such value are to

- deepen the understanding of demand elasticity and customers’ behavior by analyzing existing data or conducting experiments
- segment customers more effectively along dimensions besides price sensitivity (such as current and lifetime cost to serve, delivery times, quality, and support)
- communicate the value of the offering more effectively
- develop innovative pricing structures that elicit each segment’s full willingness to pay

One approach is to change the pricing mechanism in a way that raises the prices of those elements of the offering to which customers are less price-sensitive and lowers them on the elements to which they are more price-sensitive.

Seattle-based Washington Mutual astutely used its deep understanding of its customers' price sensitivities to transform itself from a regional player into a major national retailer of consumer financial services. It determined that many consumers were fed up with per-transaction costs, minimum-balance requirements, and monthly fees. So it offered an account that was free of those charges and restrictions but paid no interest and charged "acceptable" penalties for bouncing checks and other actions within the customer's control. The result was a large increase in checking-account customers and a significant rise in the income they generated. Washington Mutual is not alone: other banks are also seeking more palatable ways to increase prices.

"To Improve Price Realization, I Need to Change the Pricing and Discount Structure"

All too many executives are figuratively and literally in a cloud when it comes to knowing the prices that their customers actually pay. Consider the *pricing cloud* illustrated in the exhibit below. The industrial goods company had a long-standing strategy that called for rewarding large accounts with lower net prices (higher discounts). If the policy had been implemented, the pattern of the dots (each representing a customer) would reflect a steady increase in the discount index, moving from the smaller accounts on the left to the bigger accounts on the right. In other words, the pattern would show that bigger accounts received lower net prices. But, as the lack of any discernible pattern indicates, there was little, if any, relationship between actual discounts and customers' volume. Discounts for many smaller accounts were actually much higher (and prices much lower) than those for bigger accounts.

Such situations are common because it is often difficult both to get the data needed to see what is going on and to control all the people in different parts of the organization who are in a position to undercut the established price. Many companies excel at managing individual components of pricing, but few manage all the components in a coherent or coordinated way.

Many people in the organization "touch" pricing, but nobody owns it. Pricing decisions, expertise, and information are fragmented and diffused across regions, business units, and functions. Many functions or business units make independent—and often conflicting—pricing decisions that collectively undermine the goals of the business as a whole and often confuse customers.

All too often, precise metrics and processes to monitor pricing opportunities, threats, and performance are lacking. This makes it difficult to quantify the true impact of incremental pricing actions. In many instances, executives are forced to make decisions on the basis of incomplete or inaccurate information. Another common problem is that incentives are frequently misaligned, creating disconnects between the overall pricing strategy and the actual tactics executed by the organization.

The result is "leakage." The average net price is much lower than it should be: the gap ranges from a few percentage points in some industries to half or more of the list price in others.

The solution is to treat pricing as a crucial discipline—an effort organized to ensure that pricing strategies are defined, measured, executed, and managed in the marketplace. Transforming pricing in this fashion requires policies, procedures, structures, and measures that inject discipline into the organization and give everyone in it a shared purpose. Only such an approach can ensure that all the actions that affect pricing support the business strategy.

When companies focus on pricing and get disparate units to operate in sync, they typically deliver at least a three-percentage-point improvement in earnings before interest and taxes. In fact, the improvement can be as high as ten points. (See "Organizing for Pricing," BCG Perspectives, September 2002.)

"Innovating in Pricing Is Not Possible in My Industry"

Many executives believe that the current approaches to pricing in their industries cannot be fundamentally altered or replaced. The reality is that pricing approaches are changing all the time, but executives are so focused on the present that they do not stop to question the status quo and consider whether they might pioneer a pricing innovation.

Some companies, however, recognize that pricing practices do evolve and try to lead the change in ways that strengthen or expand their competitive advantage. They apply approaches or advanced techniques that help address their customers' unmet needs or that change the rules of the game in ways that play to their own strengths. In some cases, the approaches are genuinely new ones; in many others, they are transfers of practices that have already been proven in other industries. American Airlines' pioneering use of pricing to maximize capacity utilization of its fleet was instrumental to its becoming a dominant force in the industry. Today players in the fashion apparel industry are using yield management to optimize their use of markdowns.

Another masterly application of pricing innovation was General Electric's reinvention of the commercial-aircraft-engine business. Engine manufacturers had traditionally used engines as a loss leader to secure the lucrative business of selling replacement parts. When several trends threatened that model, GE offered airlines the option of buying power by the hour—in essence, purchasing as a package engines, parts, and MRO services (maintenance, repair, and overhaul), and paying on the basis of uptime, or per hour of use. The strategy has allowed the company to make the most of its competitive advantages (its technical skills, diagnostic capabilities, financing expertise and scale, and end-to-end MRO services) against major competitors.

GE's offering, which it calls Maintenance Cost Per Hour, aligns industry pricing with customer value (by tying prices to uptime) and aligns customers' interests with its own (by tying GE's way of making profits to uptime rather than maximizing the number of replacement parts it sells). GE's strategic use of the power-by-thehour concept has helped it transform the

competitive position and profitability of its commercial-aircraft-engine business: it now accounts for the lion's share of engine sales (63 percent in 2002 versus a mere 17 percent in 1981) and has the highest margins in the business. The company has subsequently pursued a similar strategy in other businesses.

In this era of rapidly changing technology, some companies understand that advances could have a dramatic impact on pricing approaches, and they position themselves to lead the change. One such company is Ohio-based Progressive Corporation. Progressive has been experimenting with wireless and Global Positioning System technologies, onboard sensors, and radical new pricing approaches in the auto insurance market.

Such technologies could allow an insurer to set rates on the basis of each individual's real-time driving behavior rather than use the traditional approach of determining premiums by a driver's sex, age, and driving record. In other words, actual pricing would supplant actuarial pricing.

The value proposition is compellingly simple: people who drive less, adhere to speed limits, and take safer routes have lower bills. Such an approach could allow innovators to capture more profitable customers from competitors that price on a traditional actuarial basis. In addition, first movers could potentially have a tremendous information advantage over lagging competitors in setting rates. Although this approach is still in its infancy, it has attracted the interest of governments, other insurers, environmentalists, and additional groups in North America and Europe.

"Pricing Is a Tactical, Not a Strategic, Issue in My Industry"

Many executives assume that pricing is a tactical rather than a strategic variable. Organizational issues prevent them from seeing that pricing can be a powerful strategic lever. Because pricing decisions are made at fairly low levels in the organization and responsibility for pricing is fragmented, it doesn't get the strategic attention that other critical activities, such as sourcing and product development, receive.

History is replete with examples of companies that have proved that pricing is central to strategy. Consider Wal-Mart's Every Day Low Prices, Microsoft's Office System (whose price is much lower than the collective prices of the individual programs it contains), and Capital One's offer of credit cards for every taste (more than 6,000 with different rates, credit limits, and payment terms). These companies' pricing approaches helped them upset the competitive balance of power in their industries. Moreover, advances in information technology are giving rise to new pricing strategies and increasing the potential power of familiar ones. By allowing companies to collect and analyze vastly more information than they could 10 or 15 years ago and act on it much more quickly, IT is generating numerous opportunities to apply sophisticated pricing methodologies in order to improve customer satisfaction and achieve competitive advantage.

Examples of pricing strategies that can have a tremendous impact on the competitive landscape include the following:

Experience-Curve Pricing. Costs go down with accumulated experience. They always have and they always will. The competitor that prices ahead of the expected decline can drive purchases and accelerate the accumulation of experience and the creation of advantage.

De-averaged Pricing. Pricing should reflect a matrix of relative competitive positions by location, segment, customer, or other factors. The company that understands its relative strengths and weaknesses can set prices differently in each market to maximize profits and thereby influence the dynamics of the industry. Instead of taking this approach, many companies average prices across customer segments. This practice, however, can open a window of opportunity for a focused competitor to lure away more profitable, low-cost-to-serve customers by offering them prices more closely matched to their needs.

Bundling. If one company has a much broader offering of products and services than others, it can meet customers' demand for a bundled alternative that puts competitors at a disadvantage. Industries in which companies are using bundling to steal a march on competitors include telecommunications, financial services, retailing, and software.

Loyalty-Based Pricing. Sophisticated IT is enabling companies to use customers' purchasing histories, including volume and mix, to make dramatic strides in how they tailor pricing. Such "rewards" systems encourage customers to buy more over time and, as they become invested in the continuing relationship, develop into a formidable barrier to switching. With the number and sophistication of these programs soaring, excellence in designing and implementing them has become crucial.

Dynamic Pricing. The growing ability of companies to obtain and act on information in real time means that traditional pricing regimes—and tradition-bound companies—are highly vulnerable. Setting prices closer to the moment when a customer needs a product or service is increasingly possible. To use dynamic pricing to improve profitability, however, requires a deep understanding of full and marginal costs and investments, and of the value proposition for the customer. Unfortunately, very few companies today are ready to exploit this opportunity. Imagine if a company's sales force had up-to-the minute information on inventory levels, capacity utilization, and its win/loss ratios relative to competitors'. Its advantage over rivals that price on the basis of historical data would be overwhelming.

Like crabgrass in a lawn, myths about pricing gradually creep into the management dogma of organizations. This is not surprising. In most industries, dramatic changes in pricing practices that might force executives to challenge their beliefs are the exception.

What is the cure for pricing myopia? A good first step is to answer some fundamental questions about strategy and tactics:

- Do you know what would happen to your bottom line if you raised (or lowered) prices by 1 percent?

- Do you know which of your customers are—or are not—price sensitive and why?
- Where are the pricing leakages occurring in your company?
- What functions or departments control the final pricing decisions?
- How could you change your pricing mechanism to build your advantages?

Although considerable gains can be made through one-time efforts to improve pricing, the return on developing a world-class pricing capability is much higher. Companies with such capabilities can continually design pricing mechanisms and set price levels that generate maximum sales and share growth, optimize company profits, and deliver sustained competitive advantage. Their rivals will have a hard time catching up to them.

To Contact the Authors

ASIA-PACIFIC

- Peter Werenhall
- Alumnus
- Melbourne

NORTH AMERICA

- George Stalk
- Senior Advisor
- Toronto

- Peter Stanger
- Senior Partner & Managing Director
- Toronto

WESTERN EUROPE

- Philippe Morel
- Senior Partner & Managing Director
- London

Fuente: https://www.bcgperspectives.com/content/articles/pricing_consumer_insight_pricing_myopia/