CHAPTER 1

The Value-Based Pricing Framework for Getting Pricing Done Right

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Every offering of a firm and every transaction that firm has with every customer has a price. That price may be the result of a lengthy deliberation that includes market research, competitive dynamics, highly researched algorithms, intense customer negotiations, and torrid management discussions, or just a number that popped out of someone's head. Somehow, every transaction gets priced.

That price represents a decision. A decision by the firm that reflects its business and customer engagement strategy, the unique positioning of the product offering within the market, the firm's current needs, the information the managers hold, and the biases and incentives of the current managers. Somehow, pricing decisions get made.

That price impacts many functions within the firm as well as customers and competitive dynamics outside of the firm. As such, sales, marketing, finance, operations, and even legal will want to have a say in pricing decisions. Somehow, people are engaged in the decision-making.

But how should prices be determined? What should inform pricing decisions? Who should be engaged in those pricing decisions?

The job of management is to get the right people doing the right thing at the right time toward the right goal. The managerial challenges mentioned above in pricing are well known. What isn't well known is *how* they should be addressed.

Managing businesses means getting things done through other people. CEOs cannot solve every challenge; they depend on their teams to get things done. CEOs not only lead the organization, they also define how that organization is going to work to get the necessary work of the company done.

While many functional areas of a business are organized based on precedent and cultural norms, pricing is a relatively new function. Not that pricing hasn't been done before—clearly it has—but as a corporate function, it is relatively new.

The challenge executives face is to determine how to organize the pricing function to get pricing done right. They need a framework that will help them shape their organization, routines, staff, information management, and analytical and efficiency tools that will guide the organization toward making better pricing decisions.

Pricing isn't just one thing. It isn't just a decision done before launching a new offering, a number that is estimated in conjunction with a contract or the result of a client negotiation. Nor is pricing a single technique, method of analysis, research effort, or piece of information to gather. Pricing isn't an event. It's a *continual* process.

And pricing can't be done in isolation. The decisions in pricing affect every part of the organization. They are integral to every healthy customer relationship. And, they influence the competitive engagement of the firm with its competitors.

Treating pricing as a process requires *defining* the process. The process must deliver the goal of making pricing decisions repeatedly and reliably that produce the best decisions possible, given the information that can cost-effectively be gathered in the timeframe relevant to the decision-making urgency. It will be a cross-functional activity that leverages the expertise of a pricing professional to provide analytical rigor to the information and insights gathered from sales, marketing, and finance along with other relevant senior executives within the business.

The Value-Based Pricing Framework provides a template for executives to use in managing pricing decisions throughout their

organization. It was developed through direct interviews with executives in the field, reviewing academic literature, and implementation in numerous firms. Research was conducted at firms across both business and consumer markets, from small start-ups to large global players, and in locations spanning North America, Europe, Asia-Pacific, the Middle East, Africa, and Latin America. The Value-Based Pricing Framework codifies best practices for managing prices in profit-seeking competitive businesses.

Embedding the Culture of Value-Based Pricing

Value-based pricing itself forms the core culture surrounding the use of the Value-Based Pricing Framework. In value-based pricing, firms seek to set prices according to the value customers place on the offering in comparison to its alternative. Using the nearest competing alternative as a starting point, an offering's differential benefits will either add or subtract value in the minds of customers. In value-based pricing, the prices of offerings are set in relationship to the price of the nearest competing alternatives adjusted for the offering's value differential.

When firms adapt value-based pricing, they often adopt its corollary: value engineering. In value engineering, attributes and features are added and subtracted to offerings according to the willingness-to-pay of customers for the benefits those attributes and features deliver. If an attribute or feature does not deliver benefits to the target customers in excess of the costs, those attributes and features are removed. If they do, they are added. Though simple enough to state, value engineering implies a process where innovation and pricing are inherently connected.

Overarching Pricing Decision Areas

The five key decision areas identified in the Value-Based Pricing Framework are:

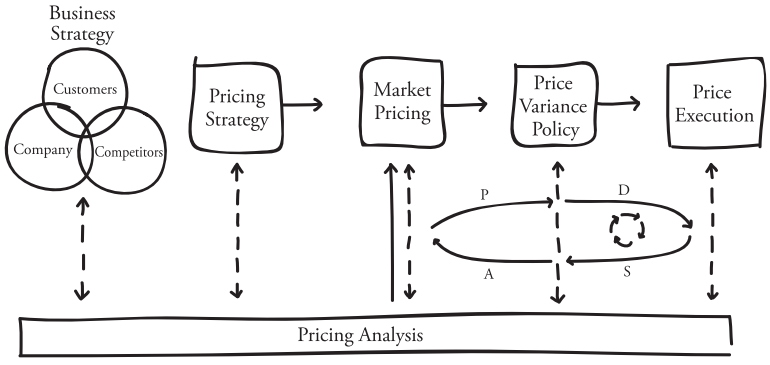
1. Business strategy
2. Pricing strategy

3. Market pricing
4. Price variance policy
5. Price execution

Undergirding these five key decision areas is pricing analysis, an organizational function used to inform, guide, and steward pricing decisions across the organization. Built into the Value-Based Pricing Framework (see Figure 1.1) are specific repeatable processes to inform pricing decision areas or provide an informational feedback loop to improve pricing decisions.

Business strategy, the first decision area within the Value-Based Pricing Framework, comprises the choices the firm makes to differentiate itself from its competitors in a way that results in serving its customers' needs more profitably than competitors. It includes the firm's customer, competitive, and company strategies. The firm's customer strategy identifies the firm's target market and market segmentation schema. This target market selection may result in the firm choosing to target a specific segment of customers, which its competitors are less able to serve as well. A firm's competitive strategy leverages its unique and inimitable resources to deliver a competitive advantage in attracting its chosen target market profitably. Its company strategy refers to the investment choices the firm makes in order to differentiate itself from competitors and to develop future sources of competitive advantage.

FIGURE 1.1 Value-Based Pricing Framework



Pricing strategy, the second decision area within the Value-Based Pricing Framework, refers to the manner in which firms will manage prices. More specifically, a firm's pricing strategy includes its price positioning plan, price segmentation plan, competitive price reaction strategy, and its pricing capability strategy. Each of these areas of a firm's pricing strategy is determined within the context of the firm's business strategy at leading firms.

Price positioning refers to the choice to price an offering at either a penetration, neutral, or skim position. Penetration pricing implies holding prices low in comparison to competing alternatives adjusted for the offering's differential benefits in order to penetrate the market and grab market share. Skim pricing implies holding prices high in comparison to competing alternatives adjusted for the offering's different benefits, and is often used as a new market entry plan. Neutral pricing implies pricing in alignment with the offering's competing alternatives after adjusting for its differential benefits. Of the three, neutral pricing should be taken as the default strategy, for it is most likely to be the most profitable strategy. All three positions can be rationally defended for different firms. The choice of which position an offering should be priced at is largely dependent on the business strategy of the firm.

Price segmentation refers to charging different customers different prices for similar or highly related offerings. Because different customers derive different benefits from the firm's offerings, they will have different willingness to pay. Price segmentation is the means by which firms attempt to price offerings for the individual customer, or at least at the market segment level. Price segmentation may either be accomplished through the price structure choice of unit pricing, two-part tariffs, tying arrangements, tiered offerings, bundled offerings, subscriptions, revenue management, and other price structures, or it can be accomplished tactically through price variance policy.

A firm's competitive price reaction strategy determines how the firm will react to price changes within the market. At times, firms should change their prices when a new competitor enters the market or existing competitors change their prices. At other times, firms should ignore competitive price moves. The optimal competitive price

reaction strategy will depend on the firm's pricing power and level of competitive advantage. If the firm has both competitive advantage and pricing power, the firm can ignore a competitor's price aggression or perhaps even attack a competitor's position. If the firm lacks both, the firm will have to accommodate its competitor's price aggression by either lowering prices or ceding market share, or both. Between these two extremes, firms have been found to be able to either mitigate price competition by relying on the strength of the differential benefits or defend market share with managed price reductions.

Pricing capability defines the firm's ability to manage pricing decisions across the company. The people, processes, and tools engaged in managing pricing are all strategic pricing issues. While the Value-Based Pricing Framework provides a template for making these decisions, it isn't expected that this template will be implemented in the same way in every firm. Rather, it is intended to provide guidance to executives in determining which pricing capabilities need to be improved and how those improvements would take form.

Market pricing, the third decision area within the Value-Based Pricing Framework, is the setting of starting prices for every offering of the firm. This includes reviewing prices of existing offerings, updating prices on enhanced offerings, and the pricing of new offerings. Market pricing determines the specifics of the business and pricing strategy. Given a specific price structure, market pricing determines the parameters of that price structure to result in the desired price position. Generally, market pricing decisions rely on some form of market research.

Price variance policy, the fourth decision area within the Value-Based Pricing Framework, determines the rules for granting discounts and promotions. At the strategic level, firms will decide if price variances are allowed or not. Price variances need not always be shunned, but if they are allowed, they must be managed. If price variances are allowed, the price variance policies determine the type of price variances allowed, their depth, and the situations in which they might be granted. Price variance policy may be customer dependent, product dependent, market dependent, or even transaction dependent. At some firms, all of these factors plus others are used to define the firm's price variance policy.

Price execution, the fifth decision area within the Value-Based Pricing Framework, applies the correct prices according to the rules developed by strategic and managerial decisions and then collects those prices from customers in a timely manner, all with minimal errors. Because price execution is a high-frequency rule-based decision area, much progress has been made in applying information technology to improve the efficiency and effectiveness of this decision area. Yet, human decisions still arise in price execution. Prices that need to be adjusted may be reverted to the price variance policy area. Price execution that is inefficient or ineffective may necessitate improvement efforts.

Supporting each of these five decision areas within the Value-Based Pricing Framework is pricing analysis. Each of these decision areas is informed by some form of analytics. While the type of analysis requirements will depend on the type of pricing decision being made, the pricing function itself can be used to routinely perform the required analytics and data gathering. While the pricing function may now own pricing decisions, it can be used to meaningfully inform executive decision-making and provide recommendations.

Analytical Routines

Three specific forms of analysis that can be routinely executed are also identified within the Value-Based Pricing Framework. Two of them rely on the plan-do-study-adjust continuous improvement process popularized by W. Edwards Deming. The third form of analysis that firms routinely execute is offering innovation and pricing.

In the continuous improvement process, executives make a *plan* and execute it in the *do* step, *study* the results of that plan to identify whether the results were caused by the plan or some other exogenous factor, then *adjust* their strategy going forward. In Price Variance Policy Continuous Improvement, firms review their decisions in making price variance policy with regard to the outcomes achieved in the price execution area. In Market Pricing Continuous Improvement, firms review their market prices in light of their price variance policy and price execution.

In Offering Innovation and Pricing, firms integrate pricing into their innovation strategy to result in value-engineered offerings. Across the phases of offering innovation, different techniques can be used to determine theoretically whether an offering should be made or not. In the early phases of offering innovation, models of the exchange value to customer, informed by focus groups or executive interviews, can be used to estimate the price a new offering would achieve in the market. As a new offering prepares to enter the market, the uncertainty inherent in the earlier price estimates can be reduced through either improving the qualitative research or conducting more sophisticated, survey-based research such as conjoint analysis.

Decision Teams

Because pricing decisions impact such a broad swath of functions within a firm, research and practice at leading firms have found that they are best made in teams. The Value-Based Pricing Framework calls for pricing decisions to engage four key roles: marketing, sales, finance, and pricing. One person may take on two of these roles simultaneously.

The marketing team is engaged in pricing decisions as it is part of this group's core job responsibility to set offering, distribution, and communications plans to capture their designated target market. Sales is engaged in pricing decisions due to their direct interaction with customers and their responsibility to capture customers within the determined pricing guidelines. Finance is engaged in pricing decisions due to their knowledge of costs and their need to manage profit expectations. The pricing function is called upon to coordinate the contributions of these various roles, inform pricing decisions with solid analytics, and steward the resulting plan through implementation.

The pricing function is made up of pricing professionals. They may report to marketing, finance, sales, or some other department depending on the structure and capabilities of the firm. Their role is consistently to shepherd and steward pricing decisions. Because pricing decisions flow from business strategy to execution, the pricing community will have both centralized and decentralized roles.

In staffing the pricing function, individuals are needed with both a strong analytical bent and business acumen, for pricing isn't just math, it's strategic.

Senior executives have a choice to create a pricing capability within their firms or not. Leading firms have created such a capability or are in the process of doing so. Many nonleading firms did not, and some of them, partly as a result of not improving their pricing practices, have either been acquired or gone bankrupt. It is proven wisdom that a 1 percent improvement in prices for the average Fortune 500 firm leads to a 10 to 12 percent improvement in profits, depending on the reporting year. The Value-Based Pricing Framework gives executives an opportunity to understand how leading firms get pricing done right.