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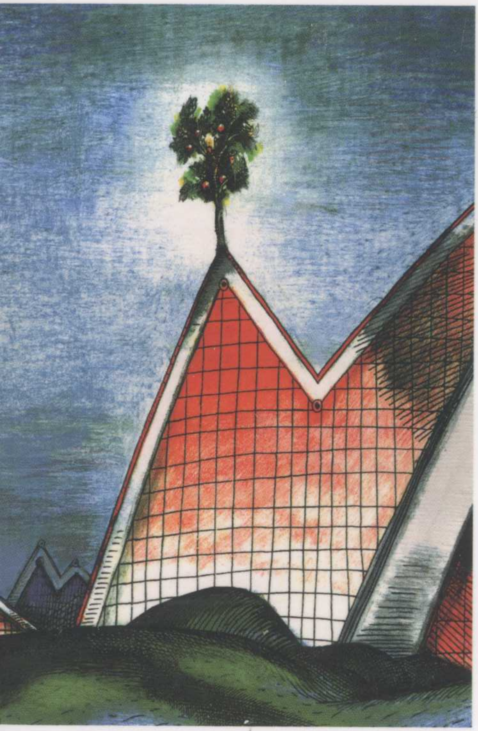

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How Do You Know When the Price Is Right?

ROBERT J. DOLAN

Executive Summary

TOO OFTEN WHEN managers think about pricing, the first question they ask is, What should the price be? In fact, what they should be asking is, Have we addressed all the considerations that will determine the correct price? Robert J. Dolan describes two broad qualities of an effective pricing process and provides eight steps to enable managers to develop and use such a process.

To work effectively, pricing efforts must complement an overall marketing strategy by sending a message that is in sync with a company's desired product image. Such efforts must also be coordinated and holistic. Proper pricing requires input from a number of people, and lack of communication or cooperation between them can make overall pricing performance dismal.

The eight steps that expand upon these principles assess the factors affecting price. Companies need to assess their customers to discover how a product or service is valued. Variations in the way customers value the same product may be turned to a company's benefit through clever pricing. Dolan analyzes factors that influence price sensitivity and describes possible pricing structures. He reminds managers to consider competitors' reactions and advises them to monitor final rather than list prices in order to have a true sense of what's going on. Finally, he discusses the significance of the customer's emotional response and suggests a method of cost-benefit analysis. The pricing scorecard included at the end of the article will allow managers to evaluate how well their pricing practices meet these guidelines.

PRICING IS MANAGERS' BIGGEST marketing headache. It's where they feel the most pressure to perform and the least certain that they are doing a good job. The pressure is intensified because, for the most part, managers believe that they don't have control over price: It is dictated by the market. Moreover, pricing is often seen as a difficult area in which to set objectives and measure results. Ask managers to define the objective for the company's manufacturing function, and they will cite a concrete goal, such as output and cost. Ask for a measure of productivity, and they will refer to cycle times. But pricing is difficult to pin down. High unit sales and increased market share sound promising but they may in fact mean that a price is too low. And forgone profits do not appear on anyone's scorecard. Indeed, judging pricing quality from outcomes reported on financial statements is perilous business.

Yet getting closer to the "right" price can have a tremendous impact. Even slight improvements can yield significant results. For example, for a company with 8% profit margins, a 1% improvement in price realization—assuming a steady unit sales volume—would boost the company's margin dollars by 12.5%.[1] For that reason, even one step toward better pricing can be worth a lot.

To improve a company's pricing capability, managers should begin by focusing on the process, not on the outcome. The first question to ask is not, What should the price be? but rather, Have we addressed all the considerations that will determine the correct price? Pricing is not simply a matter of getting one key thing right. Proper pricing comes from carefully and consistently managing a myriad of issues.

Based on observation and participation in setting prices in a wide variety of situations, I have identified two broad qualities of any effective pricing process and a "to do" list for improving that process. Not every point will apply to every business, and some managers will need to supplement the checklist with other actions that pertain to their specific situation. But in general, by using these criteria as a guide, managers will begin to set prices that earn the company measurably greater returns, and they will gain control over the pricing function.

Strategy and Coordination

All successful pricing efforts share two qualities: The policy complements the company's overall marketing strategy, and the process is coordinated and holistic.

MARKETING STRATEGY

A company's pricing policy sends a message to the market—it gives customers an important sense of a company's philosophy. Consider Saturn Corporation (a wholly owned subsidiary of General Motors). The company wants to let consumers know that it is friendly and easy to do business with. Part of this concept is conveyed through initiatives such as inviting customers to the factory to see where the cars are made and sponsoring evenings at the dealership that combine a social event with training on car maintenance. But Saturn's pricing policy sends a strong message as well. Can a friendly, trusting relationship be established with customers if a salesperson uses all the negotiating ploys in the book to try to separate them from that last $100? Of course not. Saturn has a "no hassle, no haggle" policy (one price, no negotiations) which removes the possibility of adversarial discussions between dealer and potential customer. Customers have an easier time buying a car knowing that the next person in the door won't negotiate a better deal.

The pricing policy for Swatch watches illustrates the same point. The company's overall message is that a watch can be more than just functional; it can be fun as well—so much fun, in fact, that a customer ought to own several. The company's price, $40 for a basic model, has not changed in ten years. As Franco Bosisio, the head of the Swatch design lab, noted in William Taylor's interview "Message and Muscle: An Interview with Swatch Titan Nicholas Hayek" (HBR March–April 1993): "Price has become a mirror for the other attributes we try to communicate. . . . A Swatch is not just affordable, it's approachable. Buying a Swatch is an easy decision to make, an easy decision to live with. It's provocative, but it doesn't make you think too much."

For Saturn and Swatch, the pricing policy flows directly from the overall marketing strategy. This consistency, or even synergy, of price and the rest of the marketing mix is a critical requirement for success.

COORDINATION

There are typically many participants in the pricing process: Accounting provides cost estimates; marketing communicates the pricing strategy; sales provides specific customer input; production sets supply boundaries; and finance establishes the requirements for the entire company's monetary health. Input from diverse sources is necessary. However, problems arise when the philosophy of wide participation is carried over to the price-setting process without strong coordinating mechanisms. For example, if the marketing department sets list prices, the salespeople negotiate discounts in the field, the legal department adjusts prices if necessary to prevent violation of laws or contractual agreements, and the people filling orders negotiate price adjustments for delays in shipment, everybody's best intentions usually end up bringing about less than the best results. In fact, the company may actually lose money on some orders, and some specialty items positioned to earn high margins may end up returning margins in the commodity range.

Such was the case at a major truck manufacturer. Marketing set list prices that were essentially meaningless because so many other functions then adjusted those prices for their own purposes. While salespeople chased volume incentives by offering the largest discounts they were allowed, finance and accounting were charged with making sure the company covered its variable costs on each order. In this case, the problem was exacerbated by shortcomings in the accounting systems, but the fundamental cause of the company's pricing dilemma was that the decision-making process involved people with different pricing objectives and different data. There was no coordinated process in place to resolve these conflicting objectives effectively. The company is still working on a long-term solution to the dilemma, but for the short term it has dealt with the problem by creating a separate pricing organization staffed by a group of senior executives that collectively acts as "pricing czar." The group is responsible for gathering input from everyone and then setting a price.

When considering the coordination of the pricing process, managers should ask the following questions:

- What is our pricing objective?
- Do all the participants in the process understand the objective?
- Do they all have an incentive to work in pursuit of the objective?

Proper pricing requires input from a number of people, but if there is no mechanism in place for creating a unified whole from all the pieces, the overall pricing performance is likely to be dismal.

Eight Steps to Better Pricing

Fitting a pricing policy to a marketing strategy and considering the relevant information in a coordinated manner are broad goals. The following eight steps deal with the essentials of setting the right price and then monitoring that decision so that the benefits are sustainable.

1. ASSESS WHAT VALUE YOUR CUSTOMERS PLACE ON A PRODUCT OR SERVICE

Surveys show that for most companies, the dominant factor in pricing is product cost. Determine the cost, apply the desired markup, and that's the price. The process begins inside the company and flows out to the marketplace. To establish an effective pricing policy, however, that process must be reversed. Before any price is determined, pricing managers must think about how customers will value the product.

Consider how Glaxo introduced its Zantac ulcer medication to the U.S. market in 1983 to compete with SmithKline Beecham Corporation's Tagamet. Tagamet had been introduced in 1977 and by 1983 was the number one ulcer medication and the number one selling drug in the world. Zantac, however, offered superior product performance: It had an easier schedule of doses, it had fewer side effects, and it could be taken safely with many other drugs that were not compatible with Tagamet. Thus, its perceived value to the customer was very high. If Glaxo had allowed product cost to drive the price of Zantac, it might have introduced the medication at a lower price than Tagamet; it might have used a "follow the leader" pricing strategy. But Glaxo instead relied on Zantac's perceived value to the customer, initially pricing the drug at a 50% premium over Tagamet. Within four years, Zantac became the market leader.

Northern Telecom's pricing of its highly successful Norstar telephone system demonstrates the same principle. In 1988, as Northern's senior managers developed the company's strategy for competing with Pacific Rim suppliers, they realized that initially, the inherent superiority of their product didn't matter; resellers would value Norstar only at the market price then being charged by most of Northern's competitors. Therefore, rather than considering Norstar's cost and setting a price that might have been higher than competitors', Northern's managers decided to introduce the Norstar system at the prevailing market level and then look inward to determine how they could reduce costs in order to make money at that price.

Northern's managers knew that over time, they could convince consumers that their system was better than the competition's; in other words, they knew that Norstar's perceived value would increase as the system proved itself in the marketplace. Although the system entered the market at a price below what it was actually worth, eventually, as Northern's competitors began to fight the commodity battle and lower their prices, Northern was able to maintain its price level, secure a price premium, improve margins as its costs decreased, and increase its share of the market.

In Glaxo's case, a conventional "figure cost and take a markup" approach would have resulted in forgone profits; in Northern's case, the result would have been a noncompetitive price and no sales. By turning the process around and letting value as perceived by the customer be the driver, each company found a better initial price level and the foundation for its future growth.

There are several ways in which companies can assess what value customers perceive a product or service to have. Careful market research is one way; managers also should tap employees with direct customer contact, such as the sales force, for undiluted information from the outside.

2. LOOK FOR VARIATION IN THE WAY CUSTOMERS VALUE THE PRODUCT

By customizing prices, a company can earn much greater profits than it could expect with a single product/single price policy, yet many managers fail to recognize the benefits of customizing products and prices for different customer segments. A product will often have a much higher perceived value for an "ideal" customer than it will for an average prospect. If this is the case, a company would do well to separate the markets or segments and charge different prices accordingly. For example, consider how Polaroid Corporation introduced its SX-70 instant photography camera. Polaroid knew that some consumers—such as people in the photo-identification card business—would place a high value on receiving pictures immediately and on knowing whether or not the shots had come out properly. So the company segmented the market over time. Initially, to target those customers who "couldn't wait" for the new product, Polaroid offered the SX-70 to dealers at a price of $120 per camera; end-user customers paid more than $200 on average. Two years later, to capture the wider market, Polaroid offered the SX-70 line at prices that were less than half the introductory level.

The same principle applies in any business. Airlines, for example, attempt to treat business and pleasure travelers differently by offering cheaper fares with Saturday-night stay requirements to the latter. By developing products with slightly different specifications from the same platform, companies can customize pricing for segments that value the product differently.

Customizing price not only is common; in some cases, it is the key to a company's financial health. Consider the magazine industry: The cost per copy of a magazine when a customer buys a subscription is dramatically less than the cost of a single copy purchased at a newsstand. Software manufacturers employ similar tactics: When they introduce a new version of a popular product, they offer discounted upgrade prices to customers who already use the old version. The manufacturers know that the users' ability to continue using the old version of the product makes them value the new product less than someone without the product altogether.

Simple differences in taste affect value variation to some extent—for instance, some people simply like Big Bertha golf clubs more than others. But managers will be able to spot value variation and opportunities for price customization by answering the following questions:

- Do customers vary in their intensity of use? Heavy users generally value a product more than light users, especially in the durable-product arena—golf clubs, television sets, cameras, and the like. Heavy users also may be more interested in added features or complementary products; a company can use ancillary products as a mechanism for differential pricing.
- Do customers use the product differently? Some customers will use a product differently from other customers, with a consequent difference in perceived value. For example, consider the coated air bubbles produced by Sealed Air Corporation, a supplier of protective packaging. The company recognized that for some applications of the product, viable substitutes were available in the market. But for other applications, Sealed Air had an immense advantage; for instance, its product offered superior cushioning for heavy items with long shipping cycles. Recognizing the extent of the advantages in various applications and understanding the value differential in each setting was the key to Sealed Air's product line expansion and pricing decisions. The insight helped the company grow from $88 million in revenues in 1980 to more than $500 million 15 years later.