Price is a one-figure summary of what a company has to offer.

Pricing: The Third Business Skill shows you in a clear and concise manner how to set optimum selling prices for your company, using accessible models and examples.

Cases used in this book were taken from real life and from many different industries, both B2C and B2B. These cases show what it takes to set the best possible price and build a pricing organization in which all business functions work together.

This book takes an integrated approach and deals with strategy, tactics, tools, processes, and organization. After reading this book, the pricing function will no longer hold any secrets for you, empowering you to get started on structurally improving your margins right away!

Ernst-Jan Bouter is a price management expert who works for both start-ups and multinationals. He specializes in organizing and changing companies in a way that achieves lasting improvement of their pricing capability.
Pricing: The Third Business Skill

PRINCIPLES OF PRICE MANAGEMENT

Ernst-Jan Bouter
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Preface

An important part of the origins of modern capitalism can be traced back to the Golden Age of the Dutch Republic. In 1602, the **Vereenigde Oostindische Compagnie** (Dutch East India Company) was established. The VOC was the first company in history to raise capital by issuing stock, which led to the foundation of the world’s first stock exchange. Global trade, on an until then unprecedented scale, was the source of the vast wealth of Amsterdam’s merchants. The Dutch preferred trade at attractive prices to conquering foreign lands as a way of amassing wealth. The richest of Amsterdam’s merchants lived in the so-called Golden Bend of the Herengracht canal. The cover of this book shows the nearly completed Golden Bend, as depicted by Gerrit Adriaensz Berckheyde in 1671-72.

This book is about setting prices for customers in a free capitalist economy, where price is a tool entrepreneurs can use to achieve their goals. This book, too, originated in the Netherlands. For you as the reader I hope this book will be a “golden bend” leading to the business success that can help you fulfill your dreams.

Naturally, it is impossible to write a book that is the product of a career without the help and encouragement of many. I owe a great debt of gratitude to all co-workers and clients I have had the privilege of working with at several companies and as an independent consult-
I am grateful for what I was able to learn from them and the time I got to spend with them.

I would like to thank Boet, Bert, and Marc for their exceptional encouragement, as for many years they kept urging me to write this book. Hans, Herman, Corinne, Leendert, Cora, and Henriëtte have been a great support to me by reviewing and commenting on the draft material I produced. Wardy, Erwin, Sander, Griet, Kate, and Milan worked meticulously in helping me turn my scribblings into a professional publication. And finally, my family, Sophie, Tobias, Bente, and Henriëtte, has shown great flexibility and tolerance of the constant switching between the highly demanding projects of a pricing manager and the peace and quiet of a writer.

Ernst-Jan
Loenen aan de Vecht (NL)
April 27th, 2013
Introduction
CHAPTER 1

The third business skill

1.1 Entrepreneurship

Entrepreneurs are the driving force behind the prosperity of their enterprises, and both personal skills and business acumen are essential success factors. When it comes to business skills, two archetypes are often used to define what makes an entrepreneur an entrepreneur: “the inventor” and “the salesman”.

1.1.1 THE FIRST BUSINESS SKILL (THE INVENTOR)

The first business skill is the ability to create value and produce goods or services. Bill Gates managed to provide IBM with an operating system for its PCs almost overnight, setting Microsoft on its way toward global dominance.

The power of creation reflects positively on entrepreneurs’ public image. Where would we be today without the inventions of Thomas Edison, Nikola Tesla, Bill Gates, Steve Jobs, Steve Wozniak, Larry Page, Sergey Brin, Mark Zuckerberg* and all those other creative business brains of our time?

* These are the product developers from the early days of General Electric, Westinghouse, Microsoft, Apple, Google, and Facebook respectively
As companies grow and departments gain shape, knowledge generated by the creation process is harnessed by R&D and product management, and applied in operations and production. A large number of the available resources go into this first business skill. The aim is to efficiently produce and provide good products.

1.1.2 **THE SECOND BUSINESS SKILL (THE SALESMAN)**

The second business skill is the ability to sell products or services. Entrepreneurs drive progress by improving sales methods for the benefit of both buyers and sellers. Jeff Bezos, Michael Dell, Pierre Omidyar*, to name but a few, pioneered sales when they started selling physical goods online on a major scale. All services and products sold under British entrepreneur Stelios Haji-Ioannou’s† ‘Easy’ brand are, as the name suggests, easy to order and use by anyone who is fed up with other providers’ poor service.

The second business skill is the domain of commerce, the realm in which sales and marketing departments operate. The extent of resources allocated to these activities differs per industry and per business model, while those in charge of commercial operations tend to be firmly rooted in the highest echelons of a company.

The two business skills are represented by two prototypes of entrepreneurs. The inventor turns a great idea into reality, and has something unique to offer consumers. The salesman can sell anything, even “ice to Eskimos”. An often recurring phenomenon is that of an inventor and a sales professional setting up a company together.

1.2 **Pricing: the third business skill**

Prevailing views on entrepreneurship claim that all the ingredients for business success are present if you know what you have to offer and how to make it (skill 1) and also manage to sell it (skill 2).

* Founders of Amazon, Dell, and E-bay respectively
† Founder of easyJet and other companies, such as easyHotel
This book focuses on the third business skill, on pricing: setting and asking the right price in order to hit business targets. This often neglected skill is indispensable for sustained success. Getting the pricing right will ensure you obtain enough revenue from those unique products and services you are selling so well.

For Google, it was the third business skill that propelled the breakthrough of a start-up with superior search technology (skill 1) that eventually became one of the most high-profile companies in the first decade of the 21st century. A revenue model that aligned advertising rates with users’ searches (skill 3) was the starting point of Google’s growth. Like no other company, Google understands the importance of a sound pricing strategy. Also for services such as YouTube, Google+, and Docs, Google takes the time to develop the right revenue model. In doing so, Google relies on the services of specialist pricing managers.

The third business skill enables entrepreneurs and CEOs to realize growth and make the most of their company’s potential. Yet, the majority of companies still largely overlook pricing in their organizational set-up. Where the first two business skills are well established in any company in the form of R&D, production, marketing, and sales departments, pricing’s place in companies’ departmental line-up is often less clearly defined. Only a very few companies have a Chief Pricing Officer.1 Responsibility for pricing tends to be scattered over different departments, resulting in suboptimal coordination of pricing.

1.3 Target readership and objective

Good pricing governance starts with the CEO. He or she understands what his or her company makes and how to sell it. The CEO needs the same level of understanding of pricing.

Ideally, the CEO himself also holds the position of Chief Pricing Officer, as did, each in his own way, Steve Jobs,2 Sam Walton3 and Albert Heijn.4 Making good pricing decisions requires vision, a cus-
customer perspective, and knowledge of all parts of the company. Failing a CEO who doubles up as a pricing chief, a dedicated Chief Pricing Officer working alongside the CEO can bring the kind of focus on pricing that the business requires.

This book sets out to raise awareness of the importance and workings of the pricing function among entrepreneurs, CEOs, and other stakeholders. Insights presented in this book will enable the reader to evaluate pricing strategies, revenue models, research methods, and the organization of the pricing function.

After reading this book, you will be able to assess to what extent your company masters the third business skill and where it needs to further hone this skill. Marketing, sales, and finance professionals will find the insights acquired through this book very helpful in their day-to-day activities. Collaboration across pricing processes will improve. And they will also acquire better understanding of the needs of pricing specialists.

1.4 Structure of this book

The next chapter (Ch.2) will focus on “the pricing perspective”. This perspective needs further development, because otherwise opportunities that present themselves in day-to-day business will go begging.

The three parts following this introduction will address this book’s central themes:
- The Art of Pricing (why?)
- The Science of Pricing (what?)
- The Execution of Pricing (how?)

“The Art of Pricing” covers the strategy underlying pricing and revenue models. We will show that there are more roads that lead to Rome. And we will identify twelve price drivers, each with its own impact on pricing. Together these form the building blocks of a pricing strategy.
“The Science of Pricing” implements the pricing strategy, defining the optimum price point based on data analysis (“to measure is to know”). We will draw on three layers of knowledge of price sensitivity, i.e., expert judgment (1), implicit measurement (2), and explicit measurement (3). Optimum use of these three layers depends on the outcome and costs of the analyses.

The final part is entitled “The Execution of Pricing”. The pricing process churns out prices for primary processes to use, such as sales, billing, and reporting. We will track the steps of this process on three process levels: strategic, tactical, and operational.

We will go into the organization of pricing efforts and the distribution of tasks and responsibilities within the company. And finally, we will discuss change management aspects that play a role in aspiring to boost pricing performance.
CHAPTER 2

The pricing perspective

2.1 Perspective

Perspective defines what you see and what you don’t see. People observe things as they appear to them in their day-to-day lives. For example, media convey those events they consider the most important and thereby shape the perspective of the audience. Their readers and viewers process news items as they are served up to them.

In a similar way, items on the agenda of a company’s board shape the perspective of middle managers and employees. Price is rarely an item on that agenda, which is down to the fact that no one on the board has direct and undivided responsibility for pricing. The commercial director is responsible for sales and revenue. The financial director’s focus is on accounts and reports, as well as on major financial transactions. The operational director makes sure production is efficient. And the CEO fulfils a coordinating role and is the public face of the company.

Broken up into several pieces, the pricing policy comes under the competency of the commercial, managing, financial, and operational directors. Each director only sees a piece of the pricing puzzle, and
the consequences of suboptimal prices often go unnoticed. Pricing is considered a *given*, and not a critical *decision*; the price is exogenous instead of endogenous.

The result is an underdeveloped perspective on pricing. Scant heed paid to pricing matters at board level leads to pricing decisions being sometimes made almost casually, with the decision-making process largely hidden from view, and only the end product, i.e., prices, reaching the desks of managers and employees.

Organization of the pricing function is barely explicit and almost always suboptimal. Every echelon of management rates projects in other areas more highly. These prioritized activities can therefore count on greater attention, perpetuating the status quo of poor pricing awareness.

Pricing’s invisibility is in stark contrast to the opportunities better pricing offers. Prices have a major impact on financial results. A study involving 2,463 companies\(^3\) showed that a 1% improvement in price yields an average boost to profits of 11%, trumping both a sales volume increase and reduction of fixed or variable costs in terms of impact on profit (also refer to Figure 1). A price improvement will, after all, raise revenue but not costs. This creates a lever effect on operating profits, which due to stagnant costs will increase by the same amount as revenue (also refer to Figure 2).

![Figure 1](image_url)  
**Figure 1** Price improvement has the greatest impact (also refer to Marn and Rosiello, 1992)
Figure 2  Lever effect of price (also refer to Marn and Rosiello, 1992):
(a) averages of costs and profit as a percentage of revenue emerging from the survey
(b) lever effect of a price improvement of 1%. A 1% better price generates 1% more revenue (1:100). Revenue rises from 100 to 101. Costs remain unchanged. Profit will consequently also go up by 1, i.e., from 9 to 10. This is an 11% profit increase (11% = 1:9)

The outcome will be different from one company to the next, as the ratio of fixed to variable costs will not be the same in every company. Current profit levels condition the relative impact of improvements. However, the impact of price is always greater than that of the other three profit drivers, i.e., sales volume, fixed costs, and variable costs.

These kinds of studies have meanwhile caught the attention of company directors, partly through the influence of boardroom advisors who have discovered the benefits of pricing. And yet it often turns out to be hard to achieve improvements. Most companies lack a broadly shared idea of what is needed for better pricing. This is due to a lack of vision on pricing and inadequate expertise. In the words of former soccer great Johan Cruijff: “You won’t see it until you’ve figured it out”.6 And that is precisely what this book intends to do, help you “figure out” pricing.

This chapter will focus on the consequences of the underdeveloped perspective on pricing, showing how important that perspective is. In the following chapters, this book will embark on a step-by-step journey toward full understanding of the pricing function that will help companies bring their perspective on pricing into focus.
2.2 Conventions of pricing

2.2.1 TWO POPULAR CRITERIA

Research performed in developed and emerging economies has shown that most companies go by two criteria in setting the price for their products or services: cost price and market price. This leads to two pricing methods that are referred to as “cost-plus” pricing and “competitive” pricing.

The popularity of these two criteria is striking, as pricing experts have pointed out that they do not lead to optimum prices. From Chapter 3 of part I (“Art of Pricing”) onward, we will explore alternatives and improvements. This section, however, will first focus on cost-plus and competitive pricing, on how they work, what the drawbacks are, and why they are so popular.

2.2.2 COST-PLUS PRICING

Cost price as a basis for selling price

Under the cost price principle, selling price equals average cost price plus profit mark-up, whereby cost price is calculated by dividing total costs by sales volume. The extent of the profit mark-up is derived from internal return requirements, historic conventions, or generally accepted practices in the industry.

The calculation is therefore as follows:

\[
\text{Selling price} = \text{average cost price} \times (1 + \% \text{ profit mark-up})
\]

Average cost price = total costs / sales volume

Reasons for popularity

Cost-plus pricing gets its appeal from three qualities that this method is generally believed to have: simplicity, fairness, and prudence. Implementing this principle seems simple, as it comprises a straightforward calculation that uses input that is readily available internally. Using a fixed profit mark-up is considered to be a fair way of recoup-
ing costs and putting a “justifiable” part aside for future investments. And its prudence lies in the conviction that costs are “always covered” this way.

The ostensible advantages of simplicity, fairness, and prudence are, however, based on fallacies. By exposing these fallacies, we will open new avenues toward a better pricing strategy.

1. Nontransparent
The alleged simplicity of cost-plus pricing only stands up when you take the sales volume forecast and extent of the profit mark-up as read. If you were to explore these factors further, links would be revealed between sales volume, market circumstances, competitiveness, profit mark-up, and pricing.

Cost-plus pricing hides the market’s supply and demand forces behind the sales forecast and profit mark-up variables, obscuring the company’s view of the reality of the customer and the market. This is what makes the pricing analysis nontransparent. Cost-plus pricing analyses neither what prices customers would be willing to pay, nor which product features really matter to customers and drive them to choose your product over that of your competitors.

2. Unfair
The fairness of cost-plus pricing is relative. The profit mark-up is in itself a subjective choice. And other components of the cost calculation require further subjective choices regarding, for example, volumes. Aside from that, it is unfair to withhold certain products from people only because the average total cost price is beyond their purchasing reach, when they would be able to afford a price that is higher than the variable cost price. For example: the price of medication can be lower in the Third World after fixed costs that went into R&D investments have been recovered in the First World. Cheap tickets for flights will remain available to tourists as long as the airline can cover the fixed costs of maintaining the route by selling expensive tickets to business travelers, who are willing to pay a premium for better service and greater comfort.
And finally, is it really unfair to provide consumers with free search engines online and free software? Users are satisfied with the service Facebook offers, but they are not paying anything to cover Facebook’s costs.

3. Reckless

Prudence too is a quality that has been erroneously ascribed to cost-plus pricing. After all, this prudence depends heavily on the forecasts of total costs and sales volume being correct. Failure to live up to forecast sales volumes will put pressure on profits. This often prompts a company to start giving discounts, which will eat away at the profit margins that the company put on the selling price as a measure of prudence. Besides, this sends a signal to customers, as well as sales staff, that the price was too high initially. Customers will expect another discount next year, even when they were satisfied with the product.

We are seeing that this method leads to reckless behavior, which can run companies into financial difficulty as they chase false truths. The only genuine truth a company can go by is confirmation of supplied value. Profitable prices that reflect the value for customers provide that confirmation: the proof of the pudding is in the price.

Subjectivity

It is important to realize that average cost is a subjective factor, because calculating average cost requires assumptions in three areas:

1. total costs
2. sales volume
3. profit mark-up

Total costs are made up of direct and indirect costs. Indirect costs include overheads, R&D investments, production facility costs, and sales channel expenses. To a certain extent, indirect costs are allocated to products arbitrarily. They depend on, among other things, considerations of volume, value, production capacity, and tax implications. And then there is also the distinction between fixed and variable costs. The way investments are written down influences the cost calculation.
The sales volume that is relevant for pricing is the sales volume in the future. This value will be unknown at the moment costs are calculated: it is based on estimation. And the profit mark-up, finally, is by definition also a subjective choice.

Besides assumptions in the three aforementioned areas, the source of the data used is also chosen subjectively. This data is obtained either from accounts based on the past (actual costing), or from the budget or business plan based on a forecast (cost estimate). Ideally, cost estimates and actual costs are aligned. A cost estimate will then be calibrated on the level of products, services, and subcomponents based on the actual costs. In practice, however, this kind of alignment is rarely performed as a structural and transparent activity that adheres to fixed procedures.

2.2.3 COMPETITIVE PRICING

Market price principle
The market price principle synchronizes the selling price with the price competitors charge. Salespeople want prices that are in line with those of the competition. “Because whenever a customer can choose between my product and someone else’s product that costs 10% less, a customer will naturally always go for the competitor’s product.”

Drawbacks
This reasoning seems legitimate. Customers are drawn to lower prices. But price is not the only thing that differentiates you from your competitors. This book will explore the possibility of improving selling prices through differentiation. Competitive or me-too pricing is a form of laziness.11 “Price” is often quoted as the reason for losing business. But in most cases, there is a significant lack of insight into the needs of the customer and the actual weight of the price in customers’ acquisition decisions. Generally, price only has a share of under 50% in consumers’ and companies’ buying decisions. Other factors combined (such as quality, service, brand and terms of supply) are at least equally important.
Failure to recognize market dynamics and supply factors is another risk users of the competitive pricing method expose themselves to. Price cuts are tempting if sales and market share are only dependent on price and market prices are a given. However, competitors will match your price cuts, especially when the entire industry is caught up in the competitive pricing paradigm. A downward spiral is easily sparked, but the consequences will reverberate for years in the form of a marginally performing industry.

Defining “the” market price is not as easy as it seems. It requires thorough understanding of who your immediate competitors are: your so-called peer group. And it is also important to keep track of competitors’ prices using an explicit and structural process. In practice, these kinds of activities are often only performed irregularly and inconsistently.

2.2.4 FROM TUNNEL VISION TO AN INTEGRATED APPROACH

The problems of cost-plus and competitive pricing are the result of tunnel vision. Although costs are a relevant benchmark in assessing the impact of price on a company’s financial health, and a cost analysis will therefore provide the input needed for pricing, cost is not the only or even the dominant driver.

Prices competitors charge for a certain product give consumers a rough idea of what the normal price is for that kind of product. Market price is consequently an adequate starting point in setting a price, but you can only add value by being different. You can express that in your price through, for example, price customization, price communication, or by boosting returns on relationships with customers, stakeholders and/or users through pricing.
2.3 Analysis and execution

2.3.1 A strategy is only as good as its implementation

An effective pricing strategy that uses sound criteria to set prices will be worthless if it is poorly executed. In practice, many problems will arise as a result of, for example, inadequate analyses and research methods, poorly trained staff, a divided organization and/or processes that eventually lead to incorrect, incomplete, or inefficient implementation of decisions.

This section will focus on problems in the area of analysis and execution, presenting examples of instances where quality and accuracy are at issue, and looking at the importance of speed, customer focus, training, and quality control.

2.3.2 Quality and accuracy

Suboptimal pricing often goes hand in hand with inadequate tooling and insufficient attention to detail in the implementation. Such negligence has a major impact. A calculation error of 5% in pricing is sometimes spotted late, while it can cut annual profits by half. And yet it is understandable that underlying calculations and tooling fall short, when you consider that operations and training simply lack a pricing perspective. Below you will find a few examples of situations where poor quality and inaccuracy of prices cause problems.

Manual data processing

Changes to a hardware manufacturer’s price list have led to numerous incorrect invoices to importers. An inquiry ordered by the board reveals that marketing managers are entering price changes manually. They do this separately in two systems, the price list in MS Excel and in the ERP system. They receive no support from IT.

The price list is the basis for communication with importers and customers. It contains tens of thousands of prices for products and parts in dozens of countries, sales channels, and currencies. Invoices are sent from the ERP system. Managers populate the tables in both
systems manually, entry by entry, without verifying the correctness of the input. Errors in the systems are only corrected when reported by importers.

**A salesman’s “win price”**

A successful business service provider has a pricing process that involves comparisons of market prices, cost prices, and margins. When drafting an offer, every salesman estimates the “win price”: the price that will land him the contract. Salesmen base their estimate on several offers from the past year, feedback from customers, and prices that have landed their or other companies contracts in the past.

Finance subsequently calculates how much profit this price can be expected to generate. They calculate fixed and variable costs and eventually either ratify or reject the proposed price. Sales staff is remunerated based on the revenue they generate. It is an open secret at the company that members of its sales staff estimate “win prices” as low as possible to maximize their chances of landing a contract. As a result, there is little mutual trust between Sales and Finance.

Finance managers negotiate the process on autopilot. They do not develop tooling aimed at validating market price estimates consistently, integrally, and factually. This leads to an internal and natural downward pressure on price.

**Supply chain**

A truck manufacturer moves its European production to a facility in Scandinavia. This facility’s financial management uses its own cost allocation method for electric trucks that are in high demand. Consequently, the internal transfer price the production department charges the sales division is higher than the market price the sales division charges its customers. Due to the negative margin, account managers cease their sales efforts for this type of electric vehicle. Based on a technology-led perspective, the head office employs a top-down management approach. It lacks insight into the quality of prices in the supply chain and fails to act on time to define a cost allocation method for production that does justice to variable costs and value in the market.
Supermarkets

With a plethora of prices to deal with, which they also frequently change, supermarkets have a tough job monitoring the quality of their prices. On the reference date of 24 August 2012, Ahold (€10bn in revenue in the Netherlands), for example, uses the same price for a 450-gram jar of own-label strawberry jam as it does for a 600-gram jar of exactly the same strawberry jam, of the same brand (€1.55).\(^{12}\)

The *per-unit* price will normally be lower for larger packaging or at least be the same. And still, on 20 July 2012, Ahold charges €1.59 for 400 grams of cherry tomatoes in an economy pack, while 250 grams in the regular packaging costs €0.79.\(^{13}\) The per-unit price is therefore €3.98/kg for 400 grams in an “economy pack”. That is 25.8% more expensive than the €3.16/kg Ahold charges for regular *smaller* 250 gram trays.

2.3.3 SPEED

The lack of a perspective on pricing has a major impact on the speed with which a price can be set. This speed is particularly important when a price is not a previously set given, such as would be the case with a customized service or product. Speed is also important when a price is no longer adequate, such as when market circumstances have changed or inflation of raw material prices drives up costs.

When a (new) price is not set quickly enough, sales will be affected in terms of volume, revenue, and margin. Customers are sometimes unwilling to accept a delay, and will switch to a competitor who will welcome them with open arms. And if sales staff does still manage to tempt customers to buy, the price may be insufficiently customized. This will erode profitability, as illustrated by the following examples.

*International deals*

Globally operating suppliers in industries such as IT, mechanical engineering, the automotive industry, staffing, facility, etc. strike cross-border deals with a view to capitalizing on their scale and meeting the needs of major customers. But a global pricing director is often lacking.
An account manager at such a supplier, who wants to quote a price to a customer of the likes of Procter & Gamble, Shell, Vodafone, General Motors, Honeywell, or any other Fortune Global 500 company, will personally have to collect all standard prices from the company’s various subsidiaries across the globe. He is the one who gives customers discounts and sets surcharges or margins for customization. He subsequently submits his price proposal to the (central) finance department for approval. A team of financial analysts will then compile a business case. However, this team has little knowledge of the value provided to customers or how accurate sales forecasts are. Nonetheless, the business case they compile passes the desks of all CFOs in the regions and countries concerned for approval. This is a lengthy process that may take up to several months.

One commonly used way of bypassing this sees companies setting up a global unit that enters into and manages global contracts. But the same problem crops up again: forming a good agreement for one hundred countries requires information about costs and market prices from local units. The challenge global deal makers face is to have information about local prices readily available. When the authority for pricing is bestowed on a global unit, central pricing specialists can cut the time spent on drawing up an offer from several months to 24 hours. Pricing managers can, furthermore, tailor the structure of the quoted price to the customer. Deal makers can then rely on support that improves the quality and velocity of sales.

### Fashion retail
Retailers of fashion clothing often use one and the same price throughout a season. This retail price was set when the item was launched. Toward the end of the season, any remaining stock will be put into the sale to make way for the next collection. Stores will, however, know well before that which items will remain unsold. Retailers are traditionally slow in using price and discounts as sales tools. They put that off until the sales, missing out on valuable percentages of revenue in the process. Marking down prices of poorly-selling items and raising prices of items that are more in demand will set any retailer on the road toward more revenue. Better pricing will offer retailers who work with narrow net margins much-needed opportunities.
2.3.4 CUSTOMER FOCUS

Customer-driven pricing sometimes puts managers in two minds. They want to make as much as they can from customers, and therefore prefer to limit customer-friendliness to aspects that are not related to price. Financial services providers, for example, prefer not to display customer focus in the transparency of their fees. But customer focus not only plays a major role in transparency, it is also crucial in the pricing model.

In 2010, Dutch mobile telecommunications operators decided to round call charges up to the minute. As a consequence, a 10-second call was charged as a 1-minute call, while a call that took 1 minute and 5 seconds was recorded as a two-minute call. After a wave of protest and pressed by the government, the operators soon reversed the general applicability of the new rounding up rule. They decided, albeit reluctantly, to additionally offer contracts under which calls are charged per second under different rate plans. This coexistence of two charging models has, however, not helped ease market complexity.

Another example: in the late 1990s, Coca-Cola came up with the idea of fitting refrigerated vending machines with a thermometer so as to crank up the price of a Coke as temperatures rise. After all, the hotter it is outside, the more people want an ice-cold Coke. The idea sparked outrage. The San Francisco Chronicle branded it “Coca-Cola’s cynical ploy to exploit the thirst of faithful customers”, while the Philadelphia Inquirer concluded that it was “the latest evidence that the world is going to hell in a handbasket”. Coca-Cola executive Doug Ivester countered the critique by explaining that paying more under hot weather conditions is fairer, but his retort was to no avail. Coca-Cola soon cut its losses and dropped the idea.

2.3.5 TRAINING

There is little regard for (embedding) pricing skills and development of best practices. In most cases, IT only provides very limited support for pricing. Employees are insufficiently equipped to analyze prices.
Marketing, commercial, and financial education spends little to no time on pricing. General textbooks for courses furthermore tend to exclusively cover largely inferior strategies such as cost-plus pricing and competitive pricing. Subjects that specifically focus on pricing are not part of the compulsory curriculum at business schools and economics faculties.

Employees and managers therefore lack the required knowledge to be able to optimize prices and run and implement processes adequately, even if they have enjoyed an Ivy League education.

2.3.6 QUALITY CONTROL

Companies have control processes in place to monitor the quality of production, the safety of their operations, the correctness of their financial statements, the development of management resources, and the performance of commercial departments, but quality control for pricing is lacking.

Even though the quality of the pricing policy is a major factor in a company’s financial health, responsibility for pricing is often placed in the hands of operating companies without expert review of the soundness of pricing decisions. Control is restricted to general financial reports afterwards, which fail to specifically address the pricing policy and the implementation thereof.

2.4 Perspectives in this book

2.4.1 PRINCIPLES FOR PRICING IN THIS BOOK

Part I (The Art of Pricing) will address twelve possible price drivers or principles underlying the selling price (the 12 Cs of pricing). The art of pricing is to select the right revenue model and pricing strategy from these 12 Cs, i.e., those that are best aligned with a company’s business model, market, and target customer group.
We will distinguish between price drivers based on performance, transaction, communication, and relationship. This will put the cost price and market price principles into a broader perspective, one that does justice to the vast array of different opportunities that are open to a company.

2.4.2 ANALYSIS AND EXECUTION IN THIS BOOK

Part II (The Science of Pricing) will subsequently go into analysis and research methods that are needed to provide grounding for and eventually implement the pricing strategy. Our approach will be an integrated one, combining commercial managers’ knowledge, experience, and intuition with information from readily available data sources. Executive decision makers can then decide in consultation with their pricing managers whether more in-depth and specific research is required to gain more detailed insights.

Part III (The Execution of Pricing) will first discuss the pricing process. We will go into the structure of this process and how it ties in with other primary processes. After that, our focus will shift to the organization of pricing, allocation of responsibilities, access to information, and selection and training of capable human resources. We will conclude with change management aspects of pricing improvements.
PART I

The art of pricing
Cohesion
Co-selling
Cross-selling
Complexity reduction
Tacit collusion
Communication
Costs
Customization
Competition
Customer value
Corporate strategy & business model
Company profitability

Company profitability
Corporate strategy & business model
Customer value
Competition
Customization
Costs
Communication
Tacit collusion
Complexity reduction
Cross-selling
Co-selling
Cohesion
CHAPTER 3

The freedom of pricing

3.1 Pricing as a creative process

People like to pursue clear targets. How well children do at school, for example, is quantified in the form of a grade on a report card. The same linear pattern is used in companies, where commercial management is focused on sales figures, while the CFO pursues clear goals on the level of costs. Targets for success are often one-dimensional.

In the more creative sections of a company, this kind of linear approach is unproductive. Innovations and creative improvements are not the fruit of a pursuit of an unequivocal target, such as a specific number of promising ideas a day. This is the realm of inspiration and perseverance: these are the true sources of innovation.

Numerous managers also take a linear approach to their company’s pricing policy. After all, a price is just a number that can only be higher or lower, or so it seems. However, the optimum price in an absolute sense does not exist. Pricing is a creative process, regardless of the fact that it involves countless seemingly objective calculations presented by spreadsheet specialists and consultants.
The amount of freedom you have in setting a price is exceptional. There is a huge variety in the different kinds of prices and discounts you can offer, as well as in their level. You can offer certain products free of charge, while charging steep prices for others. You can serve one customer instantly at a high price, while you keep another waiting. You can present a price on a price list solely to influence customers’ perception. You can set a price per minute or per ounce, kilobyte, or any other unit. Nobody’s stopping you. Other operational decisions tend to be far more dependent on external factors and physical possibilities.

In practice, few entrepreneurs and managers realize that they have such great freedom when it comes to pricing. Whenever you discuss the subject of pricing, they will cite less conscious considerations and implicit rules as decisive for pricing. These kinds of convictions are deeply instilled in the minds of those who count pricing among their duties, obscuring their view of the options available to them. But general principles that were formed in the past are perhaps no longer appropriate for the company or the market. In such cases, untangling the options for improvement turns out to be more complex than initially thought.

Even with a relatively simple measure such as merely raising or lowering a price, things do really get complex when you oversee the consequences of that price change. Lowering a price will, for example, generally boost demand, while cutting the margin. These are two opposite effects on profitability. Your price cut may also prompt your competitors to do the same. That is a third effect. The way you communicate about price subsequently partly determines the impact of price changes, as will a restriction of the validity of the price change, as would be the case with a special offer. All in all, there are a lot of factors to weigh up in setting a price.

The FirstPrice Pricing Clock (FPC) is the point of departure for our explanation of the art of pricing. The FPC contains twelve considerations, or drivers, for pricing (see price drivers in Table 1). The FPC unites a number of different directions set out in professional literature, which are rarely linked in publications.
The best pricing managers are those entrepreneurs who are able to create a revenue model that is perfectly aligned with their business model and business philosophy. From the twelve price drivers, they will collate the revenue model that will best enable them to accomplish their business objectives. You are encouraged to do the same.

<table>
<thead>
<tr>
<th>Focus</th>
<th>Price driver</th>
</tr>
</thead>
</table>
| Performance | (C1) Company profitability  
               | (C2) Corporate strategy & business model                                      |
| Transaction | (C3) Customer value  
               | (C4) Competition  
               | (C5) Customization  
               | (C6) Costs                                                   |
| Communication | (C7) Communication to customers  
                 | (C8) Tacit collusion  
                 | (C9) Complexity reduction                                               |
| Relationship | (C10) Cross-selling  
                 | (C11) Co-selling  
                 | (C12) Cohesion                                                          |

Table 1 The 12 Cs of pricing and revenue models

3.2 The twelve price drivers

3.2.1 PERFORMANCE

Chapter 4 will go into the objectives and performance of the company. The first price driver is the direct objective of profitability (C1). The second price driver is made up of the objectives of corporate strategy and business model (C2).

3.2.2 TRANSACTION

Chapter 5 will view pricing from the viewpoint of the transaction. We will address the value (C3) that customers assign to an offer within the context of competing (C4) alternatives. This chapter will also focus on the possibility of varying prices from one customer or customer segment to the next (C5). In order to assess the contribu-
tion of the above concepts on profits, we will conclude with the cost analysis (C6).

3.2.3 COMMUNICATION

The role of communication is discussed in Chapter 6. With the right communication, you can steer customers and competitors in a subtle way. Customers’ perception is influenced by the way in which you inform them on prices (C7). Within certain boundaries, you can exert a positive influence on the market price, as long as you don’t see your competitors as enemies (C8). And finally, price engineering will often complicate internal and external communication. In industries such as mobile telephony, energy, or air travel, the average customer will be unable to instantly take in the many thousands of options. Complexity reduction (C9) is then a price driver in its own right.

3.2.4 RELATIONSHIP

Chapter 7 will deal with the return on customer relationships. Putting relationships center stage may clash with transaction-based drivers. How about providing services free of charge as per the “free-mium” model? Retailers draw on this same logic when they deploy “loss leaders”. These are products with a selling price that is below their cost price, intended to generate footfall, in the hope that these people will also purchase other items.

Cross-selling (C10) requires a relationship with the customer, who will enjoy a direct financial benefit in a transaction. The price you offer is “too low” to further strengthen the relationship with the customer. Co-selling (C11) is based on a value exchange among several parties. This involves giving a discount to one party in order to make more off another party. Co-selling is a tactic often seen at commercial TV stations and Internet companies, but also in large infrastructure projects. Cohesion (C12), finally, is all about mutual relations between price drivers. The chance of success is greater when price drivers work together.
4.1 Objective

What you intend to achieve with the price you decide on will determine the level and structure of your price. In a narrow sense, price is a tool that enables you to boost profitability and your company’s value directly. The first price driver is therefore company profitability (C1). This is achieved through the effect price has on sales, revenue, and profits, without considering other factors.

Price can, however, also be a means to ends from the business strategy and business model that reach beyond directly boosting profits. The strategy will in that case determine the pricing objective. When a company, for example, aspires to attain cost leadership, it may choose to lower prices to stimulate sales, banking on economies of scale to lead to lower costs. Corporate strategy and business model (C2) is the second price driver.

This chapter will further detail the two performance-related price drivers.
4.2 Company profitability (C1)

Generating more profit is an obvious price driver, due to the simple fact that price greatly influences sales, revenue, and margin. Entrepreneurs therefore often test prices to see how they affect their bottom line. Direct assessments of the influence of price on profitability do not require in-depth analysis of customers, competition, costs, or other factors. In practice, price testing is mainly performed for small price changes. These involve less risk, meaning that the analysis of the underlying dynamics will not be missed as much.

Annual upward price indexation is a popular way of picking up a little extra profit every year. However, it also forces customers to up their budget every year, which changes the dynamics of the relationship, and may lead to irritation and protest. In 2012, some scientists were so fed up with the increasing cost of scientific journals that they encouraged each other to publish in free open-source journals. The counterargument that what university libraries pay for each article read has dropped over the past years, as a result of the greater uptake of journals, simply cut no ice with them anymore.

Over the past few decades, companies have enhanced, often instigated by financial controllers, the analysis of their profitability. Where a profit and loss account at overall company level used to suffice, companies now have a lot more information readily available; data warehouses can map profitability for every part of a product and service portfolio. The advantage of this kind of detailed information is that it makes it easier to use price as a tool to achieve the objectives. But there is also a drawback, namely that the information does not provide insight into the underlying reason for profitability, such as the market situation or customer relationships. Also, the cost calculation and profitability analysis are, to a certain degree, subjective (refer to Chapter 2) and generally tailored to finance and tax needs of cost and profit allocation rather than to the objectives of strategic pricing analysis (see also paragraph 5.5).

* On a cost basis, the price per download in the U.K. fell for example from £1.19 in 2004 to £0.70 in 2008.
It would therefore be sensible not to put all your eggs in the basket of the first price driver C1, i.e., profitability, in a direct sense. In the following, we will continue with the second price driver, corporate strategy and business model.

4.3 Corporate strategy & business model (C2)

4.3.1 VARIETY OF STRATEGIES AND BUSINESS MODELS

Entrepreneurs’ creativity in developing strategies and business models seems to know no bounds. Just look at the number of schools of thought and approaches in the area of business strategy. Strategies and business models set out how to add value. The revenue model and price drivers are a part of that. The strategy will often not define profitability as a direct objective, but rather target more sales, a greater market share, or larger customer base. The second price driver (C2) is the direct objective of the strategy.

The scope of this section will be confined to three important examples of a possible strategy: cost leadership, market dominance, and niche leadership. Maximizing profit in the short term is not the aim. There are other direct objectives, which are intended to lead to greater profits in the long term.

4.3.2 COST LEADERSHIP

When a company seeks to attain “cost leadership” (lowest costs), the short-term goal will be higher sales. Larger volumes will produce economies of scale in the area of production, delivery, and procurement, hence lowering cost per unit. Numerous Chinese manufacturers, but also retailers such as Walmart, Aldi, and Lidl, have adopted this strategy. Aiming for more sales calls for a low price, one that is considerably below the value customers assign to the product. A price that is “too” low will spark demand and “push” smaller providers out of the market.
4.3.3 **MARKET DOMINANCE**

A second widely-held goal is a dominant market position. Multinationals have been setting targets along the lines of “being number 1 or 2 in every market” for years. They regularly come up with an aggressive pricing policy with an eye to growing their market share. The importance ascribed to market dominance is partly the result of the so-called PIMS studies. These studies into the variables that influence the performance of a large number of companies showed a positive statistic correlation between market share and profitability. Consultants and board members the world over inferred from that outcome that a large market share is what they should be aiming for.

Over the past few years, the importance of market dominance has waned in companies’ strategies, and the focus has shifted to alternatives such as niche leadership. This shift was prompted by follow-up studies that cast doubt on the causality of the aforementioned correlation from the original PIMS studies.

4.3.4 **NICHE LEADERSHIP**

Another possible strategy is to try to conquer a niche. Dominance in a specific section of the market can be based on propositions such as:
- no-frills* (e.g. Aldi)
- value-for-money (e.g. Ikea)
- product leadership (e.g. BMW)
- exclusivity (e.g. Rolex)

These kinds of propositions are exclusively focused on one niche. No-frills suits the lowest market segment, while exclusivity will work best in the highest market segment.

* No-frills: keeping cost down by cutting non-essentials in order to be able to charge the lowest possible price.
4.3.5 **ALIGNMENT**

Whatever the strategic goals may be, a successful pricing policy is always one that has been integrated into the business model. One look at the history of Dutch supermarket chain Albert Heijn shows what happens when pricing policy and business model are misaligned.\(^\text{20}\)

Around the turn of the millennium, supermarket holding Ahold used high prices to maximize the returns (C1) of its subsidiary Albert Heijn, the market leader in the Netherlands. Ahold needed resources to fund its acquisition drive, which ended up making this company one of the world’s largest retail conglomerates at the time.

It worked out well for them for a while. Supermarket customers are loyal. Most customers shop at the store that is nearest to where they live. And they furthermore always go to the same supermarket for their groceries, because going to a different one would involve having to find their way round a different shop layout and assortment. And yet, after a while, increasing numbers of shoppers started noticing that Albert Heijn’s prices were quite high, perhaps even too high for their liking. Customers started turning their backs on Albert Heijn. And it was mainly families that did so: they tend to buy large quantities and could therefore potentially make greater savings on their groceries when shopping elsewhere.

The *high prices* and high *per-item margins* the holding forced Albert Heijn to use went against Albert Heijn’s business model, which favors *revenue and absolute per-customer margin* and the *number of customers*. After all, supermarkets and department stores are in the game of making the most of their broad assortment. Attractive prices boost returns by drawing *more customers* (C2) into the shop. Secondly, low prices also tempt customers to buy more products per visit. Earning the highest *absolute per-customer margin (in euros)* (C2) depends more heavily on per-customer revenue than on the relative (percentage) margin per product. The importance of per-customer revenue and number of customers was even greater for Albert Heijn because their assortment is broader than that of its competitors (see Figure
3). All Albert Heijn needed to do was to keenly price items that its competitors also carried.

Albert Heijn would then have been able to “subsidize” these low prices using the margins on items customers could not get at its competitors. That would have been a relatively cheap way of attracting shoppers, and enticing them to buy all their groceries (even the more expensive ones) at Albert Heijn.

Parent company Ahold failed to factor in the optimum business model when it decided to impose price hikes. This eventually led to a decline in Albert Heijn’s market share and profitability. When a boardroom crisis at Ahold liberated Albert Heijn from the yoke of its parent company’s rigid pricing ideas, Albert Heijn immediately instated a keener pricing policy. This led to a tremendous rise in the number of customers and revenue, as a result of which both profitability and market share grew.
CHAPTER 5

Transaction

5.1 Beyond the flat world

Cost-plus and competitive pricing are one-dimensional and overly simple ways of setting the selling price. These two popular methods lead to a passive attitude. All there is to it is to slap a standard margin on top of the cost price, stay in line with “the” market price, or strike a happy medium between these principles in two dimensions. Some people still seem to believe the world is flat.

For the price drivers that are covered in this chapter the emphasis is on the transaction. A transaction is the exchange of something of value between two parties. Price drivers that are centered on this factor have a broader perspective, as they distinguish more dimensions for pricing. We will look at the factors that determine whether or not transactions come about when customers are free to choose. The central focus will then be on the differences and similarities between options. The differences are determined by the uniqueness of customers, products, or companies. Similarities provide benchmarks against which prices can be offset. The art of pricing is to identify the similarities and appraise the differences.
Customer value (C3) is what a customer thinks your product or service is worth. If that value equals or exceeds the price, a customer will proceed to purchase. Competition (C4) is important in two ways. Firstly because customers use competitors to compare the price-to-value ratio. And secondly, your product’s relative value will change as soon as your competitors change their prices. Customization (C5) offers the opportunity of charging certain customers different prices, based on individual value perception. And costs (C6), finally, determine your minimum price. It is important that every price be higher than avoidable costs and not higher than the average total costs, as is the case with cost-plus pricing.

The four Cs of transaction-driven pricing (C3, C4, C5, and C6) are the core of the domain of pricing that is referred to as value pricing,* as taught nowadays at business schools and described in management literature.21

5.2 Customer value† (C3)

The idea behind value pricing is that customers are willing to pay any price that is below the value they assign to a product or service. In pricing, this leads to the principle of customer value (C3), which is also referred to as “willingness to pay”. The optimum price mirrors this value. When a price exceeds the customer's perceived worth, there will be no sale, and charging a price that is lower than the willingness to pay is not necessary.

The logic of the value principle is attractive. Innovating, successful, growing companies that charge a value-based price have given value pricing a good name. Apple, Nespresso, and Audi, for example, stood out in a positive sense in 2011 with a combination of value-based prices, satisfied customers, and high profitability. There are,

* Customer perceived value pricing is another widely-used concept. This is an addition that goes with the price driver C7 “communication to customers”, which will be covered in Chapter 6.
† Customer value: a customer’s assessment of what a product or service is worth. The term customer value is also used with a wholly different definition, i.e.: the financial value that serving a customer represents to a company (over the years). This is not what we are referring to here.
however, three reasons why operationalization of the concepts of value and valuation is far from straightforward.

First of all, customer value is difficult to observe, because it is partly a subconscious value and because customers do not always answer honestly when asked about their perception of a proposition’s worth. Secondly, this value is not objective, but subjective. Perception of a product’s or service’s worth will differ from one customer to the next. Thirdly, value is changeable, because it depends on numerous variables. Value perception will change, for example, due to changes in a customer’s budgetary circumstances, economic conditions, shifting preferences, and developments at the competition or in technology.

These are the reasons why it will remain hard to get a grip on value pricing for managers for whom pricing is not their first priority. This will, among other things, lead to resistance during implementation processes, as these need a clear goal and a transparent method for the organization.

Pricing experts are more familiar with these concepts, and use them pragmatically. Their main focus is on the choices customers are making, from which they derive customers’ implicit perception of worth. Part II (The Science of Pricing) will go into the operationalization and quantification of concepts such as value and price sensitivity in greater detail. This chapter will cover the conceptual framework and approach.

There are various factors that play a role in the formation of customers’ perception of a product’s or service’s worth. In marketing, these factors are referred to as the “value drivers” or “purchase factors”. Purchase factors are the reasons on which a customer bases his or her decision to purchase a product or not. In the context of a simplified example of cars, the value drivers are product-related features and financial factors (see Table 2). The value drivers are not all equally important. In this case, the power of the brand, for example, weighs heavier in the decision to purchase a car than fuel economy (10%).
Value drivers | Weight
---|---
**Product-related** |  
Engine | 20%  
Model | 15%  
Reliability | 20%  
Power of the brand | 20%  
**Financial factors** |  
Trade-in value | 15%  
Fuel economy | 10%  

Table 2  Example of value drivers for mid-range cars (fictitious data)

Value is driven not just by the attractiveness of a product. Availability of alternatives also comes into it. Nagle and Holden\(^\text{22}\) have split the value of a service or product into two components:

\[
\text{Value} = \text{reference value} + \text{differentiation value}
\]

The alternatives are what determine the “reference value”. A customer comparing a €20,000 VW Golf to a €18,000 Kia Cee’d will try to figure out which *unique* features justify the €2,000 price difference. The *reference* value of €18,000 is not questioned as much, as customers perceive that to be “the” market price for that kind of car. The customer’s attention goes to the unique premium the VW Golf would have to offer for €2,000.

There are more alternatives than just directly competing propositions. There are four sources of reference value:

<table>
<thead>
<tr>
<th>Alternatives</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Own product/service</strong></td>
<td>VW Golf ↔ VW Polo</td>
</tr>
<tr>
<td><strong>Direct competitor</strong></td>
<td>VW Golf ↔ Kia Cee’d</td>
</tr>
<tr>
<td><strong>Indirect competitor</strong></td>
<td>Car ↔ motorcycle, train, ...</td>
</tr>
<tr>
<td><strong>Delay decision</strong></td>
<td>Keep current car</td>
</tr>
</tbody>
</table>

Table 3  Sources of reference value

Value drivers should be seen in light of the unique value a certain feature can have for customers. Volkswagen is a stronger brand. But a Kia offers a premium in the form of its seven-year warranty, which is longer than the warranty Volkswagen offers. Setting a value-
based price therefore requires understanding of customers and value drivers — of the company’s proposition and that of the competition.

The price drivers of customer value (C3) and competition (C4) are intertwined. After all, the value of your proposition (C3) partly depends on the alternatives that are available (C4). The price and value of a competing proposition are relevant reference points in defining your price and value. Pricing is then focused on *price-to-value ratios* in the market, and not on market prices.

In closing: for value-based pricing to be applied properly, it needs to be embedded into a value-driven commercial approach. Such an approach should accurately combine three things:
- creation of value in product development,
- communication of value through marketing and sales, and
- generation of revenue from value through pricing.

5.3 **Competition (C4)**

Together, market price and competition (C4) define the reference value, making them *indirectly* determinative for the value (C3). Value pricing is based on differences (unique value) and similarities (reference value) in relation to competitors or alternatives. This is a more sophisticated approach than competitive pricing, which uses market price as a direct standard. Value pricing uses the price-to-value ratio as the reference point in setting a price.

A “value equivalence” diagram provides insight into market positioning (see Figure 4).23 With value on the horizontal axis, and price on the vertical, the “equivalence line” denotes the ratio of price to value.

* These concepts can be further refined to *perceived* value and *perceived* price. Perception can be steered by communication (refer to Chapter 6).
In a stable market, propositions will be on the value equivalence line, meaning that prices are an adequate reflection of the perceived value. In Figure 4, the prices of A, F, and C are in balance with the market value. E and D, on the other hand, offer a premium, while B is relatively expensive. Table 4 below lists the data on which Figure 4 is based. This table contains prices, value drivers, and their relative weight. (Part II (The Science of Pricing) will go into the methods that can be used to compile this kind of table.)

**Table 4** Value drivers for mid-range cars, whereby 1 = weak, 2 = average, 3 = strong, 4 = excellent (fictitious data)
Table 4 tells us that the premium offered by E lies in the value drivers of “engine”, “reliability”, and “trade-in value”. The price for B is relatively high. This car basically scores poorly on all points. The market price principle would, actually, result in a different conclusion about the price of B. The price would then not be considered high, but as relatively low. After all, B is, after C, the cheapest of these cars.

Needless to say, this kind of analysis will be less accurate than a test in a physics lab. But still, useful indications of value that are comparable to weather forecasts or election predictions in terms of accuracy are indeed possible. The methods used will generally point in the right direction and estimate effects within a certain margin of error. Accuracy depends on how the analysis is performed and what budget there is available for data collection.

5.3.1 Defending price and value

By considering value and price as a unit, you are managing not only pricing effectively, but also your sales department’s performance. Good salespeople focus on the value proposition they offer. Whenever a price or value proposition is off target or offers room for improvement, they will give factual and detailed feedback to the pricing manager.

Less-experienced sales staff will, however, not be able to address their losses and successes in terms of value. They will simply brand “the” price “not competitive”. These salespeople would benefit from targeted training and an exchange of best practices with fellow top-ranking salespeople, who would then assume the role of change agents.

5.3.2 Competing on price

The price-to-value ratio diagram also provides insight into market behavior. Not all price reductions, for example, are an act of aggression. If B from our example were to launch a promotional campaign offering discounts, the price-to-value ratio would lead to us considering
that a corrective and defensive move, not an aggressive one.* Players A, C, and F will not have to take up their price weapons in defense.

5.3.3 **COMPETING ON VALUE**

The diagram furthermore shows that improvements that increase value without being accompanied by a price hike are aggressive movements. E is basically already taking up such an aggressive position; E could consider raising its price. Sales would, due to the strong value proposition, probably not see a considerable drop. So all in all, a price rise would likely lead to an increase in the absolute margin.

One example of competing on value can be found in the detergent market. The introduction of an improved formula that delivers better cleaning at lower temperatures is an aggressive move. After all, without an accompanying price rise, the formula would deliver greater value for the same price. A good defense against such an attack is to selectively use the weapon of price through a volume discount (2 for 1) just before the launch date of the competitor’s new and improved formula. Consumers will then likely stock up on your detergent, causing slow sales of the new detergent. This will buy you some time to come up with an innovation of your own.

5.3.4 **TARGET GROUP**

One aspect that the price-to-value diagram sheds insufficient light on is the fact that not all customers or customer groups have the same value perception. A comparison will only hold when manufacturers focus on more or less the same target group. For Mercedes-Benz, for example, the value Chevrolet drivers assign to a Mercedes is less relevant, as Chevrolet drivers are not part of their target group. But they are interested in how customers of other luxury brands perceive their cars. These luxury brands are in their “peer group” or “reference group”: manufacturers with the same target group.

* Again, when going by the market price principle, such a price reduction would be judged differently, and would indeed be considered an aggressive move instead of a defensive one.
The definition of the target group of customers and peer group of competitors is therefore a crucial decision in the implementation of a value-based pricing strategy.*

5.4 Customization (C5)

Companies often treat certain customers differently in the sales process. Quality-conscious customers, for example, receive more attention than “bargain hunters”. Price customization (C5) allows you to make this same distinction in the pricing policy with a view to making more profit. That would lead to price differentiation: a price customized to a particular sales opportunity.

Price customization is a widely used tactic. What, for example, does a can of Coca-Cola cost? That question is virtually impossible to answer. A better question would be: how many different prices are there for a can of Coca-Cola, and what are they? A can from a vending machine at a sports venue may cost up to €2.50 or more, while that same can in a 24-can pack from the supermarket will only set you back €0.46.

Let’s take the example of an orchestra that sells 1,000 tickets to one of its concerts at one uniform price of €35 per ticket, generating revenue of €35,000 (€35 * 1,000) (see the dotted rectangle in Figure 5a). Under pressure from cuts to the orchestra’s subsidy, the orchestra’s manager decides to start charging two prices. He now offers regular tickets at €50 each. But the venue has a capacity of 1,500 and hardly ever sells out. He therefore decides to charge students and people on a low income €25 per ticket (see Figure 5b). The price rise for the regular tickets is 43%, while the price of the discounted tickets is 29% lower than the previous single price.

* There may also be differences in value perception within one target group. Someone who drives a company car, for example, will have cost considerations that differ from those of someone who buys his or her own car. Seeing as our focus is on underlying principles, we will not go into such layered details.
Figure 5 One single price (a) compared to two customized prices (b and c). Price is shown on the y-axis, volume on the x-axis. The surface of the box represents revenue (price x volume).

Thirty percent of those who currently come to the concert are either on a low income or students. A price reduction of €10 enables the manager to sell 500 instead of 300 tickets to this customer segment. The other audience members’ decision to come to the concert is not affected by price. They have more money to spend and like going to concerts by the only orchestra in their city. Sales of tickets to these people at the new regular price of €50 therefore remain steady at 700, the same number of people from this segment that bought tickets at €35.

After differentiation in prices, revenue comes in at €47,500. In Figure 5b, this is represented by the checkered surface that results from adding up the amount of €35,000 (€50 * 700) generated by expensive tickets and the amount of €12,500 (€25 * (1,200 — 700)) generated by discounted tickets. We can only conclude that this price differentiation has had a considerable effect. Revenue is up 36% or
€12,500 (€47,500 — €35,000). This rise in revenue is depicted by the surface of the areas of Figure 5b that remain after you subtract the rectangle from Figure 5a. This difference equals the two checkered rectangles minus the rectangle with the black-and-white dots in Figure 5c.

There is also a positive impact on profitability. After all, the costs of staging a concert have remained unchanged except for a slight rise in administrative expenses owing to the fact that the administration now has to handle two types of tickets.

The only downside for the orchestra’s manager is that 300 students and people on a low income would also have been willing to pay €35, as we saw prior to the price change. As was to be expected, they gratefully take advantage of the option of buying a ticket to the concert for €25. This special form of price erosion is known as “price dilution”. In order to counter price dilution, the orchestra could also start charging two prices for students and people on a low income: €35 for a ticket with the usual terms and conditions and a no-frills “last-minute” ticket for a seat at the back for €25. That would take the number of tickets on offer to three (including the general €50 ticket).

In practice, revenue increases from several percentage points up to 10% are commonplace when using price customization instead of one single price. Given that the costs of implementing differentiated prices are relatively low, the major part of the additional revenue will go straight toward profit. When asked about the impact of differentiation of price and services, former British Airways chairman and CEO Sir Colin Marshall replied:

“If you can deliver something extra ..., some people will pay a slight premium for it. I want to stress that when I say “slight”, I mean precisely that. In our case, we’re talking about an average of 5%. On our revenues of £5 billion, however, that 5% translates into an extra £250 million, or $400 million, a year.”25
The strategy of price differentiation is particularly effective when there are large differences in:

- **Customer value (willingness to pay)**
  Prices vary based on willingness to pay, such as when one customer segment has greater spending power.

- **Variable costs (cost to serve)**
  Boosting sales by introducing lower price options is only attractive when variable costs are low, such as when there is overcapacity.

There is a snag though. Although you may be able to achieve a lot through price customization, how do you get one customer to pay €50, while charging others €25? It could lead to indignation among customers, who may decide not to go or try to find ways of being eligible for the €25 ticket. Sales of the regular-priced tickets will subsequently be under pressure and the regular price may erode.

This has triggered several measures aimed at making price customization a success, which are jointly also referred to as “fencing”. We will now go into five dimensions where price segmentation can be applied:

- **Customer**
- **Purchasing process**
- **Product or service**
- **Volume**
- **Price conditions and pricing model**

### 5.4.1 **CUSTOMER**

Willingness to pay differs from one customer to the next. In the case of one-on-one relationships with customers, it is relatively easy to personalize prices. The fee a business services provider charges a law firm will probably be higher than the fee it charges a cleaning company. Consumer markets are less personal, but there is still customization of prices to customers. A food company, for example, can offer a discount when consumers enter a code on their website. Only price-conscious customers will actually go to that trouble.
A situation where customers can choose which price to pay is referred to as “self-selection”. Customers will choose for themselves whether or not to go to the food company’s website to claim the discount. The costs involved in administering this kind of fencing are low, and customers appreciate the freedom of choice.

5.4.2 PURCHASING PROCESS

A price can be subordinated to the location or the moment of booking, sale, payment, or delivery. When you, for example, book a holiday home early, it will be cheaper. A coffee at the airport is more expensive than a coffee at your local café. Home delivery is more expensive than delivery to a pickup location.

5.4.3 PRODUCT AND SERVICE

Different versions of a product and service are priced differently. Customers whose focus is less on price and more on quality will generally buy more expensive versions. Apple, for example, sold its iPhone 4 at a lower price than the faster iPhone 4S in early 2013, while charging even more for the most advanced model, the iPhone 5. Consumers who have got less to spend will settle for the iPhone 4, while those with the greatest willingness to pay will go for the iPhone 5.

5.4.4 VOLUME

Volume is a popular basis for price customization. The per-unit cost to serve is lower when customers purchase larger volumes. Willingness to pay is also lower, as large customers tend to have more reason to look for low prices. But the ease with which salespeople give volume discounts in practice, such as by using a graduated scale, is not without risk. Large customers’ willingness to pay may sometimes be greater, such as when the product or service is important to them or because they have ample budgets. In that case, the discount does not need to be a large one.

There are several focus points that need to be heeded when designing a tiered discount structure. You would, for one, be best off limiting
yourself to a small number of discount levels in order to keep com-
plexity low (refer to Chapter 6). Five levels will normally be more
than enough. Monetary values form a good basis for setting bounda-
ries for discount levels. “10% discount when you spend €10,000 or
more” should be preferred over “10% discount when you buy 1,000
items or more”. Monetary amounts are more stable over time, and
purchases of multiple products and services are easy to add up.

The boundaries of the tiers should be chosen based on the customer
base and competition in the market. Section 2 of Chapter 10 contains
an example of this for B2B* software licenses.

For practical reasons, large discounts for large volumes should not be
revealed to smaller customers. After all, they will not buy such large
volumes. And if they were to see the kind of discounts that are unatt-
tainable by them, they may become dissatisfied with the smaller dis-
counts they get for smaller purchases. Discounts should in any case
not be too steep, even when it is commercially expedient to offer a
low net price. A discount of over 20% reflects badly on the credibility
of the gross price list. A better way of offering a very low net price is
to only state that net price on the offer or to use a second gross price
list (with keener prices) for special cases. A third alternative is to
charge fixed surcharges as standard and waive these whenever you
want to offer a lower price.

A cumulatively structured tiered discount system will appear more
economical to customers (see example in Table 5).

<table>
<thead>
<tr>
<th>From</th>
<th>Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>€5,000</td>
<td>5%</td>
</tr>
<tr>
<td>€10,000</td>
<td>10%</td>
</tr>
<tr>
<td>€25,000</td>
<td>12%</td>
</tr>
<tr>
<td>€50,000</td>
<td>13%</td>
</tr>
</tbody>
</table>

Table 5 Cumulative tiered discounts, the listed discount will only be given from the threshold amounts

* B2B: business-to-business, these are markets where companies produce goods and services for
use by other companies or by public sector parties.
The 10% discount will, in fact, only be given between €10,000 and €25,000. Purchases below €5,000* will not even entitle the customer to any discount at all.

The cumulative tiers may lead you to expect a 10% discount on an invoice of €20,000. But the actual cumulative discount on this invoice amount will only be 6.25% (€1,250):

<table>
<thead>
<tr>
<th>€0</th>
<th>— on the first €5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>€250 (5% * €5,000)</td>
<td>— between €5,000 and €10,000</td>
</tr>
<tr>
<td>€1,000 (10% * €10,000)</td>
<td>— between €10,000 and €20,000</td>
</tr>
</tbody>
</table>

A graduated scale with cumulative discounts will furthermore mean that the net invoice amount for a somewhat larger order will never fall below the net amount due for a somewhat smaller order. That could happen when discount percentages are applied to the full amount or full volume purchased as discounts abruptly jump to the next level up.

When calculation of discounts is accurately and transparently explained on the price list, both customers and sales staff will soon be familiar with the natural and logical operation of cumulative tiered discounts.

5.4.5 **PRICE CONDITIONS AND PRICING MODEL**

Price conditions that apply to a purchase and delivery also offer an opportunity for price customization. One example is a 1% prompt payment discount. More complex forms of this kind of discount come about as pricing managers start using different price parameters. For a cell phone, for example, you can take out a monthly contract with a voice allowance and a data allowance. An alternative would be to buy calling and data credit, which you use up as you make calls and browse the Internet (“prepaid”). Price conditions

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* This works in a way that is similar to that of progressive income tax. Just as you will not be taxed on the amount below the first threshold, customers do not get a discount when they spend under €5,000.
and parameters make a good starting point for price customization to usage patterns.

A pricing model can set the tone for an entire industry. At the start of this century, record companies were having a difficult time as consumers became increasingly unwilling to purchase CDs with full-length albums. The music-buying public wanted more flexibility and turned to illegal downloads of individual tracks. Steve Jobs, however, believed that consumers would indeed be willing to pay for music, if only they could get flexibility. Apple saved the music industry on 28 April 2003 when it introduced per-track pricing for music to replace per-album pricing. The success of iTunes made selling music online profitable.27

The online music service Spotify marked another milestone for the music industry in 2008 when it launched a pricing model that was wholly unrelated to the volume of music consumed. Spotify sells unlimited access to its music database on a subscription basis, charging a fixed monthly fee.

5.4.6 IN CLOSING

Not all attempts to customize prices are successful in the market. It is always conditional on consumers accepting the differentiation. That acceptance was lacking when Coca-Cola introduced a vending machine that automatically raised the price of a can of coke on hot days (refer to Section 2.3.6).

Value pricing uses the price-to-value ratio (C3) as the standard on which to base prices. This worth is defined in relation to alternatives (C4). Price customization (C5) yields extra profits for the salesperson. It gives customers greater choice and a tailored proposition.

A logical question is subsequently what role costs play in pricing. Indeed, when the price is lower than the costs, the company will run at a loss. The crux of the matter here is how you define costs, which takes us to the next price driver, C6: Costs.
5.5 Costs (C6)

5.5.1 VALUE ADDED

It is not the role of costs (C6) to help define the selling price, as happens in cost-plus pricing. Costs (C6) form a constraint: they are the lower limit for pricing. Viewed from the perspective of the transaction (C3, C4, C5, and C6), a company will not make a profit when the selling price is below the cost price. Above that, there is no upper limit when setting the selling price. Application of the principle that income should exceed expenditure requires a correct and integrated cost calculation. This calculation differs from what accountants, bookkeepers, and financial managers are used to, because it has a different purpose.

A cost evaluation as needed by a pricing manager is focused on value added instead of the “right” allocation of costs across products, departments and business units from the perspective of “fair” performance measurement or tax considerations. It will not offset the specific price against average cost, but expressly consider variable costs. The principle is twofold:

1. the price per specific transaction is greater than the specific costs of such a transaction
2. the average price is greater than the average costs

Another difference in comparison to traditional calculations is that we are not using retrospective costs from the profit and loss account*. The pricing manager’s approach revolves around the combination of:

- avoidable, variable costs
- alternative costs or dilution
- a relevant forecast of future costs

In the remainder of this section, these three perspectives will be reviewed one by one. At the end of the section we will look at costs and price as part of a holistic management approach.

* On an organizational level, this different approach leads to a need for clear and comprehensive alignment of the method with financial management.
5.5.2 **AVOIDABLE, VARIABLE**

Throughout the 1970s, American Airlines\(^{28}\) only filled half the seats on its planes. It mainly targeted business travelers. When the U.S. government relaxed market regulations, charter airlines suddenly found they could offer flights on a broader scale. These market entrants had fewer overheads and they had great success selling cheap tickets to non-business passengers. Purchasing factors such as punctuality and flexibility are not as important to this customer segment.

American Airlines was the first major airline to act on the knowledge that the *avoidable* costs of empty seats are very minor. These avoidable costs are the *variable* costs of fuel, service, and sales efforts for only one extra passenger at a time. Revenue generated through business passengers “covers” the non-avoidable, fixed, costs of airplane, crew, and overheads.

“If we could figure out a way to sell those empty seats at the prices the charter guys proposed, thought [American’s CEO Robert] Crandall, we would make a lot of dough.” \(^{29}\)

American introduced super saver fares for tourist travel and family visits. The company succeeded in selling a significant number of the available seats that used to stay empty. The percentage of occupied seats, the occupancy rate, went up by a hefty 50%.

5.5.3 **ALTERNATIVE COSTS**

Loss of income from business travelers is a risk you run when you start selling cheap tickets to tourists. When your business customers also decide to start buying super saver tickets, they will effectively be paying a price that is lower than the price they are willing to pay. These are the *alternative* costs, which is also referred to as dilution.

American, however, managed to implement effective fencing methods for its fares (C5). The company saves customers who pay higher fares a seat on their planes. Inventory management systems predict demand for tickets for every flight and limit availability of
cheap fares whenever necessary to make sure premium customers can always get a seat. Restrictive conditions for super saver fares, such as advanced booking, no cancellation, and a minimum stay, mean that lucrative business customers will prefer to pay a premium for tickets without restrictions. Additional benefits for loyal customers, such as frequent flyer miles and lounges at airports, have further bolstered customer loyalty.

The method American Airlines uses is referred to as revenue management. Revenue management draws on the understanding of avoidable, alternative, and future-oriented costs, when these are dynamic and dependent on scarce and temporarily available capacity. Apart from in the airline industry, this discipline is currently also increasingly deployed in industries such as shipping, road haulage, hotels, stadiums, car rental, holiday homes, fashion stores, production capacity, etc.

5.5.4 RELEVANT AND FUTURE-ORIENTED

Pricing decisions have an effect in the future, not in the past; future costs are therefore important for pricing. The average price when launching a new product may initially be below cost price. As sales grow, economies of scale will subsequently reduce costs. Price driver C6 takes the expected future cost price as its reference point.

Cost analyses are often based on past performance, simply because that is data that can be found in the accounts. Finance then uses these past costs in combination with the high-level input from senior management to make a budget for the future. Pricing managers, however, need far more profound insight into product development and R&D to be able to estimate the economies of scale and the flexibility that may or may not exist in cost commitments inherent in for example labor agreements, real estate rental contracts or in the financial setup of production facilities than they can obtain from the limited detail of traditional budgets.
5.5.5 **QUANTUM BUSINESS**

Business is often presented as a linear process. A new product or service is born out of a flash of inspiration, an idea, regardless of whether it is a brilliant one. The inventor or R&D department will take that idea and turn it into an invention, apply for patents, and mount a production process (first business skill).

Next, the entrepreneur faces the challenge of selling the newly developed product (second business skill). No matter how fantastic the new product is, potential customers simply do not know it yet. Marketing and sales departments will therefore spring into action to spread the happy news, preferably on a grand scale and involving a little pushing, seduction, and manipulation, all for a good cause. Based on our belief, or pretend belief, in our product, we expect part of the market to eventually appreciate the improvements we are bringing, prodded by some gentle pressure from advertising and PR.

This is the basis for a “realistic conservative” forecast of sales and expected average cost price. The selling price is obtained by adding a profit mark-up and possibly adapting the price to “the” market price.

These steps follow each other in a linear fashion. Each step determines the next one in a cause-and-effect relation (see Figure 6). This process can have one of two outcomes: success or failure. Success means the product is profitable and customers are happy, while failure will lead to a cessation of production.

Some entrepreneurs do things differently. They start with the end in mind. When you estimate beforehand what a customer will be willing to pay, you can optimize the cost structure as you develop a product, and vice versa. The entrepreneur will then optimize price and cost simultaneously as a “quantum business” (we are introducing this term by analogy with quantum mechanics, which changed the perspective of cause and effect in physics from a sequential to a simultaneous link).
Connection (c) in Figure 7 depicts the mutual alignment of price and costs. This is important in manufacturing the product, setting up the production process, and defining price customization and volume discounts. In sourcing, you will select suppliers that can anticipate and adapt to your needs.

Steve Jobs simultaneously optimized product, design and cost, sales opportunities, and price. Apple’s functional and top-down organization continuously weighs up costs of raw materials, design of components, and value of product and design against each other. The superior quality of the glass in iPhone and iPad touch screens was one of the results. During the design stage of these devices, Apple factored in procurement costs and economies of scale of its supplier, as well as the value and price of the end product.
5.5.6 **IN CLOSING**

In Chapter 4 we dealt with the performance-based price drivers (C1, C2). This chapter revolved around the aspects of an optimum price in a transaction. We discussed the importance of the relative value (C3) you provide in comparison to competitors or alternatives (C4). And we also saw that it pays to customize prices to different “price segments” whenever there are differences in willingness to pay or cost to serve (C5). And finally, costs (C6) are the lower limit for a selling price from the perspective of the transaction. With every transaction, the specific price needs to be higher than the avoidable costs. The *average* price of total sales must be higher than the total *average* costs.

As pointed out earlier, the FirstPrice Pricing Clock makes two additions to the six price drivers we have covered so far. The first is the use of communication in improving prices. The second addition is boosting returns on relationships with customers, stakeholders and/or users through pricing.

Chapter 6 will go into price drivers that involve communication (C7, C8, and C9). Chapter 7 will subsequently focus on the relationship-oriented price drivers (C10, C11, and C12).
CHAPTER 6
Communication

6.1 Perception drives behavior

A fundamental ongoing debate among economists deals with the nature of economic behavior. This debate pitches two perspectives against each other.

The neoclassical school of thought considers people’s economic behavior an essentially rational phenomenon. The ratio of price to volume of demand allows logical understanding and objective determination. Demand for a product is connected to the price and worth of that product in a market owing to its knowable purpose. This notion is comparable to classical mechanics’ description of the earth’s orbit, which says that the earth’s orbit is dependent on the weight and movement of other celestial bodies. The transactional price drivers which we discussed in the previous chapter can be considered to adhere to the neoclassical school of thought.

The other approach is of a more humanist and social nature. This is an approach rooted in psychology, a perspective that does not assume economic behavior to be rational. People’s motives are, after all, subjective, as well as often subconscious and inconsistent. Perception
and beliefs are what drives behavior, and the way in which you communicate therefore influences the choices consumers and companies make. This chapter is based on this way of thinking.

What we will be exploring is customers’ perception when they evaluate prices. The way in which price is communicated will determine people’s impression of their options. This is the next price driver (C7). In the following we will look at patterns of implicit communication between competitors that influence price levels in a market to a certain degree. This is what we refer to as tacit collusion (C8). The last communication-related price driver delves into information processing in relation to prices. Companies can refine prices to such an extent that price management almost becomes impossible. Complexity reduction (C9) will then be required to manage communication and alignment in the supply chain.

### 6.2 Communication to customers (C7)

This price driver shows that communication of prices has an effect on customers’ choices. Experimental behavioral science describes a number of effects that marketing and pricing managers target in their communication and pricing. We will go into the relativity of prices and the effect of price “anchors”, which provide customers with a point of reference. Following on from that, we will discuss communication about uncertainty and the good-better-best pricing tactic. We will subsequently conclude with the “fairness” of price changes and the intended purpose of “psychological prices”.

#### 6.2.1 RELATIVITY OF PRICES

It may not be something you dwell on every day, but money is an abstract variable that renders an air of quantifiability to perceptions of wealth and possession. We use monetary values such as our salary, prices, or our bank balance for all kinds of calculations. That works rather well: when you earn €2,000 a month, after tax, and your rent is €750, you will have €1,250 left for other expenses.
But perceptions of wealth and possessions are hard to quantify objectively. The scale on which we perceive money can therefore not be accurately captured in a numerical value. If an income of €2,000 makes us feel reasonably happy, €4,000 will not automatically make us twice as happy. In 1959, Japanese researcher Tarow Indow concluded from an experiment with his students that in order to acquire a watch they considered twice as desirable as another watch, they were willing to pay 8.7 times as much. Harvard psychologist Stevens ran an experiment that led him to conclude that his students were twice as happy when they unexpectedly received four times as much money.31

The relativity of prices also comes to the fore in the way people respond to a windfall.32 In 1985, Richard Thaler described how his respondents preferred winning $25 and $50 in two lotteries to winning $75 in one lottery. Thaler’s advice was therefore “not to wrap up all Christmas presents together in one box”. By accurately and separately highlighting all aspects of a product in marketing and advertising material, a consumer’s perceived value of that product will increase.

The “Permanent Discount” rail card offered by Dutch rail operator NS is a fine example of that, and certainly lives up to its name. NS lists the various benefits of this rail card on its website (see Figure 8).33

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**Permanent Discount rail card**

*Do you regularly take the train to work, school, or just to go on a day out? The Permanent Discount rail card will give you a discount whenever you travel! Both during the week and on weekends.*

- Always a discount, no matter when you travel
- 20% discount during peak hours
- 40% off-peak and weekend discount
- 40% discount for co-travelers after 9am and on weekends the whole day (max. 3 persons)
- Are you over sixty? For only €14 (2nd class) or €39 (1st class), you get 7 additional days of your choice on which you travel for free
- Annual rail card €20 per month, i.e., €240 per annum
- Monthly rail card €25 per month

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*Figure 8  Example of “discount on top of discount” to appear even more economical*
6.2.2 ANCHORS

The attractiveness of a price is generally not tangible or quantifiable to people as a real number, but prices are comparable. It is easier to assess which price is higher than another than to assess how high one price is. People subconsciously look for help in their environment in these situations, and are susceptible to insinuation. They look for an “anchor” on which to base their assessment. When judging a price, the anchor, quite remarkably, does not have to have any rational link to that price.

One experiment\(^{34}\) asked participants to enter the last two digits of their social security number on a form. Having done so, they were subsequently asked to bid for two bottles of wine, a 1998 Côtes du Rhône and a 1996 Hermitage. The researcher told the participants that the Côtes du Rhône came with a quality rating of 86 points, while the other wine had a rating of 92 points.

It turned out that the higher the last two numbers of someone’s social security number, the higher their bid! Subconsciously, the social security number apparently offered a (totally irrational) anchor. The participants did, however, bid more for the Hermitage than they did for the Côtes du Rhône. This is in line with the ratings. Contrary to how much they bid, the outcome of the price comparison between the two products was rational.\(^*\) Assessing the level of a price can be arbitrary, but price comparisons are generally more consistent.

Nobel Prize winner Daniel Kahneman and his colleague Amos Tversky are among the architects of “behavioral economics”. This discipline within the field of economics studies people’s behavior using empirical research and experiments. In 1974, Kahneman and Tversky demonstrated the “anchoring”\(^{35}\) effect in their famous “United Nations” experiment. In this experiment, a participant would first observe a wheel of fortune that was made to stop either on 65 or 10 (the wheel was manipulated to only point at either 65 or 10 to simplify the ex-

\(^*\) It is unclear how objective the ratings of the wine were. Participants were only told that the rating came from different specialist wine magazines.
periment). Having seen the wheel point to either 65 or 10, the participant would subsequently be asked to estimate what percentage of countries in the United Nations are in Africa.

Participants’ estimates turned out to be related to the number the wheel of fortune had shown them. Those participants who had observed the wheel stop at 65 estimated that around 45 percent of UN countries are African. If the wheel had pointed to 10, this estimate was around 25 percent. What is striking here is that the participants knew that the outcome of the wheel was random, and that it was in no way related to the question they were asked.

Needless to say, this experiment set the academic community thinking. Multiple follow-up experiments were organized. These all confirmed the effects of anchors. It emerged that the anchoring effect does not disappear when participants are given a financial incentive to be more accurate in their estimate, and neither when anchors have extreme values. Absurdly high anchors, such as a $7,000 book, have the same influence as “more plausible” anchors. Anchors have also been shown to affect professional experts, such as realtors, despite the fact that they so confidently claim that they cannot be influenced.

In the luxury segment, shops like to show a limited number of highly exclusive and extremely priced items. These products are not directly intended to be sold, but only serve as an anchor. Thanks to these anchors, “regular” big-ticket items will suddenly seem more attainable and sell better.

Coach, for example, a retailer specializing in luxury handbags and accessories, likes to display one or two ultra-expensive handbags in full view and with the price tag clearly showing at its flagships stores. Its range contains for example a $7,000 crocodile leather handbag and an almost identical ostrich leather bag that costs $2,000. By making sure shoppers see the $7,000 price tag for the former bag, the $2,000 price tag for the latter will suddenly not seem so steep.
Anchoring also works in negotiations. Although negotiations may take longer when you start high, research has shown that starting high leads to better end results. And the first blow is half the battle: being the first to name a price means that you are dropping anchor, and it is near to impossible for the other party to ignore that anchor. In negotiations, price is not so much an expression of what someone wants or needs, but rather of what someone thinks they can get. Negotiation training at business schools always teaches executives to use the anchoring effect and to be prepared for when the other party uses this technique. Convincing executives of the fact they too are susceptible to these subconscious processes is no easy task.

It is in any case expedient to study people’s choices in a realistic setting. A company can derive great benefits from experiments with pricing and different forms of sales and communication. It is always a good idea to test what works best for your products and your customers.

6.2.3 UNCERTAINTY

Uncertainty plays a role in the introduction of new products and services and when entering into long-term contracts. The value of contracts can, after all, change over time due to inflation and currency risk. People tend to choose certainty over uncertainty, but there are nuances to this statement. It has, for example, been demonstrated that most people choose avoiding a loss over the chance of earning a profit. This phenomenon is referred to as “loss aversion”. A second nuance concerns communication. The way in which you describe the uncertainty will influence customers’ choices. We will explain this using a price indexation example.

Inflation leads to uncertainty about future prices. Most people therefore go for contracts with inflation indexation. The influence of communication becomes clear when we compare the following descriptions:

* Also refer to Part II (The Science of Pricing).
A. the “certainty” of contract prices with inflation indexation in real terms
B. the “uncertainty” of contract prices with inflation indexation at a level you do not know yet

Options A and B both offer inflation indexation and basically say the same thing. And yet, A is preferred by relatively more people. Option B wrong-foots some people. Customers are partly led by alarming wording in contracts. They assess risks differently due to the way they are communicated.

6.2.4 GOOD-BETTER-BEST PRICING

The good-better-best (GBB) strategy consists of offering a product or service in three versions:
- good: the basic version
- better: a better version
- best: the top-of-the-range model

Price is in step with quality here: best is the most expensive, good the cheapest, and better, you guessed it, lies somewhere in between.

A salesperson can use this strategy to do three things:
- uncertainty reduction by offering the better version
- anchoring effect of the high reference price of the best version
- competition on low prices using the good version

Marketing professionals often glorify these three versions with appealing names such as silver, gold, and platinum service conditions. The fact that even the cheapest version has a swish name also helps. Silver conditions are better than bronze ones, so just imagine how great the gold and platinum conditions are!

Other manifestations of this phenomenon include L/XL/XXL designations for drinks and food, expert/professional/ultimate for sports gear, or for example take up!/move up!/ high up! for the Volkswagen up!.
Uncertainty reduction will ensure most people go for the better version, simply because that is the safest bet. The price of the better version therefore has the greatest impact on financial results. A high price for the best version will lead to a favorable anchoring effect for the price of the middle version. The price of the better version will be made to look more attractive, and can be raised slightly, which would not be possible if the anchor of the higher price for the best version were to be absent.

The price of the good version is a rewarding marketing tool that is used to improve the price image or attract shoppers to your store, website, or brand. The good version is less important from a revenue point of view, as people's uncertainty reduction tendency will drive them not to choose the lowest-quality product at the actual moment of purchasing.

Sales of better or best versions can be further stimulated, at the expense of the good version, by varying the placement of products from these segments in the store or on the website. Anthropological research has shown that people are less likely to buy products that are placed low down on the shelves because that requires them to bend down. Products placed at upper body height sell best: they are easy to grab and the most visible. Studies have also shown that products sell better when they are in the right-hand part of consumers’ field of vision.41

6.2.5 **FAIRNESS AND PRICE CHANGES**

Consumers want “fair” prices. But what exactly that means is unclear. As pointed out earlier, consumers do not really have an opinion about
the absolute level of a price. So when a price rises, what they tend to look at is the change, not the absolute level of the price. A clear explanation and understandable selection of arguments are what makes the difference. Arguments based on “cost pressure” or “inflation” are more likely to be accepted than those based on “scarcity in supply”.

Naturally, some gumption also comes into it. Manufacturers will often introduce new packaging containing less of a product, but without changing the price. Sales to loyal users will go up by 10%, because they run out of the product sooner. Customers are less likely to notice these kinds of hidden price rises.

Another way of reducing transparency is to make it more complicated to calculate the per-item price. The options Pampers offers its customers in terms of diapers and pack sizes make it harder to compare prices. Take Pampers’ options for size 5 diapers, for example:

- 45 diapers “Baby Dry value pack junior” at €15.25
- 38 diapers “Simply Dry Junior” at €10.16
- 26 diapers “Easy up small pack junior” at €10.99
- 62 diapers “Baby Dry jumbo pack junior” at €19.49
- 38 diapers “Active fit value pack junior” at €15.25
- 54 diapers “Active fit jumbo pack junior” at €19.99

Both the number of diapers per pack and the price are never “round”. Extrapolating a per-diaper price requires just a little too much effort, making it more difficult to compare prices. Customers will subsequently base their choice on other aspects.

Seeing as price rises resonate negatively, while price reductions come across as positive, Dutch supermarket chain Albert Heijn uses an interesting system that was laid bare by two students, Thijs van der Tuin and Matthijs Neppelenbroek. One day, they decided to keep track of all of Albert Heijn’s price changes. Eighteen months later, they had counted more price cuts (15,000) than price rises (5,500), while across the board prices were higher. That was down to the fact that the average price rise was 35 cents, while the average price cut was 12 cents. Apparently, Albert Heijn thought it better to have its customers take the “pain” of a price rise in one go, and give them the
“pleasure” of a price cut in small doses. What is more, Albert Heijn does not broadcast price rises, while even small price cuts are widely publicized in their supermarkets and adverts.

In response to the discovery by the two students, Albert Heijn said that “the analysis failed to factor in changes in size” and that “prices are dynamic”. “We never said we would not raise prices ever.”44 It is clearly not easy for a company to defend its morality when its tricks have been revealed. The changes in size Albert Heijn invokes work both ways. And it also remains to be seen how credible customers find announcements of price cuts when prices rise so much more than they are reduced.

6.2.6 PSYCHOLOGICAL PRICES

Psychological prices are prices that end in 9, 95, 98, or 99. The reason behind using these prices is that a price of 9.99 feels cheaper than a price of 10 euros. A price of 9.99 is thought to generate more sales than a price of 10 euros for the same product. As the salesperson realizes more sales, the “investment” of 1 cent per item will hardly be noticed.

Scientific research into the effects of psychological prices has, however, so far not been able to corroborate that such pricing tactics actually work.45 Due to the fact that it is such a widely used tactic, customers may infer different messages from these price endings. Some customers turn out to expect a good deal when seeing a psychological price. Others see it as a ploy and subsequently mistrust the shop’s general pricing. It is therefore important that these psychological prices tie in with brand perception and positioning. Tests can show which of the two abovementioned effects of psychological prices is the dominant effect among your customers.

6.2.7 IN CLOSING

In this section, we looked at the relevant effects of communication in relation to pricing. Behavioral psychology teaches us that people’s buying behavior is often marked by irrational patterns. These subcon-
conscious choices consumers make cannot be predicted with any great certainty based on previous scientific studies. That makes it wise to test out within your own sales environment which prices, sales techniques, and combinations of products return the best results.

So far, we have based ourselves on competitors that are vying with us in courting the favors of customers, with price playing an important role. In our discussion of transaction-based drivers, we highlighted the importance of the value of the proposition. Price is an expression of added value in comparison to competitors. You can improve your competitiveness by customizing your prices and hence tap new customer segments. This section focused on the price communication that can also convince customers to buy your product.

The next section will go into ways in which the role of price can be reduced and the hatchet of competition can all but be buried.

6.3 Tacit collusion (C8)

6.3.1 THERE ARE ONLY LOSERS IN WAR

Sales departments in certain industries are often marked by an aggressive atmosphere. Projects are run from war rooms. The mere mention of a competitor’s name will make many a manager grimace. Although this animosity may forge a winning spirit in a team, it is not conducive to sensible pricing. Pricing requires a more prudent consideration of positions, competitors, and their behavior. Pricing-savvy companies, therefore, are less macho and more measured in their actions. They take a broader view, surveying all opportunities the market as a whole offers for all providers.

Competition on quality and within specific target groups is more worthwhile than aggressive direct competition on price. The price driver of tacit collusion (C8) helps keep prices in a market at a sustainably healthy level.
6.3.2 COMMUNICATION TO COMPETITORS

Tacit collusion relies on a kind of communication about prices that differs from that of the price driver from the previous section. Communication for tacit collusion is communication to the market instead of to customers.

Collusion is collaboration between two or more parties aimed at dampening competition. There are two forms of collusion: overt collusion and tacit collusion. Overt collusion is a conscious and explicit deal between competitors, as in a cartel. To protect consumers, this form of collusion is banned in free markets. In 1929 however, Chamberlin\(^46\) identified the phenomenon of tacit collusion, which sees companies look for a price level that maximizes revenue for all providers. These providers have all become aware of the fact that competition on price will not win them greater market share. After all, competitors always neutralize a price cut by following suit.

Tacit collusion emerges in transparent markets with a small number of competitors and little differentiation on product level. Two or three providers tend to dominate in a local market, such as in the mobile telephony market, gas stations, in infrastructure, and in flight routes. When the threshold for entry or exit is high,\(^*\) these parties know that they will have to generate revenue together for a long time. Their behavior then becomes less aggressive, as market players match each other’s price rises.

The term tacit collusion suggests patterns in market behavior, whereby providers decide, for their own best interest, not to compete on price. However, they do not enter into agreements with competitors about this, neither in writing, nor verbally, nor in any other way. This behavior is the result of repeated experiences in the market that always lead to the same conclusions and outcome. Market players hence develop fixed responses.

\(^*\) This is the case when start-up investments are high. Start-up investments include capital items, landing rights, locations, and licenses.
Price driver C8 requires that we factor in these tacit patterns. Our actions generally adhere to unwritten rules, which we will only break after having carefully weighed up the consequences.

### 6.3.3 **COMPETITION REGULATIONS: AN EXAMPLE**

This kind of market behavior is a tricky phenomenon for competition authorities. The situation on the Dutch gasoline market proves that. Dating back to the 1990s, Dutch authorities have been investigating unlawful market behavior, possibly based on illegal agreements. They acted on the suspicion that gas prices in the Netherlands were kept artificially high. In the five-year period between 1996 and 2001, for example, the bare price of a gallon of gasoline (i.e., exclusive of sales tax and fuel duty) in the Netherlands was 10% higher than in Belgium, 19% higher than in Germany, and 17% above the European average.

Oil companies suggested that the costs involved in loyalty schemes for consumers, high density of gas stations, and strict Dutch environmental requirements caused this difference. These same oil companies, however, give financial support to local gas station proprietors who are faced with competition on price. These proprietors are paid an amount (margin contribution) that compensates the lower local price level. This enables these proprietors to discourage a local price war by charging even lower prices. In game theory, this is what is called a credible threat, urging all providers in the area to compete on any factor but price.

A 2002 study by the Netherlands Competition Authority (NMA) concluded that this kind of support to gas station proprietors was objectionable, as it was thought to engender “supracompetitive” prices. But they never found any proof of price-fixing agreements in the gasoline market. In 2011, Maxime Verhagen, the then minister of economic affairs, reported to parliament that the gasoline market was “functioning properly”.

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* The Dutch equivalent of the U.S. Department of Justice’s Antitrust Division
Tacit collusion is legal, as long as there are no agreements between market parties and no one holds considerable *market power*. In case of doubt, the best thing to do to be on the safe side is call in legal experts to assess the situation and always abide by legislation.

### 6.3.4 PRICE LEADERS AND PRICE SIGNALS

A market where tacit collusion has appeared is often one with a “price leader”. This is the party who is the first to change its price in response to external factors. The price leader is often also the market leader. Van Damme provided an example in 2002, when he noted about the Dutch gasoline market that “Shell’s recommended retail prices are also followed by resellers of competing brands”.\(^{51}\) The other parties in the market are called “price followers”. Price followers charge the same price as the price leader, or maintain a fixed “price distance”. All patterns in pricing behavior are implicit. There are no agreements.

The status quo in a market where tacit collusion reigns is delicate. There is always a lurking danger of something unsettling this status quo. Clarity from all players will help sustain the equilibrium. This requires consistent and clear communication. Market players use “price signals” on two levels for that:

1. Pricing
2. PR policy

**Pricing**

A company can use its prices to express its opinion on its competitors’ prices. Response patterns will soon produce results in markets with electronic price distribution systems and with players with a dedicated price management structure.

In the airline industry, one airline will generally be the dominant party and price leader at its hub.\(^{52}\) This airline decides what a healthy price level is for a certain route from that hub. If a challenger to this dominant position were to emerge, the price leader can use price changes on other routes to put the challenger in its place. The dominant airline will do so by temporarily charging extremely low prices,
preferably in market segments in which the airline it is looking to correct has concentrated most of its operations.

A fictitious example is that of a U.S. airline based in Chicago that wants to attract more transatlantic business. The company starts offering a low fare of 349 euros for flights to the U.S. on the German market. Chances are that the market leader for flights between Germany and the U.S. is not happy with this form of underselling by the Americans. In reply, this dominant party in the German market could decide to introduce an extremely low fare of 99 dollars for flights from Chicago to Germany. This would hit its U.S. competitor directly at its hub. And only offering this extreme fare of 99 dollars for flights to Germany is a clear hint as to the reason behind this price signal.

Seeing as all prices immediately show up in electronic distribution systems, the pricing manager of the US-based airline will probably quickly discontinue the promotion in Germany. Its German competitor might then respond by also revoking its cheap fare. Owing to the speed of the systems involved, these kinds of tit-for-tat signaling techniques can unfold within a time span of only a few hours.

**PR policy**

A second price signaling method is provided by the PR policy. This policy will be effective when all public announcements about price developments issued by a company are consistent and clear. Reasons behind price changes must be predictable and credible. Commonly used reasons include inflation, higher costs of raw materials, or general worries about the health of the industry. Even if the argumentation is factually correct, a price leader often takes the opportunity to raise prices by more than strictly necessary. It is hard for authorities to identify unlawful acts if there aren’t any that violate the letter of the law, because companies communicate in a well-considered manner and only through public channels.

Here’s an example: container shipping company Evergreen gradually raised its rates from 1 January 2012. Market leader Maersk responded with a nearly 100% price hike. Many other shipping companies followed suit. The Dutch association of shippers, EVA, was startled by
this illogical price development in a time of surplus capacity. It called on the European Union to keep a watchful eye on this situation.\textsuperscript{53} But the companies involved were only raising prices and making public statements about cost developments, and not breaching any competition legislation.

6.3.5 \textbf{PROFITABLE PRICE WARS}

The principle underlying tacit collusion is a desire to maintain equilibrium and avoid competition on price. A price war can, however, in some cases also turn out to be profitable, if it brings sufficient:

- growth of the market
- growth in market share
- cost savings

Cost leadership through economies of scale and great market potential are in this case important prerequisites. The Chinese market has seen successful price wars that were started by, for example, Changhong (TVs) and Galanz (microwave ovens), but also among Chinese manufacturers, price wars often do not yield the desired result.\textsuperscript{54}

6.4 \textbf{Complexity reduction (C9)}

Pricing specialists consider a specific price for each customer the ultimate goal of price customization (C5). Communication subsequently requires even more price points, which are to trigger the anchoring effect during the purchasing process (C7). A company that has enthusiastically taken to deploying price drivers will therefore see the scope and complexity of its pricing structures increase. One way of staying on top of those pricing structures is to hire more pricing analysts and use more specialist IT systems to manage prices. The danger is that the board, sales managers, and service staff lose their handle on the complexity of prices. A lack of pricing transparency leads to suboptimal decisions at the company. Customers too are left with a negative impression of the company. How many customers are positive about air fares, cell phone charges, or photocopier service charges? Complex prices put customers off from buying your goods.
Complexity reduction (C9) is an often neglected price driver at companies that are taking their first steps toward a better pricing policy. And yet it is important to, right from the start, keep structures simple and explain them clearly. A less complex price list can, nonetheless, still be very comprehensive. The idea is to ensure that pricing policy is easy to explain and transparent, not only to customers, but also to colleagues at your company.

Google, for example, has a specific advertisement rate for each keyword. This price is determined through an auctioning mechanism. It therefore has a huge collection of prices for all possible keywords. And still, prices for a Google ad are not complex. Customers will only see the rate for the keyword they are interested in. Internally, the logic behind that is easy to explain. Each keyword is sold to the highest bidder, i.e., the person for whom the keyword represents the greatest worth.

Another example: laptop price customization. This is based on product customization. Again, simplicity is better than a profusion of prices and products. Who else but Apple can accomplish complexity reduction and simplicity? Let’s compare the product offering of Apple and Dell on 20 February 2012.

Dell has three different laptop lines (Inspiron, XPS, and Alienware) and offers a plethora of options on top of that, such as five different screen sizes and six possible processors (i3, i5, i7, Atom, Pentium dual core, and Celeron dual core). You can “land” on various different webpages when shopping for a laptop on Dell’s website. There is a page with a few good deals only, but also one with the most popular products, and a page with a comprehensive “overview” of all possibilities. And that while Dell has simplified its website in recent years.

In its online store, Apple dedicates only one page to laptops. The choices are simpler: two laptop lines (MacBook Air and Pro), four screen sizes, and two types of processor (i5 and i7). Design and information are instantly clear, because complexity is low at Apple and subordinate to the objective of helping customers.
7.1 You have to spend money to make money

This chapter is about revenue models that focus on utilizing relationships. Low prices, for example, can provide a way of striking up or strengthening relationships.

Cross-selling (C10) revolves around the one-on-one relationship between salesperson and customer. The salesperson entices the customer to purchase by offering a discount and then makes a profit on subsequent transactions with this customer. A building contractor, for example, may submit a low tender for a road building contract put out to tender by the local council. Profits will subsequently be made on related follow-up contracts that are awarded to the contractor privately.

Co-selling (C11) is aimed at capitalizing on the value that customers or users may represent. Facebook sells the attention of its users (“co”-selling) to advertisers. In essence, Facebook is not a free service, as users pay for this social network with their attention.

Cohesion (C12), finally, describes mutual relations between price drivers. They are, after all, not stand-alone entities: price drivers in
a revenue model should reinforce each other in order to successfully implement the company’s strategy.

7.2 Cross-selling (C10)

7.2.1 The Value of Relationships

Price drivers C3, C4, C5, and C6 depart from the perspective of the transaction. In the analysis of the price-to-value ratio, the relationship with the customer, however, barely comes into it. But this relationship does feature explicitly in the tenth price driver: cross-selling (C10). Cross-selling as a sales strategy is not out to maximize profit from one transaction, but instead tries to attract customers with a view to making money off them through multiple transactions. Price is used as bait, and therefore less related to value, costs, or market price: it is based on what the salesperson can earn from the relationship. Given that customers often need more than one purchase to fill a need, this sales technique is widely used and as old as the hills.

In modern times, it was King Camp Gillette who demonstrated the power of cross-selling as a revenue model. King was an anti-capitalist who pursued utopian socialism his whole life. He was also an inventor, and really hit the big time at the age of forty when he came up with the idea for the disposable razor blade. After earlier less successful attempts, his big breakthrough came when he started charging a low price for the razors. This allowed Gillette to generate enormous recurring revenue from the sale of disposal blades. By 1910, this had made him so rich that he moved in circles where he rubbed shoulders with the likes of Henry Ford and Theodore Roosevelt. He turned to them for support in putting his utopian ideals into practice. But contrary to his business exploits, he was less successful in politics.57

There are four different ways of applying cross-selling:
1. Split solutions
2. Simple basic version
3. Broad range
4. Bundling
7.2.2 **SPLIT SOLUTIONS**

This involves selling a product or service in two parts that are both required to meet a need. One part of the split solution is then sold cheaply to attract customers, as Gillette did with his razors. The other part can then be sold at a relatively high price: the blades.

Another contemporary example is Nespresso. Prices of Nespresso coffee machines are low (from €50). Real espresso machines are hundreds of euros more expensive. But a Nespresso machine only works with special Nespresso capsules. And in 2012, these sold for between €0.33 and €0.37 a piece. That makes one cup of Nespresso more expensive than a real espresso: the price of the coffee beans needed for one cup of coffee from an espresso machine ranges from €0.04 to €0.24, depending on brand and quality. As you would expect, Nespresso claims that the coffee in its capsules is of superior quality. But still, the primary aim behind the price of the capsules seems to be to maximize profits generated thanks to customer loyalty. On average, customers spend €80 a month on capsules. The variable costs of capsules customers fork out for every year is therefore approximately one thousand euros. Good-quality coffee beans for an espresso machine are available for an average price of €0.14 per cup of coffee. These variable costs add up to around four hundred euros per annum. That makes an espresso machine six hundred euros a year cheaper to use. By charging a premium on the coffee, Nespresso is able to recoup costs that go into keeping its coffee makers cheap in no time, even after deduction of the costs of a global advertising campaign starring George Clooney.

There are many more examples of split solutions. Mobile telephony operators give away free phones to secure revenue from voice, data, and other services through long-term contracts. Amazon offers customers a Kindle tablet at a low price to be able to sell more e-books, music, and other electronic content to them.

In B2B markets, cross-selling is a rather more nuanced undertaking. Business customers tend to be more conscientious buyers, scrutinizing all aspects of their procurement outlay based on a TCO calcu-
lation. TCO stands for total cost of ownership: buyers assess costs across the full period of usage. The cross-selling revenue model will then fall short relatively quickly. Business customers will ask Nespresso for discounts on capsules to bring total cost of ownership into line with alternative solutions.

Still, providers of services and products to business customers are managing to create major additional revenue by selling split solutions. Car leasing firms, IT service providers, photocopier vendors, and other service companies sell long-term contracts based on a volume estimated by the customer at a keen per-unit price. During the term of the contract, volume often turns out higher than estimated, such as in the case of a leased car doing more miles than expected or a photocopier making more copies than the customer thought he would need. The vendor will then capitalize on that by charging the same unit price for excess volume, while unit costs will be lower due to economies of scale. Lower volume than estimated, on the other hand, will entitle the customer to a relatively small discount on the total invoice amount. And that while costs of execution will be significantly lower when volume is lower. This way, the provider always achieves an extra margin when actual volume differs from estimated volume.

7.2.3 **SIMPLE BASIC VERSION**

As part of this form of cross-selling, the vendor will offer a simple and cheap basic version of a product or service. The underlying aim is to subsequently sell the customer a more comprehensive and expensive solution. Customers will generally first try out the basic version. If they are happy with the product, they may decide to upgrade.

The use of freemium pricing has really taken off in the world of software and Internet services over the past decade. Internet games are free, but as you play them, you may want extras that will cost you. Skype offers free Internet-based telephony, but charges you for group video calling. Sharing pictures on Flickr is free, but additional GBs of storage space for your photos is not.
Akin to offering the option of upgrading after trying out a service is to arouse customers’ interest through a basic service. A manufacturer or store will then advertise a low from price for a stripped-down basic service. Once this has drawn the customer into the store or showroom, he or she will eventually purchase a more expensive version that better meets his or her needs. In the automotive industry this kind of basic version is referred to as an entry-level model. Nearly every single car ad touts an irresistibly low from price. But the specs of an entry-level model are not very attractive. Popular options are not included and the price does not include any dealer fees. Customers will eventually end up buying a more expensive version. The advertised low price of the entry-level model is an eye-catcher that gives customers the impression that the model is within reach.

In the travel industry, from prices are also a favored advertising ingredient. One week at a luxury five-star all-inclusive resort, including flights, for 499 euros? Yes, but only in low season, not during school holidays, when booking six months ahead, and using a quadruple room, otherwise the price will be higher.

7.2.4 BROAD RANGE — LOSS LEADERS

This tactic sees the provider communicate a low price for a popular product to attract as much attention as possible. After the low price has served its purpose and generated footfall, the salesman will try to sell other products from his broad range to these customers.

Major accountancy firms, for example, do not only base their revenue model on the invoice they submit to companies for their annual audit. They also sell other services, such as tax advice, transactional support, management consultancy or auditing services to their business relations at CFO level.

In B2B markets it is common practice to submit a low price proposal for the first project. Contractors, facility management providers, and IT service providers will often choose to submit a low price offer just to get their foot in the door. As their relationship with that client
endures, they gradually increase their share of wallet* by selling this client other services from their portfolio.

Department stores and supermarkets are masters at selling loss leaders at extremely low prices in the hope that, once in their stores, customers will do all their shopping there. Many marketing campaigns that offer you something for nothing are inspired by the hope that you will turn into a regular customer and purchase more products and services.

7.2.5 Bundling

Price bundling is a special kind of cross-selling. The previous cross-selling tactics all consisted of companies using a low price to lure in customers in order to then sell them other products and services. In the case of price bundling, however, companies draw attention to the great value customers get when purchasing a combination of goods that the seller has bundled together instead of offering a steep discount on the first purchase alone. Price bundling has the same dynamics as a volume discount (refer to Section 5.4).

The objective of price bundling is to raise revenue. Cable companies, for example, will often bundle Internet, phone, and TV together and sell these packages for a fixed monthly fee. This is cross-selling of Internet and phone, alongside the traditional offering of TV channels.

7.2.6 Complexity of Analysis

The pricing analysis for cross-selling is complex. It requires assessment of demand at various price levels for multiple products and services. The individual products and services appeal to different customers and customer segments. They each have their own specific competition landscape. The attractiveness of interlinked offers to customers is consequently not the sum of the individual products.

* Share of wallet: the share of a customer’s budget that they spend on your product or service. A facility services provider, for example, cleans a building for €10,000. Their customer’s total facility costs amount to €100,000. That makes facility service provider’s share of wallet 10%; an opportunity to gain 90%.
Results of cross-selling are difficult to predict or evaluate. And comparing the effectiveness of two forms of this tactic is also quite a challenge. Defining and applying these kinds of pricing models requires a great deal of commercial experience.

7.3  Co-selling (C11)

7.3.1  NETWORK RELATIONSHIPS

Contrary to cross-selling (C10), the focus of co-selling (C11) is not on relationships with customers, but on relationships with third parties. Co-selling thrives in a network. A manufacturer can make money out of other parties in a network by offering certain groups cheap or even free services. A simple form of co-selling is a B2B supplier who sells services to his client’s employees, which are paid for by the employer.

The C11 price driver is particularly relevant when the parties involved are far removed from each other. Most advertisers do not traditionally have a relationship with users of Internet companies such as Facebook or Google. These Internet powerhouses offer their web services for free. And they subsequently sell advertisers access to their users through co-selling. Co-selling is one of the driving forces behind the Internet economy (more about this later). On numerous websites, consumers “pay” for the service with their attention.

Still, co-selling was around long before the Internet started its ascent. Just think about how often people give someone a benefit in order to curry favor with a third party. Commercial television and complex infrastructure projects are examples from the traditional economy. Commercial TV channels let consumers watch for free, while advertisers pay. Influential environmental pressure groups have the power to curb the progress of major infrastructure projects, such as for oil drilling or the construction of motorways or railways. “Free” additions such as a wildlife crossing are an effective way of ensuring construction and exploitation of the motorway can continue unimpeded.
7.3.2 CO-SELLING AND THE INTERNET

Co-selling has taken off online in the way that it has thanks to the Internet’s unique structure of cost and value. Certain costs are considerably lower online. And the Internet also enables forms of value creation that entrepreneurs never even dared dream of before 1990.

First off, we will look at factors that are making the cost function incomparable. Next, we will go into the unique online sources of value creation.

7.3.3 LOWER COSTS ONLINE

Costs can traditionally be allocated to four sources:
- Design and creation — “R&D”
- Production and raw materials — “factory”
- Delivery — “logistics”
- Marketing and sales — “sales & marketing”

A company’s R&D department designs the products. It compiles specifications and submits these to procurement, production, and assembly for execution. Design and production come with significant cost. The company launches marketing campaigns, while its account managers visit customers. Supply chain management sees to it that the physical goods are delivered.

Online costs, on the other hand, sometimes stem from only one source: design and creation. Costs from the other three sources are as good as negligible. We will outline how the Internet makes these costs “disappear” in the following order:
- a. Production
- b. Delivery
- c. Marketing and sales

a. Production

In traditional industries, more sales mean higher costs for production, raw materials, and delivery. Online, the variable costs of serving users (“production”) are nearly zero. All that is needed to absorb a
growing user base is server space. Data centers are cheap and costs will drop over time. Therefore the only significant production costs that an Internet company incurs are one-time costs for the design and creation of the application. This requires an effort in writing the code for the software.

b. Delivery
The costs involved in providing an Internet service are low and flexible. Besides, both bandwidth from the data center to the cloud and connectivity for users are becoming ever cheaper.

c. Marketing and sales
Marketing and sales costs are low. In offline sectors, it can be quite expensive to advertise for customers. Satisfied users of Internet services, however, bring in new users with great ease, quickly, and for free. Word-of-mouth advertising for a good website happens both offline and online. Google has made billions of dollars from its search services without spending anything on marketing. Attracting customers and sales to advertisers can be virtually free.

7.3.4 Higher value online
Value creation traditionally primarily happens through the seller’s proposition. The low cost of doing business online now offers unprecedented opportunities of combining users and services in a way that will boost value. In the following, we will go into four sources of additional value creation:

a. Transparency
b. Modularity
c. Unlimited supply (“long tail”)
d. Network

a. Transparent
Easy access (“one click away”) and the absence of geographical obstacles (“virtual”) make it easy to quickly form a perception of a website’s value. The quality of providers can be verified by checking blogs, taking part in chat sessions, or through other forms of communication across the enormous Internet community. Transparency
also concerns the price. Price comparison websites force providers to give some serious thought to how they can differentiate themselves from the competition.

**b. Modular (“link”)**
Traditionally, companies compete with each other. They want to provide the most comprehensive service possible to their customers. Internet-based companies, however, like to supplement each other in order to help customers, either through formal partnerships and affiliate marketing programs or otherwise. Sites often use links to refer users to applications that can meet a specific need. Providers are increasingly specializing in their own area. When an Internet company has become the leader in a specific market segment, it will after a while often end up serving the vast majority of that market (winner takes all). Websites that do not offer a certain feature themselves will link users to the dominant and most developed website in that specific market segment.

c. **Unlimited supply (“long tail”)**
There are few limitations to the online presentation of a product range. The assortment can be changed at any time of the day. In principle, the number of goods or services that can be offered is endless. Traditional sales channels that present products in showrooms and shops are confined to the physical floor space they have available. Sales staff often has a catalogue and price book that are periodically updated. The extra range that can be presented online is known as the Internet’s long tail. One single item from the long tail will create relatively little revenue. But Internet-based companies will still have tapped a considerable source of revenue, as they can offer a nigh on unlimited assortment.

d. **Network value**
As soon as an Internet company has conquered its niche through differentiating quality, it will create a large network of users. The huge and global scope of Facebook and Skype were unthinkable back in 1990. For that reason alone, these networks in themselves are already valuable, because a social media user wants to be part of the largest networks. After all, that will give him or her more contacts, as well as
the opportunity to strike up more connections than elsewhere. And those people who were already using the network are also winners, because the influx of new users means they always have new users with whom they can communicate. At the end of the day, all Facebook users benefit from using one and the same network instead of posting their photos and messages on ten different networks.

7.4 Cohesion (C12)

7.4.1 Balance

Cohesion (C12) is the last price driver in our review of the art of pricing. This is not a stand-alone price driver, but instead one that emphasizes the need for balance between the other eleven price drivers. Cohesion requires the well-honed skills of a true pricing manager. Creativity, intuition and experience are what’s needed.

7.4.2 Example: The Airline Industry

A fine example of the power of cohesion can be found in the airline industry, where traditional airlines maintain networks of routes. This section will first look at the pricing techniques these network airlines use. Despite using many price drivers to optimize revenue from their networks, their financial results are almost always poor. We will therefore compare them to another category of providers, the so-called low-cost carriers. What becomes apparent is that there is insufficient cohesion between price drivers at traditional airlines.

Traditional airlines increase the number of routes they can sell by striking up strategic alliances with airlines in other parts of the world or through acquisitions of other airlines (C2). The value they provide hinges on a timetable that is predictable to customers, good service on board their aircraft, and great concern for safety (C3). For each customer segment and for each route, they pay a price that matches the value provided. On routes where there is little competition, they generally charge higher fares (C4). They also use price customization (C5) in a range of different ways, such as:
- based on the time and place of booking and the flight, with lower fares for passengers who book their flights early and by charging a premium for flights at sought-after times;
- based on customer segment, by giving a discount to holidaymakers, for example;
- based on the number of flights purchased, which can see an airline give a volume discount to companies;
- based on product and service, as reflected in the distinction between economy class and business class, for example;
- based on distribution channel, by giving discounts to tour operators and agents (online and offline).

Airlines also offer services related to flying, such as hotel accommodation and car rental, while selling a varied range of goods on the actual flights (C10). And they pioneered the concept of loyalty schemes, awarding business travelers popular frequent flyer miles to coax them into flying with them as much as possible, while the employer pays for the (more expensive) tickets (C11).

The traditional airlines are convinced that price drivers help them make a profit. They have, especially when compared to other industries, large pricing departments that are often manned by hundreds of employees. They are particularly enthusiastic about price driver C5, price customization. Former American Airlines CEO Robert Crandall once said: “If I’ve got 2,000 customers on any given route and 400 different fares, I’m clearly still 1,600 fares short.” American Airlines pioneered the kind of complex revenue management and pricing systems that were later copied by all major traditional network airlines.

But how well are these airlines actually performing? Profitability across the industry has traditionally always been low. In the US, the airline business as a whole made a cumulative loss of $2 billion between 1947 and 1991. There were some signs of a recovery at the end of the 1990s, but by 2005 the cumulative result from 1947 was negative again, both in nominal and real terms.* The long-term fi-

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* Nominal: effects of inflation have not been factored in. Real: effects of inflation have been factored in.
nancial performance of this industry, which has been a major driving force behind the development of advanced pricing, more than any other industry, are so poor that unquestioningly following their methods may not be such a good idea.

Over the decades following American Airlines’ introduction of revenue management, a second business model for airlines emerged. Southwest Airlines and Transavia were the first successful low-cost carriers. Many so-called no-frills airlines are profitable and generate above-average growth thanks to low prices. They manage to keep fares down through, for example, low costs of an efficient fleet, limited service, and cheaper staff.

One critical factor underlying the success of low-cost airlines is the complexity reduction they have accomplished in processes and operations. When it comes to pricing, they limit themselves to the forms of price customization that matter most to them. They simply do not bother with other forms of customizing fares.

Around the year 2000, low-cost airlines were the first to start selling all their fares online, achieving unprecedented levels of fare transparency and purchasing convenience. The network airlines, on the other hand, still had confusing websites that would initially not reveal their cheapest fares to online shoppers.

Low-cost carriers customize fares based on the time of booking and supplementary services. A fare will be higher if more people have already booked a seat on the flight in question. And supplementary services are charged separately. There are surcharges on top of the fare for services such as additional luggage allowance, reserving a specific seat or drinks and snacks on the flight. The time of booking and supplementary services are two essential dimensions for low-cost carriers that allow them to assess willingness to pay and cost to serve across their market. This way, they can create the desired price image in customers’ perception by advertising a very low from price, while simultaneously generating sufficient revenue through more expensive tickets.
Traditional airlines simply cannot match this kind of simplicity. They use complex fare structures and conditions such as a minimum stay, advanced purchase, booking classes with different rules for changing or cancelling a ticket and corresponding fees, frequent flyer schemes for passengers, loyalty schemes for companies, upgrade options, lounge access, priority lanes, corporate discounts, and other schemes aimed at attaining “optimum” price customization. Not only have traditional airlines proven to be insufficiently capable of reducing complexity (C9), the very way they work also leads to more costs (C6). By taking differentiation between customers to such an extreme in selling and executing flights, they are increasing their costs. And traditional airlines are also deficient in the area of fairness (C7). Although CEO Crandall of American Airlines would not be satisfied until he had 2,000 different fares for 2,000 passengers, most travelers are not amused when they find out there is a large difference between what they paid for a ticket and what the person next to them on the plane paid; they may also think that the fare depends on (too) many different factors.

The network airlines have overshot the mark in their application of pricing methods. Their pricing policy is hampered by a lack of cohesion (C12) between the price drivers of customization (C5), costs (C6), communication (C7), and complexity reduction (C9).

7.4.3 **EXAMPLE: INTERNET COMPANIES**

High-profile Internet companies such as Facebook, LinkedIn, Twitter, Google, and Spotify have managed to amass a network of users and become dominant in their respective niches within a short time span. They all provide services for free. The success of their revenue model hinges on cohesion (C12) between cross-selling (C10) and co-selling (C11) on the one hand and the opportunities that the Internet’s unique structure of cost (C6) and value (C3) offers on the other hand.

Google’s search engine is free to use. They sell adverts based on the search terms users enter (C11). Adverts tie in with an acute need of a potential customer. An advert will appear at a very relevant moment, namely when a consumer enters a specific search term. This rele-
vance is the true value (C3) that enables higher fees for Google ads based on co-selling.

LinkedIn sells valuable advertising space, as it enables the advertiser to select where to advertise based on the user’s professional domain and location (C3, C11). Business services providers can hence get in contact with interested employees at their clients. An IT provider from India can reach CIOs in countries where it intends to increase its market share. Also, LinkedIn lets professionals post a profile with a CV for free. They do charge, however, for options such as sending messages (InMails) to potential employers or clients (C10).

Facebook lets advertisers select where to advertise based on detailed personal characteristics (C11). The value Facebook offers its users is very high. Users spend a lot of time on Facebook and the number of users has grown rapidly. Revenue from ads, however, has been disappointing so far; users seem to take little notice of adverts on Facebook. Cohesion (C12) between Facebook’s customer value (C3) and advertising revenue (C11) is therefore seen as not yet being optimal. Obviously, this status at the beginning of 2013 may very well change in the years to follow.

Spotify offers free unlimited (C3) online music streaming with commercial breaks. If you want to listen to music online without adverts, you will be charged 5 euros a month. For a monthly fee of 10 euros, you can also do so offline (C10). Spotify has developed modular value by entering into an alliance with Facebook (C11). Facebook friends can share the music they are listening to on Spotify. Users benefit from simple and valuable suggestions for songs and bands from people they know.

7.4.4 IN CLOSING

We have now reviewed the twelve price drivers you need to take into account when designing a revenue model and setting your prices. This naturally leads to the question of how best to determine the price and which price drivers carry most significance for any specific type of company. The answer to that question lies in the nature of art.
Selecting price drivers is an art: the art of the true entrepreneur who chooses a strategy, business model, and price drivers, and creates a corporate culture, that best suit the objectives of this enterprise, as well as himself as a person. Objectively choosing the best price driver is therefore not possible. You can compare this to style choices made throughout the history of painting: Dutch masters in the seventeenth century based their style choices on considerations that differed from those used by Karel Appel in the twentieth century, who basically threw some paint at a canvas using brushes, filling knives, and his bare hands. And in that same vein, the value-driven pricing methods deployed by German car manufacturers are wasted on Facebook and Google, who are changing the world by making valuable services available for free and unlimited in exchange for user details and attention.

In this part, the central focus was always on the level of prices, while we paid relatively little attention to the basis of prices (the pricing model). This was a conscious choice, aimed at keeping the explanation as simple and accessible as possible. However, selection of a pricing model is subject to the same twelve price drivers we discussed in this part of the book. Note: in industries such as software, (public) transport, telecommunications, and publishing, the basis of a price has such considerable influence that it cannot be considered separately from the level of a price. For a taxi company, for example, the choice between a fixed fee per journey, a per-minute rate, or a per-mile rate is a fundamental one; the same goes for software companies, which can opt for a licensing-based model or a subscription model.

In the preceding chapters we covered the twelve considerations that determine the price and pricing model. In the next part, we will go into the methods available to us to, after having selected one or multiple price drivers, set the best possible prices.
This free sample (part I “Art of Pricing”) was offered to you by the author. To also read part II “Science of Pricing” and part III “Execution of Pricing” order your full copy of “Pricing: The Third Business Skill” from Amazon or www.FirstPrice.nl
‘Price is a one-figure summary of what a company has to offer’

Pricing: The Third Business Skill shows you in a clear and concise manner how to set optimum selling prices for your company, using accessible models and examples. Cases used in this book were taken from real life and from many different industries, both B2C and B2B. These cases show what it takes to set the best possible price and build a pricing organization in which all business functions work together.

This book takes an integrated approach and deals with strategy, tactics, tools, processes, and organization. After reading this book, the pricing function will no longer hold any secrets for you, empowering you to get started on structurally improving your margins right away!

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