Protect Pricing Integrity for Higher Profits

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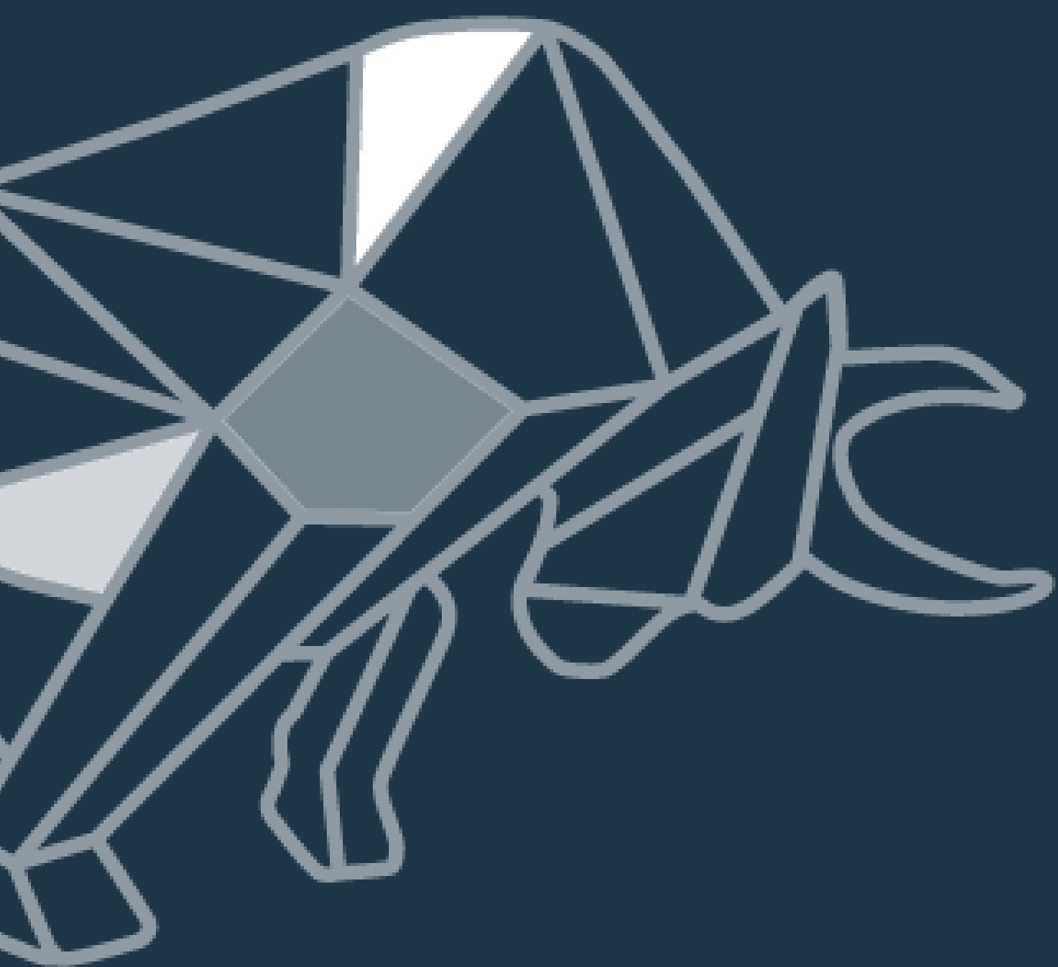


HOLDEN ADVISORS

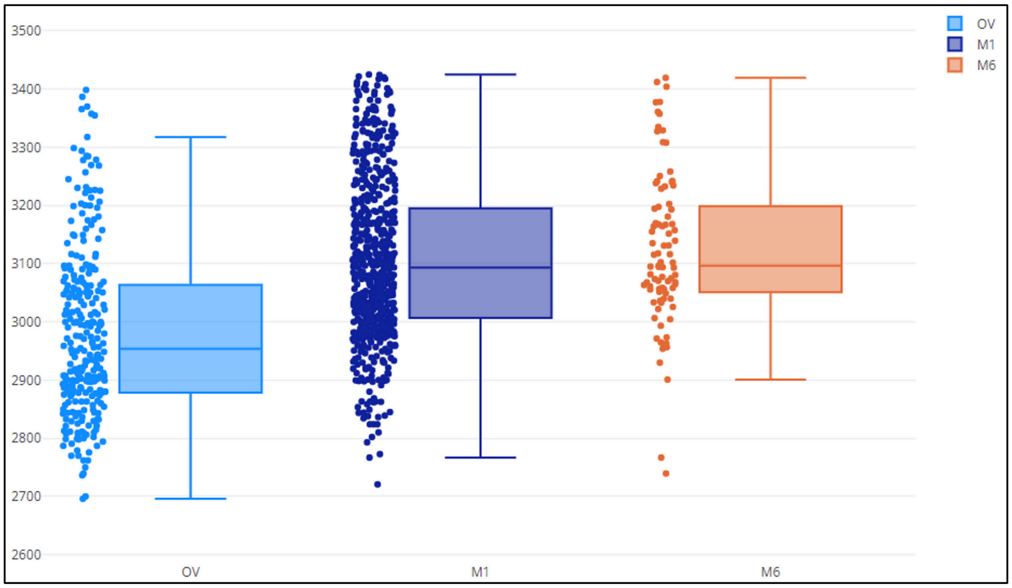
Executive Summary

When prices vary by wide ranges without rational justification, customers lose trust, learn to game the system, and sales teams are unable to negotiate effectively. To ensure prices retain meaning, firms should regularly assess transactions to ensure rational alignment with the logic actually used in negotiation and current pricing practices. To maintain and grow pricing power, it's important to document those pricing practices, ensure deals comply with these terms through governance and systems, and measure the results. Adjustments should be made on a regular basis to ensure ongoing integrity.

When controlling price is the problem

When they see your prices, do your customers trust them?

Many businesses operate with a wide range of prices for the same SKU (known as price dispersion). If price differences are due to clearly defined segmentation strategies with rational fences, the wide range of prices can be easily defended. However, one of the key signals of failed price segmentation is a high level of unexplained price dispersion. Particularly in B2B sales environments, representatives seek to close deals through one-off prices and "special exceptions." In short, prices lose their integrity.



In this example, the dispersion of prices for the same SKU between context categories display significant overlap - making it challenging to explain to customers.

Once price integrity is lost, companies experience many negative impacts:

Customers game the system and/or lose trust. When customers learn that others pay significantly less for the same product, they question if they are getting a fair deal. At best, they may try to determine the rules required to get a better price and game the system. At worst, this could be perceived as a betrayal of trust. Either way, why give your customers a reason to look to competitors?

Sales is unable to hold the price. If the dispersion between prices between customers is random, the sales team will be unable to defend why the given list price is right. They will be more likely to use discounts as they are unsure of the true value. Good fences support different price levels using easy-to-explain justifications.

Wide, unexplained price dispersions cloud an accurate understanding of true price sensitivity (price response). There is a key statistical relationship between dispersion and the confidence with which the price response function can be estimated. Without a clear understanding of the factors that drive price sensitivity, a firm cannot be confident its pricing is competitive nor set future strategies.

Maintaining bloated price books is a challenge. Large numbers of price points can be a management challenge and increase opportunities for error in firms with less mature pricing infrastructure.

Ok, but how do I know if we have an issue?

Savvy pricing teams consider what the “right” price is for an offering within the context of their entire portfolio of customers and sales use cases. They understand how widely prices should vary, where outliers exist, and which factors most reasonably explain price differences.

An assessment might begin with basic data analytics to define and size opportunities for improvement.

How spread out are prices?

Common measures of price dispersion include the Interquartile Range (IQR). Using a scatter or box plot can help to identify outliers. It is also helpful to look at a compression ratio (using the highest measure as the numerator and the lowest measure as the denominator) to get a relative sense of whether the range is acceptable. Does it make business sense that the higher price is 2x, 3x, or more of the lower price?

How spread out are prices relative to the median (or average)?
To keep the range in context, it is helpful to see the range relative to some mid-point of price. A wide dollar range for a low-dollar item might not make sense. But that same range for a high-dollar item might have more reasonable optics.

How frequently are there outliers?
Even with larger ranges, there may be a few price outliers that influence how the price dispersion is skewed. Understanding where the outliers are and how frequently they occur helps interpret the dispersion. Are there common factors that precipitate the outliers?

> “WHY?” is fundamentally the most important question we need to ask to complete the assessment.

After reviewing the dispersion data, look for trends of who is paying more/less than others. If there are legitimate reasons for paying more/less, and the level of dispersion is justified, the number of specific price points is less relevant. But if there is a wide variance and no consistent justification can be identified, there is a problem.

The focus of the assessment should quickly turn to clarifying reasonable pricing justifications based on price segmentations. To identify these price segmentations a best practice is to interview front-line sales team members to understand the types of customers served and how they negotiate.

Focus on the price levers during this conversation, not the price points. Seek to understand which factors trigger adjustments (higher and lower) to arrive at a fair price. Common factors that drive adjustments include customer size, frequency of purchase, loyalty, and value-add features (e.g., shipping or a rush order, etc.).

I found some issues - how can I fix them?

Corrections should be implemented commensurate to the severity of problems identified during the assessment.

Begin with price governance

A robust governance process provides a roadmap to determine what the price should be and how to get there. Such a roadmap clarifies the “rules of play” so they can be routinely observed. Governance begins with formalized pricing policies that outline how prices should be set, which discounts can be given under which circumstances, and who is authorized to override any of the policies. Price levers “discovered” in the assessment phase can be incorporated into the price structure. By documenting these policies, firms have a basis by which to review prices and judge if the price is compliant and within the range of what is expected.

> A price-setting strategy is only as good as a firm’s ability to enforce it. Sales representatives should have input into the published governance process and be trained to use it in negotiations confidently.

Pricing policies are never truly “complete” since markets are always in flux. Requests to modify pricing policies should be closely monitored. These change requests help identify areas where the existing policies may need reevaluation (e.g., areas with many modification requests).

Build systems to review proposed deals for compliance and performance

Once a firm has a documented pricing policy, it can better control how deals are priced using a range of mechanisms.

Especially in selling environments characterized by many complex deals, a deal desk is a sales support function to review deals and ensure they comply with documented sales governance. Deal desks help control unexplained dispersion by adding a layer of review before deals are made to ensure pricing and discounting policies are followed. The deal desk should be set up to provide fast yet thorough reviews to minimize friction while ensuring sound pricing.

If a formal deal desk is impractical, consider setting up a deal scoring system where proposal pricing can be scored according to deal context factors (e.g. market, size of customer, type of product). Sales representatives whose average deal score (e.g. high margin dollars) can earn bonuses and incentives.

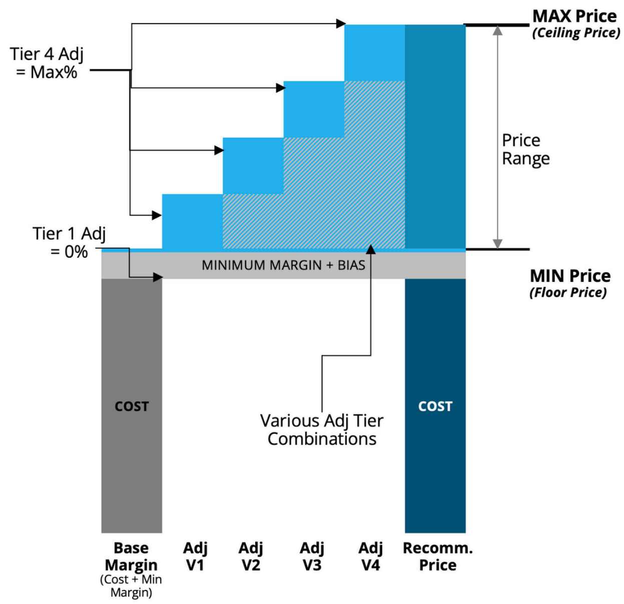
Implement systems to control pricing and discounting per pricing policies

Technology-based solutions (such as a rules-engine) provide a powerful way to standardize pricing per governance. While sales may object at first, well-designed systems should leverage many of the levers sales teams already use to derive the proposal price. To get short-term control over price dispersion, a rules engine can be configured to set the price range (difference between the ceiling and floor prices) and provide a justification for (via selection of adjustment factors and their relative impact) price differences.

In a recent client engagement, we used a rules engine is to calculate a floor price, and then add margin under pre-defined conditions to calculate a final price:

The floor price should be configured to determine the absolute minimum price that the product should be sold. Perhaps this will be at a level to merely cover costs and/or some minimum-margin requirement. The calculation of a floor price should be sound enough that extraordinary justification would have to be required to sell the product below the floor. The floor price should reflect the lowest price you might offer the largest client giving all reasonable discounts to seal a large sale.

Adjustment factors reflect the factors you would consider when providing discounts (or not). The exact adjustment factors to use will be different by industry and purchase decision, but the main point is that the adjusting variables will be set at levels that trigger price increases relative to the price floor. Using adjustment factors identified by the sales team will help in implementation and execution.



After meeting floor price criteria, adjusting factors determine price up to a ceiling price which determines a price range.

The ceiling price will be the floor price plus all the maximum values of the adjustment factors and reflects the highest possible price a customer would pay for the product.

As a result, prices were produced using justifications vocalized by the sales team but compliant with pricing policy.

Measurement

Pricing is a dynamic process where market feedback must be constantly considered. Review the measures of price dispersion—as identified in the assessment phase—periodically to ensure prices are within expected ranges and comply with governance. Dispersion should be explainable by the factors used to set price and provide discounts as outlined through governance.

While a rules engine can help to gain initial control over prices, the customer's price response is not fully considered. Therefore, monitor dispersion and sales levels with extra vigilance. The pricing and sales teams should be ready to adjust the engine in response to both positive (e.g. ensure sufficient inventory if sales volume increases) and negative (e.g. change pricing rules if sales quickly dry up due to non-competitiveness) market responses.

Look for statistically derived price/volume response when prices normalize. Especially with a rules engine in effect, recommended prices should begin to normalize to the levels between the floor and ceiling and be explained by the selected adjustment variables. Using the adjusting variables as controls, clearer relationships between price and volume can be established.

These relationships provide a foundation for statistically based price elasticity optimization. If clear price/volume relationships remain unclear, search for other variables to be considered for future adjustments.

Conclusion

Consistent observance of pricing governance leads to consistent pricing practices. As a result customers can trust they are getting a reasonable deal as sales representatives are able to rationally justify the price. Further, firms can measure market responses to existing prices and take appropriate corrective actions to pursue strategic objectives (e.g. increase profits or market share).

When prices lose their integrity through one-off deal pricing and lack of consistency, opportunities for mistrust and lost profits abound. Forward-looking firms regularly look at pricing dispersion as a part of their assessment and performance measurement processes. They make corrective actions to price governance and pricing practices.

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