PRICING BEYOND THE 3 CS

Contents

1. Why Study Pricing?

(1) Even slight improvements in pricing can yield significant results. For example, for a company with 8% profit margins, a 1% improvement in price realization, assuming a steady unit sales volume, would boost the companys profits by 12.5%. By contrast, decreasing fixed costs by 1% would only lead to an increase in profits of 4%. (Dolan 1992)
   - Continental Airlines had 44 million passengers in 2001, at an average ticket price of $193. Charging $2, or 1.04%, more per ticket would have transformed a loss into a profit.

(2) 80% of managers know how much it costs to produce their product. 23% say they know their customers' willingness to pay for the product.

(3) 41% of firms have identified their inability to recruit employees with the right pricing tool sets as their major barrier to implementing pricing practice overhauls.

2. Three Cs and Pricing

Typically an introductory marketing class teaches that any pricing strategy should reflect the '3 Cs' of pricing:

- Costs
- Customer
- Competition

Advanced pricing analysis, however, views the 3 Cs as describing a set of *constraints* that pricing strategies must *overcome* to succeed. The 3 Cs also describe three bad pricing strategies.

- Cost-Based Pricing. Or, pricing on the basis of what it costs you to make the product.
- Customer-Based Pricing. Or, allowing your customers to dictate your pricing policy.
- Competition-Based Pricing. Or, choosing your pricing strategy exclusively on the basis of what your competitors do.

2.1. **Cost-Based Pricing.** Cost-Based Pricing involves setting a price such that

$$Price = (1 + percentmarkup)(UnitVariableCost + AverageFixedCost)$$

Practical implementation problems:

(1) You have to know costs.
  - A baby sleepsuit company made a loss despite engaging in cost-plus pricing, because they did not realize how much their packaging cost.
  - For example, Diamond Deliveries in Philadelphia. The bicycle division, which management thought of as Diamond's core business, generated just 10% of total revenues and barely covered its own direct-labor and insurance costs. Diamond was charging customers $4.69 per job, but with fully allocated costs of $9.24 per job, the company was losing $4.55 every time a cyclist picked up a package.[1]
  - You need to be able to estimate the costs of everything.

(2) Costs are a function of sales which are in turn a function of prices. This makes such calculations circular. Imagine a firm whose average costs decrease with sales.
  - If they sell less, their costs go up. But is a time of declining sales really the right environment to increase prices?
    - For example, Wang Computer
  - If they sell more, their costs go down. But pricing at average cost for small-scale capacity means that the firm may never discover this. This is an issue for firms that face large economies of scale or unknown experience curves.
    - For example, an aeroplane manufacturer found that every time they managed to double their sales, they reduced labor time per aeroplane produced by 10 percent.

(3) Cost-based pricing is misplaced in industries where there are high fixed costs and near-zero marginal costs. Distributing fixed costs is hard.
  - Complicated when products affect fixed costs in different ways.

[1]'Are We Making Money Yet?', Inc Magazine July 1 1995.

- Activity-based pricing is where the customer agrees to pay the price when the cost is determined with an agreed mark-up based on the contribution to fixed costs. Activity-based pricing is better than regular cost-based pricing in such situations.
  - For example, Owens Minor, a medical supply equipment distributor, improved pricing performance by adjusting its mark-up to be higher on adult diapers compared to replacement ultrasound film.

(4) Ignoring the value you create leads to underpricing
- Pet Rock

Rather than asking what prices firms need to charge in order to cover their costs and achieve their profit objectives, firms should ask how their pricing strategy will affect their cost structure.

2.2. **Customer-Based Pricing.** There are many versions of customer-based pricing.

(1) B2B: Salesforce allows purchasing agents to dictate their prices.
- An aquarium cleaning product firm sold below their cost because they were scared of losing the custom of a big-box retailer.

(2) B2C: Giving away a valuable product or add-on for free because the company fears a customer revolt.
- Flickr hosts 4 billion images (as of Oct 2009). However, the user base is so passionate that managers are reluctant to charge more.

The problems with customer-based pricing are that:

(1) Customers do not reveal how much they value the product
- Radiohead launched a 'pay what you want' scheme for their album 'In Rainbows'. 62 percent paid nothing. Average price of $2.26 an album.

(2) Customers need to be educated about the value of the product
- For example, it was hard for customers to understand what TiVo offered over a traditional VHS recorder.

(3) When customers are used to being in control of a firm's pricing, they revolt at price changes
- Turbotax starting charging users $9.95 for each additional return they filed. Users revolted and gave them a 1.5 star rating on Amazon. The company retreated, reverted to charging nothing and refunded the money.
- Resident Evil 5, a computer game, tried a different approach: 'This is the part where I get to say 'BS',' the vice president of Strategic Planning & Business Development wrote on the Capcom forums. 'RE5

> is well worth every penny of $60. A huge game, with tons of replay value, loads of unlockables, new weapons, co-op, mercenaries mode, etc. If any game warrants its price point, it's RE5'

Instead of asking themselves what their customers would pay, firms should ask themselves what are the prices at which they can convince their customers are supported by their product's value. How can they segment to reflect differences in customer valuation?

2.3. **Competition-Based Pricing.** Competition-based pricing describes the situation where a firm does not have a pricing policy that relates to its product, but instead a pricing policy that reflects its competitors' pricing decisions.

Sometimes this simply takes the form of a firm copying their competitor's pricing and not conducting their own pricing research.

Sometimes such pricing can take the form of a firm setting a market share objective and discounting their price relative to their competitor until they attain it.

The problems with competition-based pricing are that:

(1) It encourages firms to ignore their unique value proposition
    - A radiology software firm with a unique 3D capability lost millions because they priced at the same price as the marketing leader.

(2) It can lead to price wars
    - If a firm sets a market share objective when the market size is fixed or declining, then this immediately signals that this gain in market share will come at the loss of a competitor. This leads to price wars.
    - For example, the 2005 price war between Anheuser-Busch and Miller was provoked by flat sales.

(3) Focusing on market share does not necessarily lead to maximum profits
    - Even in industries with large economies of scale, some segments of the population are more profitable to serve. In the UK, cable companies have often ignored this and focused on extending their market share to rural villages.

Instead of setting market share objectives, firms should focus on identifying the most profitable segments to serve, and finding ways of profitably serving them while protecting themselves from price wars.

3. To Summarize

The 3 Cs are often thought of as pricing 'dos', but they can just as well describe pricing don'ts.

Generally, the problem is that each of the 3 Cs encourages a powerless approach when it come to pricing. In all cases, the firm is reacting to a constraint, rather than shaping that constraint. The rest of this course will focus on how we can shape customer and competitive reactions to our pricing strategy, in a way which means that firms do not have to worry about hitting the cost floor.

A more attractive reworking of the 3 Cs would be:

- Create Value
- Calibrate Value
- Communicate Value
- Capture Value

The course is based around these new 4 Cs.

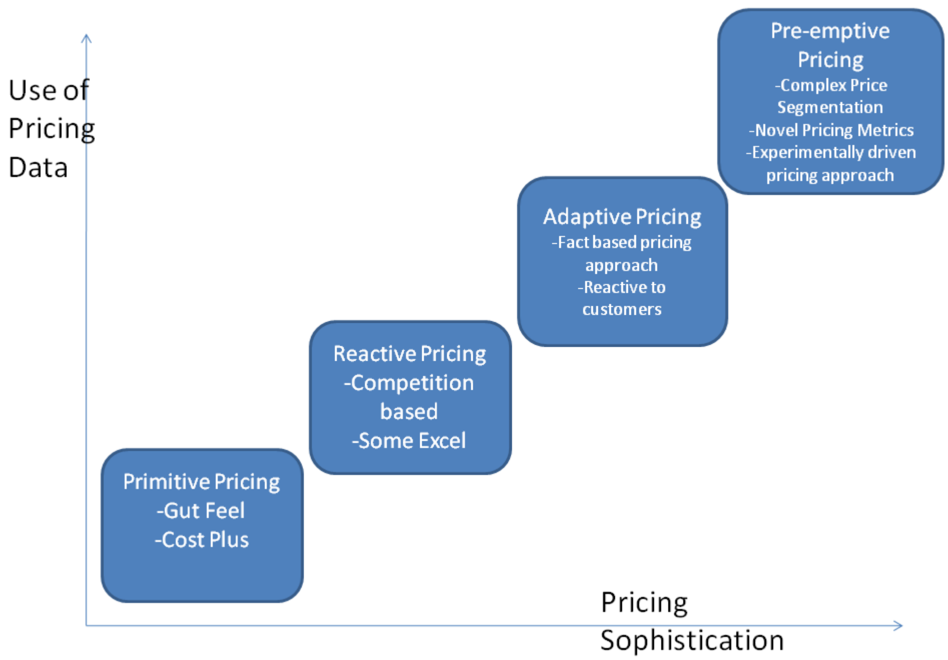

FIGURE 1. Aim of 15.818: Tools to allow students to transform industries into pricing leaders *Source: Based on Deloitte Analysis*

15.818 Pricing
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