Understanding pricing

By Tim J Smith

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Pricing is no longer a purely economic challenge to be addressed through studies of market elasticity. It can't be solved by lowering prices until customers' purchases improve factory utilization rates and it can't be solved by allocating costs and adding mark-ups. Rather, pricing today must be focused on value exchange.

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While experts and executives agree that price should reflect value, the pricing to value mantra fails to clarify the decisions executives must make. That is, what is the value that price should reflect? Whose perception of value should determine price? And, how can value be modelled and quantified? In other words, pricing decisions today, requires actionable insights.

These insights must derive from a marketing orientation of the firm with a clear economic understanding of value exchange. The marketing orientation focuses the purpose of the firm towards serving customer needs profitably - an orientation supported by the late greats Peter Drucker and Theodore Levitt. The economic understanding of value exchange reminds us that customers will purchase when the product delivers value in excess of its price after adjusting for alternatives and the firm must deliver products at a price in excess of their cost. These are two very simple concepts.

Combined, the marketing orientation of the firm and the economic understanding of value exchange, provides the foundation for developing insights required for executive decision making in pricing strategy.

Pricing challenges

Executives can structure pricing challenges into one of four types: price setting, price discounting, price structure, and overall pricing strategy.

Price setting refers to the challenge of setting the right price in the first place. Different pricing setting approaches can be used for different products, and the appropriate pricing setting approach for a product will evolve as the market evolves. Each of the dominant approaches to setting prices, exchange value models, market research methods, and economic price optimization, share an orientation towards capturing profitable customers through mutually beneficial value exchange.

Discounting refers to the inevitable challenge facing firms when customers call for a lower price. Not all products must be discounted, but most executives discover that discounting can enhance profits. Unfortunately, discounts can also destroy profits. To navigate the quagmire of discounting decisions, executives should recall the core purpose of the firm, to serve customer needs profitably, and accept that different customers will place a different value on the same product.

Appropriate discounting enables the firm to price the same product to different customers according to their willingness to pay, as long as the price is above the marginal cost to produce. Evaluating the willingness to pay of millions of customers requires the development of a new corporate capability. Proper monitoring techniques, decision processes, analytics, and incentives must be implemented to enhance the firm's discounting decisions.

Price structures refer to the strategic approach through which specific transactional prices are set. Unit pricing, two-part pricing, complementary pricing, versioning, bundling, subscriptions, and yield management are all different price structures. Each of these price structures can enhance the profitability of some markets, and each is completely inappropriate for other markets. The selection of the optimal price structure is, at its core, an economic challenge to be informed by an understanding of differences between customers within the market, the cost structure associated with delivering the product, and the firm's market strategy.

Overall pricing strategy challenges arise in considering the actions of the firm in the context of its industrial environment and its strategic resources. Competition, product evolutions, and legal decisions all influence the latitude a firm has in setting its pricing strategy. Attaining the right fit between the firm's resources and the market opportunity enables the firm to achieve higher profits, grow faster than its competitors, or both simultaneously.

Going deep

Various qualitative and quantitative analytical techniques have been developed to enable decisions that reflect both the marketing orientation of the firm and an economic understanding of value exchange. These analytical techniques go a far way in delivering the right answer to the right pricing question, one customer at a time, a million times a day. Each analytical technique provides tremendous insight into the nature of the pricing decision confronting an executive and the opportunity to improve results.

A good analysis requires both quantitative and qualitative insights. Despite the seeming clarity delivered through quantitative analytical techniques, executives cannot overly rely upon the output of a single equation.

Pricing is a strategic challenge, not an engineering challenge. Angus Maddison, professor of quantitative macroeconomic history at the University of Groningen, once stated, "no sensible person would claim that [quantification] can tell the whole story." Similarly, quantitative models in pricing enable terrific insight, but they must be informed and tempered by a qualitative understanding of the opportunity.

Understanding value exchange

Each of these four types of pricing challenges can be addressed through the marketing orientation of the firm and the economic understanding of value exchange. Moreover, quantitative and qualitative analysis can be used to further clarify the alternatives and tradeoffs. Our understanding of pricing has come a long way, and it is time for executives to grasp this modern understanding to improve the results of their decisions.

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