

A Process for Managing Price Changes

As important as Pricing is to the profit potential of a business, it is amazing how casually the price change process is managed. While intentions are always good, often the timeline becomes compressed and senior management's desire for simplicity trumps the implementation of an effective process. We believe that there is a simple, data driven process that any business can follow to ensure price changes are managed for improved profits and better customer acceptance. Moreover, it doesn't matter whether prices are changed daily, weekly, monthly, or annually; these steps must be present in some form before a company can claim that it has control of the price-setting process.

We have seen the effects of a poorly managed price change process in many companies. The most common errors can be characterized as follows:

- The peanut butter spread: direction is given to take the same price increase across all products or offers. While it is simple to calculate the new prices, this process usually results in customers' cherry picking the offerings that they will continue to buy.
- The cost driven justification: the initial response to a cost increase is to carefully calculate the impact and share these results with the customer as a justification for a price increase. This action is problematic as any eventual cost decrease may cause the buyer to ask for prices to be rolled back again. The company will have lost the connection between price and value.
- Just keep raising the price: this approach is most common with relationship driven businesses where prices are increased often at accelerated levels (sometimes in excess of +10% per year) for a number of years. In time, the prices to the best customers are well above market levels and customers typically begin to shop around. When these consumers defect, the company finds it difficult to replace this high margin business. We refer to this occurrence as the inverted price structure.
- Match competition: it is likely that a lot of time went into understanding the value and points of differentiation when your offering was initially developed. Over time, companies grow weary from many rounds of internal negotiations regarding discounts. Therefore, these companies fall into a pattern of simply matching their competition without regard for the pace of this slide towards commoditization.

Our suggested process will invigorate the pricing discussion and allow you to focus on the offerings most deserving of management's time and attention. We illustrate a 9 step process, which may at first blush seem a little daunting; however, four of the steps are analytical and the other five are designed to guide your potential actions. The process guides the analysis of the 4C's of pricing (Customers, Costs, Competition, and Conditions which includes Capacity) to ensure that all perspectives are covered. It is designed to codify company knowledge in a world where management positions can turn over every two years. See Figure 1.

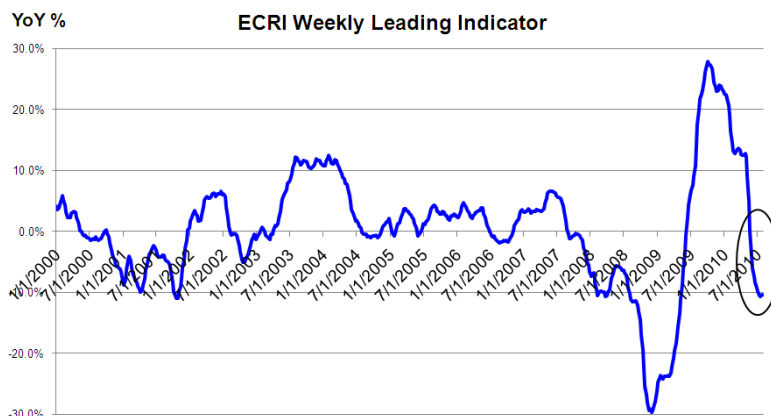
Figure One: the Price Change Process



These steps have a number of tools embedded within them. They are also designed to incorporate the best practices in Pricing Management and indicate the order and linkages between tools. The tools have been well documented in the Pricing Management body of knowledge.

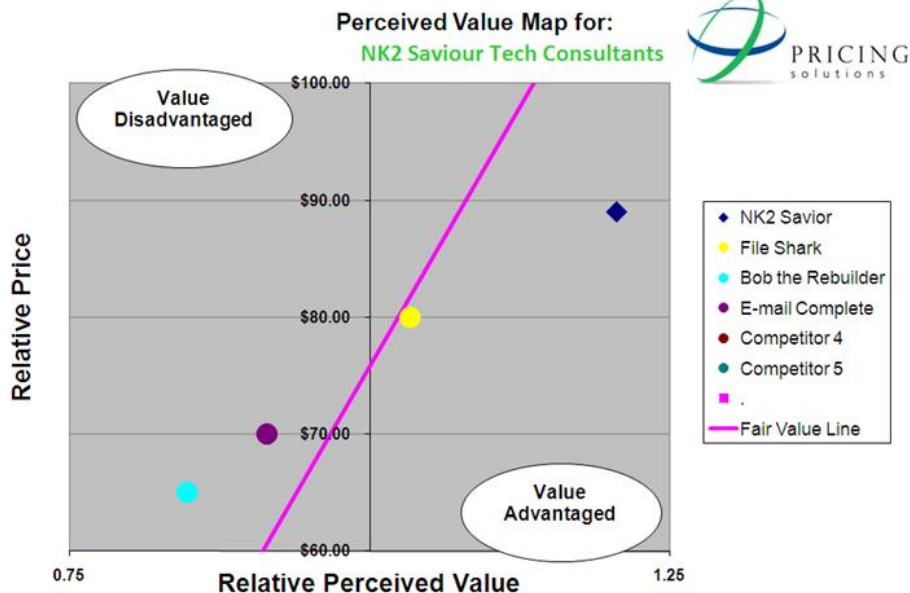
- Forecast the business climate: Looking back, it is painfully clear how many indicators were pointing towards an economic meltdown in late 2008. The lasting lesson for pricing managers is to develop processes that gather and interpret macro-economic data. The OECD provides a monthly leading economic indicator at http://stats.oecd.org/Index.aspx?DatasetCode=MEI_CLI, while ECRI provides a weekly leading indicator at <http://www.businesscycle.com/resources/>. Learning how to use these two charts and finding proxies for trends in your business will put you ahead of your competition in linking macro trends to pricing decisions.

Figure Two: ECRI Weekly Leading Indicator



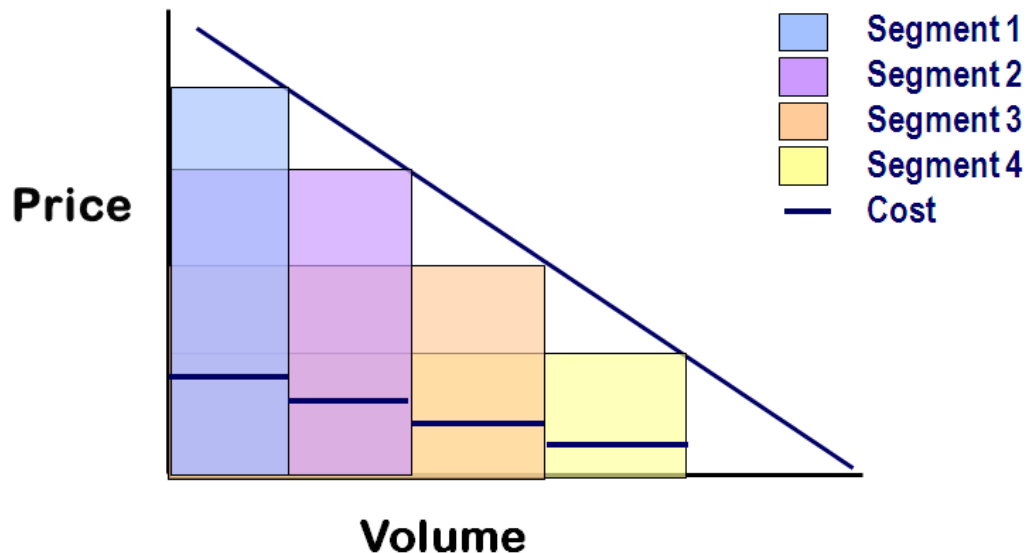
- Determine proactive / reactive stance: Not all businesses have the same degree of “Pricing Power”; therefore, the decision to be proactive or reactive in the market place cannot be the same for all offerings. There are tools that can be used to determine the Pricing Power of a product category. Generally speaking, however, you will need to think about the number and the concentration of both customers and competitors; the margin structure of the industry; the degree of differentiation among competitors; the environment of regulations; and not-in-kind substitutions. By taking these factors together, the pricing manager is able to determine when it is appropriate to be leading or lagging the market with pricing moves.
- Opportunity for improved value capture: Customers make purchase decisions based on the ratio of value delivered to price paid. That value equation is never static, nor is it the same for all customers. A value analysis is usually conducted when a product is launched; but, how well has that value materialized in the field? Are the claims of economic or financial benefits proving true? Do customers perceive the benefits as intended? The question here is whether the value equation is indicating that a price adjustment is warranted. A Perceived Value Map or Financial Value Analysis is a valuable tool to support your recommendation.

Figure Three: Perceived Value Map



- **Predisposition to Margin or Volume Plays:** Your costs are important even if you have progressed beyond being a cost-based pricer. These costs set the floor price below which you are unwilling to do business. If your margins are at 20%, then on a 5% price increase you would be willing to trade off a 20% volume loss. If the business is a fungible commodity, you might lose more than 20%; however, your predisposition will be to raise prices on a low margin business. Conversely, all volume looks like good business at an 80% margin. Your concern in this case is that a price decrease would accelerate margin erosion and stimulate further price cuts by competitors.
- **Run a play from the Playbook :** A playbook is a compilation of the pricing best practices in your business that have been built up over time. What did you do the last time industry trends were down, but costs were up? Did that work? If not, what did the team put in place at the time to mitigate the impact? Documenting and classifying the conditions and related pricing moves and results builds organizational knowledge and makes for a very professional handoff to your successor. Using the playbook to guide your price setting process is an efficient and effective approach.
- **Versioning or Segmentation Opportunity:** You are leaving money on the table if you only have one offering and one price in the market place. Revisiting your segmentation and pushing it beyond demographics or end user industry and size can enable you to find profit opportunities from customers who really value your offering. It can also help you find ways to unbundle your offering for your price sensitive customers without creating confusion in the market. The model for this strategy is shown below.

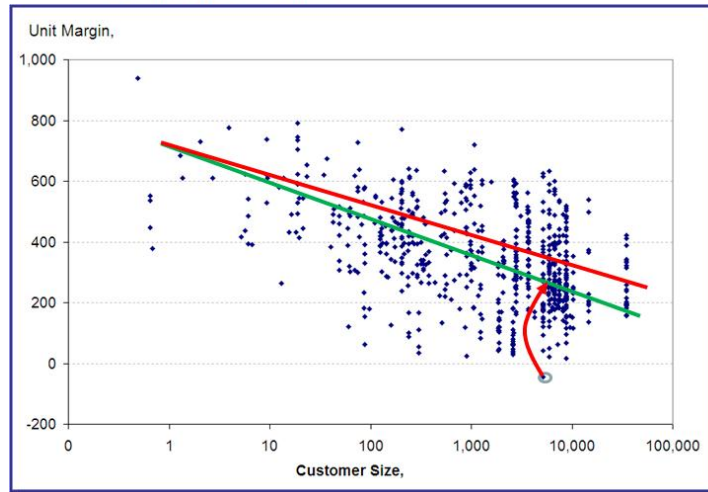
Figure Four: Segmented Pricing



- Opportunity to Reshape the Slope: In a business to business environment, larger customers are often given better prices than smaller ones. In effect, the rate at which this tradeoff is made reflects the company's strategy regarding value capture. When was the last time this slope was questioned? What is the ratio between the lowest and highest prices in the market place? Is that appropriate? Are there other factors that impact this rate of increasing discounts? Questioning the logic behind the long standing "rules" offers a significant profit improvement opportunity.

Figure Five: Margin Dispersion Chart

1. Reshape the Curve
2. Reposition Outliers



- Opportunity to Improve ROMI: ROMI is Return on Marketing Investment. We define Marketing in the broadest possible terms here including: promotions, rebates, customer incentives, annual volume plans, as well as traditional and non-traditional media. We are frequently amazed by how often this spending becomes an entitlement and is not analyzed to determine which activities are driving the best returns. Strictly speaking, this analysis is not impacting the Price Change decision; however, it will impact the customer pocket price (the amount of money they must take from their pocket to pay for the offering at the end of the transaction). Therefore this analysis should be reviewed as pricing is adjusted.
- Which customers are winning or losing?: The changes to pricing structure and programs we have mentioned suggest that it is no longer so simple as to look down your customer list and see that everyone will be paying an additional 5% next year. Each segment of customers will be impacted in a slightly different way. Some will change their behavior. A model of expected customer changes and impact will give you the opportunity to make adjustments to your plan and will give senior management the confidence to approve it. You will need to look for unintended consequences. For example, all of your price sensitive customers will receive a price increase, while the most loyal customers receive a price decrease. Is there a story that your Sales partners feel confident that they can deliver to ensure a successful implementation?



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This white paper is intended to help you organize the key questions about an upcoming price change and to set in motion a plan to be more effective in the implementation of a price change. The tools required and level of sophistication depend on where you are today and the frequency and scope of your price adjustments. This primer is designed to help you ask the right questions and give you a sense of the gaps in your current process. You are likely missing millions of dollars of opportunity without a disciplined process.

To learn more about the tools and processes supporting an effective Price Setting Process, please contact Tony Hodgson at thodgson@pricingsolutions.com

This article was written by Jim Saunders

Jim Saunders leads the Pricing Management Practice at Pricing Solutions. He brings more than 20 years of experience as a senior manager, and consultant to that role. He has been working in Pricing Management for 15 years, six as a practitioner and nine as a consultant.