Pricing Strategy - How to optimise the price

"Pricing decisions depend heavily on an understanding of the customer, product differentiation, the offer and the perception of value."

Synopsis

Pricing decisions in IT and technology companies are often the preserve of the finance department, but the best pricing strategy can only be developed with a good knowledge of the customer and a clear understanding of what they value. In this article, *How to optimise the price*, we discuss the relationship between price and value.

Introduction

Back in May 2007 an edition of *Information Age*[1] carried an article about "Dynamic Pricing Models" arguing that on-demand pricing in auctions and real-time web pricing is becoming the norm. Whilst this is certainly true for some products and services such as air travel and goods on eBay, it is a long way from the reality for most complex B2B products in IT, technology and telecoms markets[2]. Here pricing is probably one of the most important issues in determining the success of the business, but also one of the least discussed.

So why is it so important? Consider a simple example: If your gross margin is 50%, and your net profit is 10%, then a **5%** increase in price will increase your margin by 10% and profits by **50%**! Of course, this simple example assumes an inelastic market.

Who determines the Price?

It could be argued that price is essentially a marketing decision but few marketing departments are equipped to deal with the issues. Sometimes it's deemed as too important and is solely the authority of the finance department. Pricing decisions depend heavily on an understanding of the customer, product differentiation, the offer and the perception of value, all factors that marketing should be driving.

What determines the Price?

It's easy to say the *market* not *costs*. But that's difficult because although we should know our own costs in B2B markets we often don't know the market price. Good salespeople will determine the market price in the process of negotiation but often there is a feeling that there is "money left on the table" although we never know how much.

Rather than leaving it to the market, why not take control of the price by maximising the value to the customer?

1 "Liquid Commerce" Information Age May 2007

2 Interestingly, since initially researching this article I have come across an example where, after selecting a telecommunications device they needed, a bank held an e-auction to determine which channel partner through which they would purchase the equipment.

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“Value, or rather perceived value, is the important measure.”

The relationship between value and price

Value, or rather perceived value, is the important measure; customers will often pay more for greater value. This is where we can increase profitability since it’s quite possible that our costs will be similar to our competitors.

The diagram shows the relationship between total cost ‘C’, price ‘B’ and value ‘A’. Cost is dark blue, orange the profit and the width of the column can represent volume.

The objective should be to:

1. **Maximise the customers’ perception of value A.**
2. **Set the price B as close as possible to the value. Higher than A means the customer won’t buy, lower than A means “leaving money on the table”.**

This will make the gap between B and C as big as possible, maximising the profit. This should be the objective of marketing and sales.

So there are just three parameters:

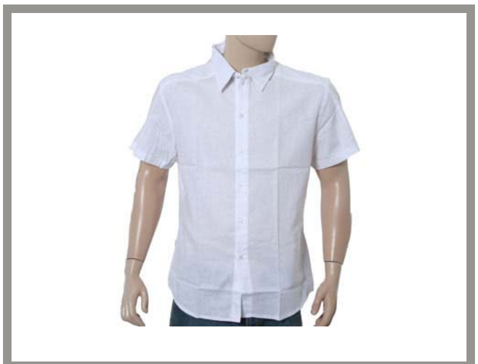
Cost: Which we would generally seek to minimise

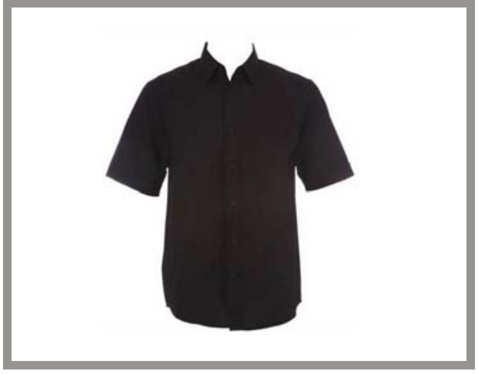
Price[3]: Set by the seller

Value: Which we need to drive as high as possible

Pricing

Finally, here’s a B2C example of differentiated pricing from the web. One of these shirts is a Versace with a *discounted* web price of £68.00. The other is an Asda shirt with a price of £6.00. Which is the Versace*?





Recommended actions:

- Make pricing part of the marketing strategy
- Remember low price can give a perception of low value
- Keep prices high. It’s easier to lower the price that increase but don’t exceed the value – that will lead to a loss of credibility

* In fact, the white shirt on the left is the Versace. Part of the value of Versace must be in the style of the shop so selling via the web reduces the value. It’s also clear that this vendor doesn’t appreciate the value of presenting the shirt in the best possible light – or at least ironing it!

3There are some exceptions. For example “widgets” for the motor industry, where the buyer sets the price. The seller still has the opportunity to change the value, differentiating on quality, service, innovation, etc.

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