

ARE YOUR PRICING METRICS AN UNTAPPED OPPORTUNITY FOR PROFITABLE GROWTH?

Why pricing more profitably doesn't mean having to raise prices

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In today's competitive environment, where companies aggressively pursue every opportunity to grow revenue and profit, executives continue to miss a critical insight that could significantly improve their bottom line performance: pricing more profitably doesn't mean having to raise prices. In our experience of working with hundreds of clients across a variety of industries, we see that price metrics (the unit of measure for charging prices) represent one of the biggest payback opportunities, yet is most frequently overlooked.

On a daily basis, purchases are made based on a predetermined unit of measure, what we call a "price metric". The metric is the means by which a customer is charged for the use, purchase, or consumption of a product or service. Gasoline, milk, and paint are charged by the gallon. Long distance phone service is charged by the minute, concrete by the yard, and seafood by the pound. For the most part, consumers don't analyze the price metric because they see some correlation between the unit of measure and the consumption of the product or service. However, for sellers, the price metric can have as much impact on the overall profitability of a product or service as the actual price point. What's more, consumers are far less likely to object to a price metric than the actual price. Yet surprisingly, companies continue to ignore the metric and focus solely on price.

Across a broad range of industries, as technologies advance, markets evolve, and competitors shift, pricing metrics based on historic industry practices may no longer be appropriate and could be damaging your overall profitability and position in the market. In some cases, using a faulty price metric can actually accelerate the commodization of your products and services.

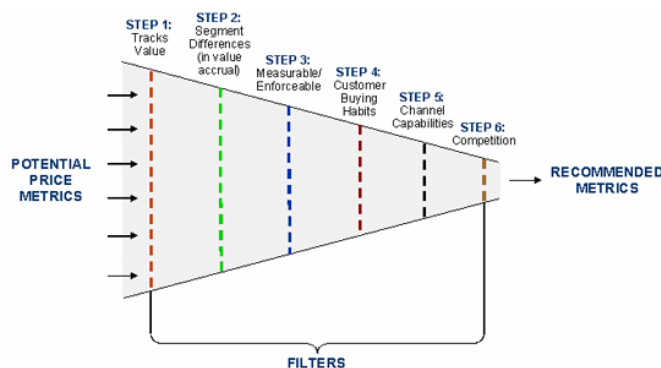
A great illustration of this happened in the aircraft engine industry several years ago. GE Aircraft Engines turned the industry on its head and created a tremendous competitive advantage by changing the way they charged customers for their aircraft engines. Instead of using the traditional industry metric of charging a fixed price for an aircraft engine, GE changed the metric to better track with the value it delivered. It introduced the concept of "on wing" pricing, which meant customers were charged for engines based on the hours of the engine's use. This move brilliantly highlighted GE's claim that its engines were of superior design and would fly longer with less maintenance than those of its competitors. In one simple but strategic pricing move, GE advanced its value proposition while simultaneously diminishing that of its competitors. This move led to a significant increase in revenue and profit for GE and turned the basis of competition in their favor.

Choosing the right metric is a critical component of an overall pricing strategy

because it establishes the link between how and what is consumed, the economic value received as a result of purchase, and the ultimate price paid. It is a fundamental, but often overlooked, component of pricing strategy.

In identifying a price metric within a well-conceived pricing strategy, six critical elements are required. Price metrics must:

1. Track with how customers realize value
2. Delineate between customer segments that receive different levels of value
3. Be both measurable and enforceable
4. Support customer buying habits
5. Leverage channel dynamics
6. Manage the competitive environment



Using these guidelines to identify the best price metric is a critical step in improving profitability. As always, each company situation is unique, and these elements need to be applied in the context of your overall business and marketing strategy.

1. Track with value

As a fundamental rule, price metrics must track to the value a customer receives. Value doesn't mean features or benefits, but the actual increase in revenue or decrease in cost that a customer achieves by using your product. Take, for example, a software company we recently worked with that was launching a new product but was unsure of how to price it. They were overly focused on setting the optimum price but didn't consider the importance of changing their price metric.

Our client's software was developed for the call center industry; they had developed a natural language voice recognition solution that was able to interpret and manage customer service inquiries in a fundamentally new way. This software not only helped to decrease the time operators spent on the phone with each call, but it also reduced the overall headcount required to handle calls. However, in the software industry, the traditional price metric was a "per user" licensing price, meaning for each user of the software, a licensing fee would be charged. In this case, using the traditional price metric created a major disadvantage for our client. Since their software actually helped call centers improve efficiency and reduce headcount, using a per-user price metric reduced their potential revenue and profit from the very outset.

After evaluating and considering a number of alternative price metrics, we ultimately suggested a per-call pricing metric that better tracked to the value the software delivered to call centers. Since our client's software enabled more calls to be handled with fewer people, it was a far better choice than a per-user metric. In addition, this price metric allowed our client to target smaller call centers that would not have been able to afford the solution on a per-user basis. This solution appealed to these smaller customers because it was priced within their reach. Large call centers did pay more under this approach, but most did not object because they understood (after a well-implemented value communication sales plan) how the solution tracked to the value they received. By using a different metric, our client was able to reach multiple customer segments and dramatically grow their top and bottom lines.

2. Delineate between customer segments

A robust price metric also helps to enable segmented pricing (i.e., a mechanism to charge different prices to different customer segments for a similar product). Our recent work with an enterprise software company illustrates how a price metric can enable segmented pricing. This software company had developed unique industry solutions (or modules) that were tailored for over 30 different business models, from industrial to consumer products. However, using a standard per-user licensing metric left significant money on the table

because the software delivered significantly different value to the various industry groups for which it was customized, and a one-size-fits-all metric just did not capture these differences. We worked with this client to develop unique price metrics that tracked more closely to the value proposition of each industry. For example, in the industrial manufacturing segment, the objective is to maintain efficient utilization of multiple manufacturing facilities and production lines. Managing complexity is a critical driver of both the top and bottom line performance. We implemented a price metric based on “per-production lines,” which provided a clear link to their economic model. This metric also allowed our client to target both large and small customers while establishing a clear link between the cost of the software and the value that it delivered.

3. Measurable and enforceable metrics

To be actionable, price metrics need to be both easily measured and enforced. We’ve worked with the advertising divisions of a number of newspaper and media companies to develop new price metrics that better align to their value proposition. Our challenge was to identify the best price metric that could be readily tracked. For example, the real estate sections of most Sunday newspapers have numerous pages listing homes for sale. These advertisements are an important revenue stream for newspapers and have traditionally been charged on a “per column inch” price metric. The downside of this standard metric is that it is too costly for many segments of the market, including for-sale-by-owners, small real estate agencies, and even large agencies marketing lower valued properties. As all newspapers strive to maximize revenue and profits, our clients asked for our help in pricing advertisements. After considerable research and analysis, we ultimately recommended and implemented a new price metric where advertisements were charged on the percentage of the cost of the advertised house, rather than a per column inch. This metric clearly tracked to value and made it more accessible to a number of additional customer segments. Most importantly, the metrics were clearly measurable and enforceable since the vast majority of ads also include the price of the home.

4. Support customer buying habits

While thinking strategically about price metrics is long overdue for many companies, we do not suggest using metrics that are so unique and uncommon that customers find them hard to adopt. The ultimate metric chosen must, in fact, support customer buying habits. A well-publicized failure in creating a new price metric occurred a few years ago when Coca-Cola introduced a new price metric for its products sold through vending machines. They began testing the ability for vending machines to raise the price of a can of Coke based on the temperature outside. If a certain temperature was reached, a simple thermometer and computer chip in the vending machine would automatically increase the price of a can of Coke. Cola-Cola executives argued that the desire (and value) of a cold drink increases during the heat of the summer, so it’s fair to charge more on hot days. However, consumers rebelled and the press had a field day. One industry analyst quipped, “What’s next? A machine that X-rays people’s pockets to find out how much money they have and raises the prices accordingly?” Ultimately a change in your price metric needs to be carefully communicated to your customers. The metric must be judged to be fair and support how your customers buy products. Carefully orchestrating the rollout is critical to prevent external forces (like the press) from derailing your message.

5. Leverage channel dynamics

Channel partners are critical in helping to establish a new price metric in your industry. They need to understand, communicate and sell the rationale for the new metric; otherwise customers will not adopt it. Price metrics should, therefore, leverage the strengths and skills that your channel partners already have.

For example, a technology company we worked with that develops both hardware and software solutions for the telecommunications industry had developed a new product whose economic value resided primarily in new software, but its channel partners were skilled in hardware (not software) sales. If our client had used the traditional “per unit” hardware metric, they would have undermined the tremendous value of the software. After considerable investigation and piloting, we ultimately recommended a price metric that

captured both the value of the software and the skills of the distribution channel. We created a price metric based on the “number of ports” in the hardware. This metric worked well because the channel partners understood and could measure hardware ports, and the number of ports was also a good proxy for the value of the software, since the software’s throughput and the ability to process data was directly linked to the number of ports on the hardware.

6. Manage the competitive environment

In some cases, the current price metric simply does not make sense. If you drove a sub-compact car, but were charged “by the tank” at the local filling station, you’d probably be a little upset. As crazy as this example sounds, there are many examples where the current price metric is equally absurd and a simple change in the metric will alleviate significant frustration.

In the airline industry, one of the major costs is for global distribution services (GDS), a fee that airlines are charged for the “distribution” of airline content (flight, seat, fare) to travel agencies. The industry standard price metric was based on “flight bookings;” however, only 80 to 90 percent of bookings result in a flown segment. As you can imagine, airlines don’t like the idea of being charged for flight bookings that aren’t converted into revenue. We worked with providers in the industry to develop a new price metric based instead on “airfare value.” This new metric allowed leading GDS providers to align pricing with how airlines generate revenue; pricing was also aligned with the growing (and increasingly important) low-cost carrier segment that aggressively manages all elements of cost. The old metric not only neglected to take into account cancelled bookings, but it also did not reflect the differences in value from short domestic flights to transcontinental flights. The implementation of this new metric helped to ease the considerable frustration of airline carriers, and provided significant competitive advantage and drove incremental revenue and profit for our client.

Summary

While setting and managing price is important, don’t forget to evaluate the implications of

implementing a new price metric. If you can identify a new price metric that can successfully pass through the filters we’ve described, you have a very good chance of adding significant incremental revenue and profit. What’s more, if orchestrated well, the new metric can help you establish a new and defensible leadership position, and you can do it all without actually raising price.

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