
Building Business Profitability: The Value Connection

Out of the Commodity Swamp

Part 2

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Introduction

In a recent speech at the Société de Chimie Industrielle, David D'Antoni, Vice President and Group Operating Officer of Ashland Chemical's specialty chemicals and distribution operations discussed the environment chemical firms face. Noting the current operating environment was indeed gloomy, D'Antoni suggested firms will not be able to count on economic changes to rescue them from declining price and profits. Offering several suggestions on how to deal with this, D'Antoni proposed companies "could make money the old fashioned way – by creating value and capturing some of that value."¹

This series of articles focuses on that "old fashioned approach," describing the process for creating value and using pricing strategy to get paid for value creation. In the first installment of this series, the concept of value delivery was introduced. This installment deals with implementing a value based pricing process, utilizing the "5C" process:

- *Comprehend* value delivery to target customers.
- *Create* products and services that deliver value to target customers.
- *Communicate* the presence of these value delivering products and services.
- *Convince* target customers to pay for the value delivered through using these products and services.
- *Capture* a portion of this value with consistent pricing and competitive strategies.

Segmentation and Targeting

In part one of this series, value hierarchies and Economic Value Estimation® (or EVE®) were introduced. A key function of the value hierarchy and the EVE® is to allow managers to comprehend how value is created for customers as they use their suppliers' products and services. But there is more information generated as managers use these tools.

Another key notion is captured in the EVE®: different groups of customers will be able to achieve different benefits (and hence different value) in using the supplier's offerings. Customers who achieve greater benefits and value can often be charged higher prices – and these customers may be the best targets for the supplier. To drive profitability, managers should develop marketing and pricing strategy targeting customers where price sensitivity is lower (customers can be convinced to pay for delivered value) and the cost to serve is lower.

Customers who receive different benefits and value constitute different segments. These different segments of customers are characterized by the differing cost reduction and/or differing revenue enhancement components identified in the EVE®. Some of

¹ Quoted in *Chemical Week*, April 25, 2001, p. 3.

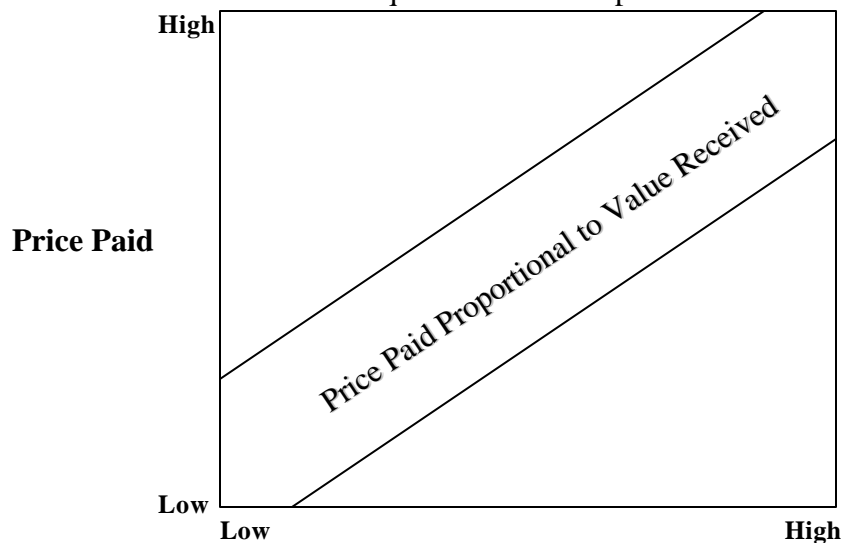
these segments of customers will be good targets for creation of products and services, because value delivery will be higher and, in theory, managers will be able to charge higher prices when serving these customers.^{2,3} Other customer segments will receive much less value and be more price sensitive; these segments may be less attractive targets.

The objective of the segmentation and targeting process is to recognize differences among customers, and determine which customers will be served (the targeting decision). The following process describes how offerings (combinations of products and services) are created for customers, and how the value customers receive through using these offerings can be effectively communicated to target customers. This material assumes the customer segmentation and targeting process is complete.

Creating Offerings – Building Packages of Products and Services

The objective of the offering creation process is to assemble a package composed of those products and services that will create unique value for each target segment. These offerings will then be priced based on the value customers receive in using the offerings (see Figure 1).

Figure 1: Creating Offerings for Multiple Customers
The “Unique Value” Concept



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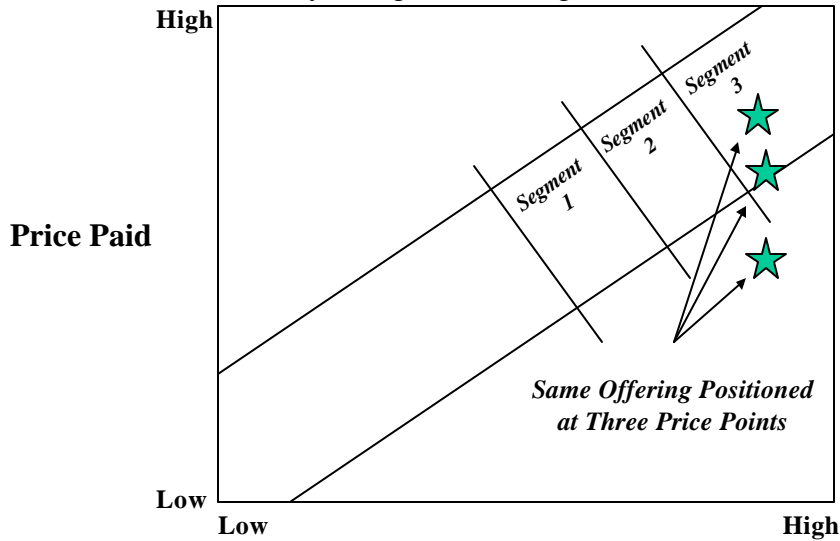
When targeting more than one segment, managers should create offerings with the appropriate value for each targeted segment. In an attempt to achieve economies of scale,

² Of course, much more will be necessary in order to realize higher prices; see the following paragraphs on communicating value and convincing customers to pay for the value.

³ Being able to charge higher prices does not ensure the business will be profitable. Not only are we interested in the price level achievable with delivery of higher levels of value, but we must also consider the cost necessary to deliver the value.

managers are sometimes tempted to serve multiple customers with the same product/service offering (see Figure 2).

Figure 2: Creating Offerings for Multiple Customers
A Poorly Designed Offering Portfolio



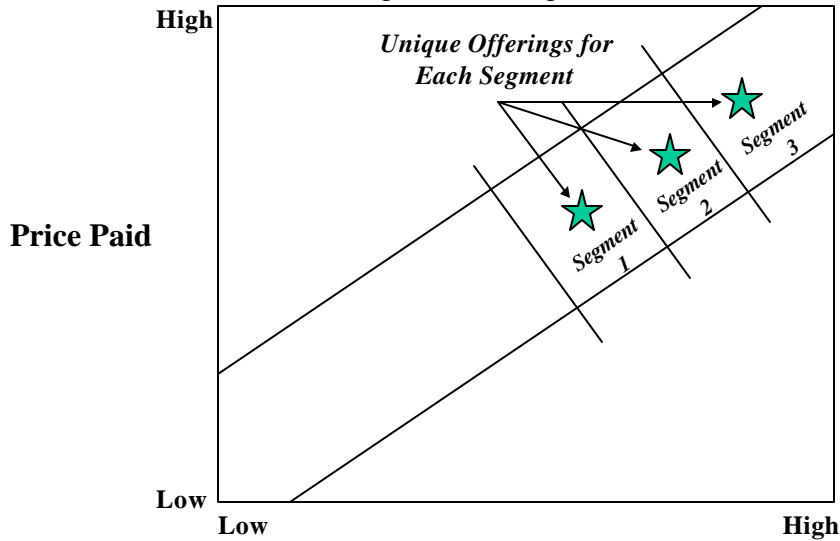
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This creates a market in which customers are asked to pay very different prices for the same offering. Unless customers can be prevented from migrating to the lower price offering,⁴ multiple price points often create higher price sensitivity and customer resentment as higher priced customers discover the existence of lower prices. In addition, when firms charge different prices for the same offering, the sales force often has no rational explanation if customers question why they pay higher prices.

A better approach is to design unique offerings for each target segment (see Figure 3).

⁴ These different prices can only be sustained if customers can be prevented from finding out about lower prices – a rare event. Even when customers do not physically communicate with each other, brokers often reveal different price levels by creating secondary “gray” markets.

Figure 3: Creating Offerings for Multiple Customers
A Well Designed Offering Portfolio



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In this approach, value and price are adjusted to each target segment. When customers question why they pay higher prices, this approach gives the sales force a reasonable explanation: customers who pay higher prices get more than customers who pay less.

Some managers argue it is too expensive to create unique offerings for each segment. This argument may be true, but it should only be accepted after comparison with the “cost” of customers demanding lower prices when they discover they are paying more for the same offering (i.e., the “cost” of lowering price to the lowest price in the market⁵).

Firms in the more mature process industries are often not able to tailor the core product to customer segments – sulfuric acid is the same molecule everywhere, for example. Frequently, however managers in the process industries are able to create unique offerings through the tailoring of value added services and/or complementary products. For example, offerings can be tailored for different target segments through adjusting times when firm order commitments must be made, or delivery cycle adjustments, or environmental services. Technical service is a staple of many process industry firms; offerings can be tailored on the availability and response time for technical service. In short, process industry firms often provide many services that can be tailored to deliver more or less value to target customers, generating the opportunity to create unique price points for each target segment.

A significant danger managers face is an attempt to build differentiation through adding product and/or service features that are different than competitive offerings, but not necessarily differentiated. As discussed in the first part of this series, features create

⁵ Many customers insist on a “favored nations” clause in their purchase contracts. This guarantees them the lowest price in the market for the same offering – ensuring their price must be lowered if their supplier grants a lower price anywhere else in the market. Firms employing a one offering for all customers and agreeing to favored nations clauses automatically build price concessions into their marketing strategy.

value only when the customer realizes benefits while using offering features. In order to be differentiated, the customer must realize unique benefits in using the offering. Frequently, though, managers ignore the distinction between being different and being differentiated, and provide lots of undifferentiated – but different – offering features. The problem, then, is that customers refuse to pay for these differences, and in essence receive them for free. These undifferentiated offering features drive up costs but not value delivery, and negatively impact the profitability of the supplier. Managers should build their offerings to create differentiated value, and avoid the temptation to provide undifferentiated but different features they will not be paid for.

The primary tool for developing offerings for different segments is the Product-Price Menu (see Figure 4).

Figure 4: Product-Price Menu

Customer Group	Core Offering	Service 1	Service 2	Service 3	Service 4	Price
A	Base Offering	10% Price Premium	Not Available	Not Available	Not Available	\$2.00/kilo
B	Base Offering	Included	5% Price Premium	10% Price Premium	Not Available	\$2.50/kilo
C	Base Offering	Included	2% Price Premium	Included	20% Price Premium	\$3.75/kilo
D	Base Offering	Included	Included	Included	15% Price Premium	\$5.50/kilo
E	Base Offering	Included	Included	Included	Included	\$7.00/kilo

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Economic Value Estimation® provides insights into each customer segment’s business needs and the value delivery provided through the supplier. The EVE® then becomes the foundation for building combinations of products and services for each customer segment, and for selecting price points. In developing the menu, the management team must determine:

- The core offering, or the base offering that each customer will receive. The minimum level for the core offering is the reference value elements – those offering elements (and corresponding benefits/value) supplied by the next best competitive offering. In addition to the reference, however, the management team may decide to include some elements of differentiation value in the core offering. There are two reasons for including differentiation value elements in the core:
 - Some offering elements that create differentiation value may be inseparable. For example, a particular quality parameter may create differentiation value for customers, but the supplier may not be able to produce a lower quality offering. In this case, the supplier would want every customer to take the offering at its

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- higher quality level and realize the benefits and value of this higher quality. Some offering elements cannot be physically separated from the core.
- It may be advantageous – from a supplier cost perspective – for all customers to take some offering elements providing differentiation value. Although the supplier might be able to physically separate these offering elements, it is not advantageous to do so. Therefore, all customers receive these offering elements – and their subsequent benefit and value – as part of the core offering.
 - The packages of offering elements that will be constructed for each segment of customers.⁶ The EVE® is used to define what offering elements are most important to each customer segment, and this then becomes the basis for deciding package elements.
 - Price points, as described in the following section.

Setting Price Points

Economic Value Estimation® is an essential tool for determining price points. Price should be set so it captures the reference value and a portion of the differentiation value. Customers are unlikely to buy if the price point is set so that it captures all of the differentiation value. Instead, price should be set so that there is incentive for the supplier to provide the offering and incentive for the customer to buy the offering. This means price is set such that not all of the differentiation value is captured by price. Setting price so there is an incentive for the customer to buy (that is, not all of the differentiation value is captured by the price point) becomes part of the communication process with the customer (see the discussion on communicating value below).

How much of the differentiation value can be captured? While the EVE® provides good quantification of the value delivery, setting price points is the “art” part of pricing strategy. Communicating value delivery using the EVE® helps in capturing a portion of the differentiation value. There are other factors that also determine how much of the differentiation value a supplier can capture. A discussion of those factors is well documented.⁷

Communicating Value to Target Customers

Creating products and services that deliver value to customers is a critical step in getting paid for value delivery. However, if customers do not understand the value delivered through the products and services they buy, they will not likely pay for the delivered value. It is not the customer’s responsibility to understand the delivered value, it is the supplier’s job to communicate the presence of this value.

Value communication consists of framing the value delivery to target customers. There are two components of value framing: framing the reference value and framing the differentiation value. Economic Value Estimation® is the foundation for framing both reference and differentiation value.

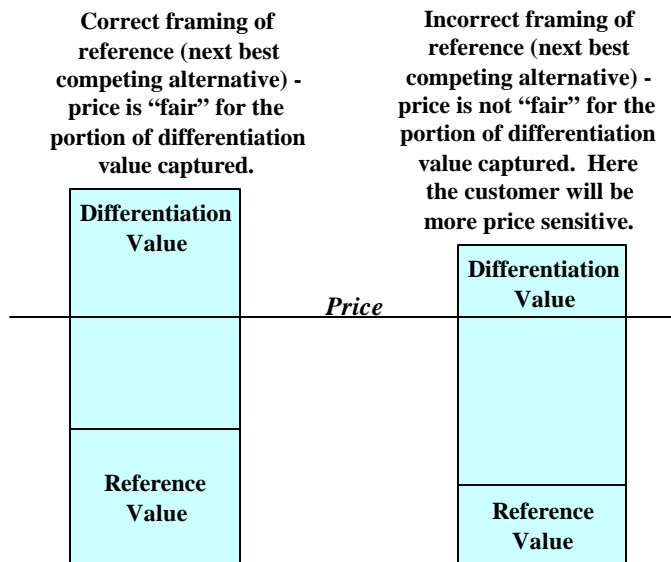
⁶ A crucial test for the management team in deciding which segments of customers to target is the ability to deliver offering elements with competitive advantage. While a firm may deliver significant value to a specific segment, it will typically be unprofitable to do so unless it has some form of competitive advantage. This will be discussed further in part three of this series.

⁷ See *The Strategy and Tactics of Pricing*, by Thomas T. Nagle and Reed K. Holden, second edition, Englewood Cliffs, NJ: Prentice-Hall, 1995, pp. 77-94.

In part one of this series, we defined reference value as the value supplied through the next best competitive alternative. For two reasons, when communicating value it is especially important to define the competitive alternative. First, customers always compare offerings to some alternative,⁸ so acknowledging the competition is an important step to getting the customer to acknowledge the value delivered through use of the supplier's offerings. Framing the value delivered by the reference offering allows the supplier to position against the appropriate competition.

This raises the critical concept of defining the best competition. Figure 5 illustrates the issue.

Figure 5: Defining Reference Value



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When the reference competitor is properly defined, a supplier can establish a price point that is consistent with the differentiation value. However, even when the same differentiation value is delivered, if the reference competitor is incorrectly framed as a lower value offering, the same price point will be more difficult to justify and more difficult to explain. At the same time, when a lower value competitive offering is the reference, customers will be more price sensitive.

⁸ Sometimes the competing alternative is “doing nothing.” For example, the author once had a client who provided environmental treatment services utilizing unique, patented technologies. The client argued their customers would have to purchase these treatment services because they would be in violation of several regulations if they did not treat waste streams – and the client’s technology was the only available treatment. Logically this suggests the client could charge anything they wanted for the treatment. But this is incorrect: if the price of the client’s technology exceeded the cost of violation fines, the customer might chose to pay the fines. Alternatively, if both the treatment price and the violation fines were too high, the customer might chose to do nothing, that is, go out of business.

Suppliers should assert the appropriate reference competitor in their communications with customers, and not wait for the customer to define the reference.⁹ As part of a negotiating strategy, customers may purposely define reference competitors whose value delivery is low, using this lower value delivery to force price concessions from the supplier.

After framing the reference value in communications with customers, the next step is to frame the differentiation value. Here the Economic Value Estimation® becomes the primary communication vehicle. Each element of the offering – its features, the benefits the customer receives, and the value, or worth of that benefit – are detailed for the customer. Customers may disagree with the value assigned to each benefit; the discussion then focuses on how the value was determined, and feedback from the customer on the validity of this calculation. This is a very different discussion than a price negotiation; the discussion has progressed to “what’s the right value” instead of “what’s the right price.” In turn, the value discussion forces the customer to reveal more about their business and operations.

The Economic Value Estimation® does not have to be precisely correct. Instead, it must be close enough to be credible. The purpose of the EVE® is to foster a discussion about benefits received and the value of these benefits.

As the communication about reference and differentiation value is concluded, price can be introduced. Again the EVE® is used to position, or frame, the price point. Price points are positioned relative to the value determined through the value estimation. Use of EVE® to position price allows the supplier to show the customer how they receive benefits and value in excess of the price (the incentive for the customer to buy, what economists call “consumer surplus”).

Convincing Customers to Pay for Value and Capturing Value

Even when customers understand the value delivered in their purchased products and services, they may not acknowledge that value – and thus not pay for it. Framing for reference and differentiation value using the Economic Value Estimation® then becomes the foundation for dealing with customer price resistance. The Product-Price Menu (Figure 4) is also key to dealing with customer resistance.

When customers desire lower prices or more offering elements at the same price, sales people should respond with the EVE® and the menu rather than price concessions. The approach is:

- When a customer asks for a lower price, the sales person should respond with a “subtraction” technique. Sales people implement the subtraction process by removing an offering element and using the EVE® to show the customer how value decreases with the element removed. The customer is then compelled to make a decision: either accept the lower value to get a lower price, or pay more to get the higher value from additional offering elements.
- When a customer asks for more offering elements at the same price, the sales person should re-frame using the EVE.® This can be done through showing the customer

⁹ A possible outcome when the supplier does not frame the reference in communication with customers is that the customer will not acknowledge the reference they use. The challenge then is that the supplier is not aware of who the competition is, and may then not be able to correctly position differentiation value.

the benefits and value of the additional offering elements, and positioning a higher price as “fair” given the additional value.

What offering elements to subtract should not be left sales person discretion. Just as negotiating price concessions can lead to hundreds of individual prices (a large administrative burden), so individual negotiations about subtraction elements can lead to hundreds of unique offerings that are both an administrative and manufacturing burden. To prevent uncontrolled growth of offering options, the management team should decide in advance the structure of the Product-Price Menu. In addition, the management team should decide menu elements sales people may subtract in dealing with price resistance.

This discussion should highlight the rationale for determining the core offering (what every customer receives). As noted above, the core offering may contain elements of positive differentiation that the supplier either cannot separate from the offering or does not want to separate from the offering (because there are cost advantages in having the customer take these elements). From a sales negotiation view, the elements in the offering core offering will not be subtracted.

In order to make the subtraction technique effective with customers, the management team must carefully chose what offering elements can be subtracted in customer negotiations. The elements selected for subtraction should be of substantial value to the customer, so the customer will suffer a significant penalty should they accept the subtraction. Subtracting low value elements will not cause the customer to debate the subtraction; instead, they will just accept the subtraction to get the lower price.

Just as subtraction elements should be pre-determined by the management team, so should the offering combinations and price points presented in the Product-Price Menu. Ad hoc offering construction in the market place often results in large numbers of offerings, poor utilization of some resources, and overbooking of other resources. Of course, decisions about which elements to offer to specific segments of customers should always be driven by the unique needs of the segment, and value delivery to the segment.

Next Steps

In the first installment of this series, we defined the concept of value and provided tools for assessing value. The key to achieving higher prices is to understand how a supplier’s products and services create an economic impact on target customer’s businesses and then implement policies to capture a portion of that value with pricing. The focus of this second installment has been the tools managers can use to create offerings that deliver value and capture value in their pricing policy.

Implementing a value capturing pricing policy is essential to achieving pricing policy, but by itself, these policies will not ensure the supplier is profitable. In order to achieve profitability, managers must actively manage competition so that their pricing policies actually provide adequate returns. The third installment in this series will develop tools for managing competitive interactions so managers actually improve their profitability.