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Pricing strategy and execution: an overlooked way to increase revenues and profits

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Introduction

In 2003, price optimization software did not make the list of the 20 most used strategic management tools. By 2005, 36 percent of the companies surveyed were working with price optimization tools, which had jumped to number 14 on the top-20 list. Clearly, some leading edge companies are looking at pricing as a potential strategic opportunity.

However, while many CEOs may wake up in the morning thinking about prices and revenues, most corporate leaders clearly don't yet contemplate the need for an overall pricing strategy supported by new software tools. This article advocates putting pricing strategy on the CEO's agenda and considers the new concept of pricing execution – the development of pricing strategy and the implementation of the strategy through a combination of leadership, management practice, and software – from the point of view of the senior management team.

Pricing execution – the development of pricing strategy and the implementation of the strategy, as reflected in the consistency and success of sales efforts and proposals – is often invisible to those outside a firm. Companies are reluctant to share information about their pricing successes publicly, lest their rivals find out. However, Wall Street analysts collect such information assiduously because "pricing execution" [1] [2] turns out to be an area with large and rapid payback – often delivering a 3 to 10 times payback on investment derived from significant improvement in revenues, margins, profits and shareholder valuation. Just as importantly, increased profitability increases the strategic resources available to grow the firm.

Surprisingly, surveys suggest that in spite of the large upside available at low risk, few companies are pursuing systematic revenue enhancement through pricing execution. While many companies are currently experimenting with price *optimization* models, AMR Research survey [3] suggests that only three percent of the firms it surveyed are attempting pricing *execution* management.

Pricing is now a dramatically different area than it has been historically. New software tools give companies a new way of setting, optimizing, and enforcing pricing changes within the organization. With the best tools, an integrated view of customers, their past purchases, benchmarked pricing by segment and size of purchase, relationship data, comparison of trends over time – all are available to provide decision support to field sales representatives, sales managers, marketers and general managers. While as a group these tools are still generally immature, and the companies building them often at early stages of development, the payback from successful implementation is frequently so high that it's an obvious target for potentially rapid profit improvement.

Exhibit 1: Pricing Management Software Installations 2003-2006, $ millions

	2003	2004	2005 Forecast	2006 Forecast
Pricing Management Software Revenues	$111	$125	$210	$320

Source: AMR Research, 2005 [3]

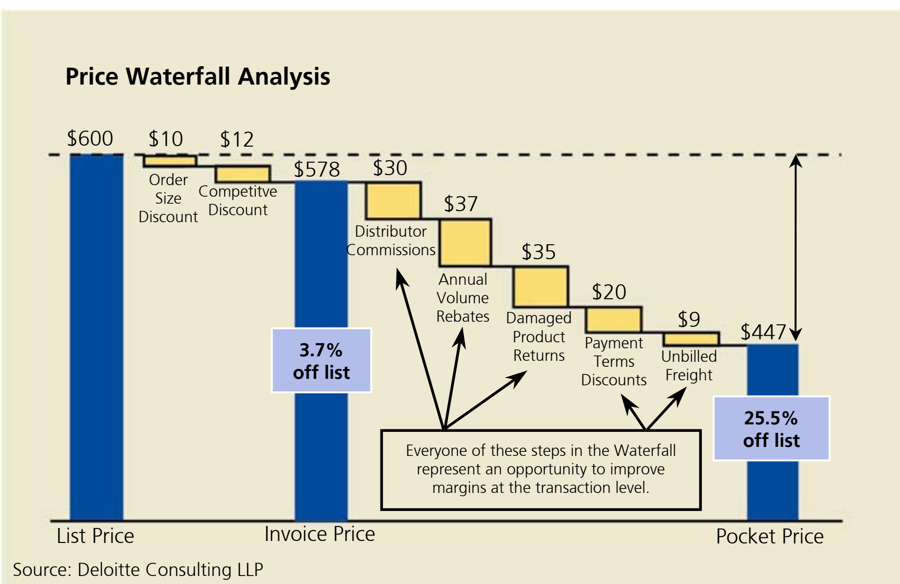
Why pricing tends to be ad hoc

Pricing variability tends to be the rule in many companies with complex multi-product businesses. So called "pocket prices" – the list price, net of discounts, dealer promotions and allowances – often vary widely. At one major company, a review of its largest deals over a multi-year period found discounts that ranged into the 90 percent range. The firm's senior management was surprised at what had been approved by their internal sales management team through an ad hoc pricing process.

This isn't as unusual as it sounds because pricing is a moving target, particularly in project-oriented markets where partnering occurs, or in highly competitive markets such as personal computers, where the value of inventories can depreciate a half percent per month. In personal computers and many other industries, customers have different volume and contract histories, different expectations about pricing and different relationships with suppliers, all leading to different price negotiation outcomes.

List prices are only the starting point in the pricing execution process. The ongoing marketing and sales activities of the organization often revolve around the discounts, promotions, channel discounts, rebates and myriad other ways that get invented to motivate stocking and purchase. These discounts have been described as the "pricing waterfall" [1] [2].

Exhibit 2



With all this complexity, the process of setting, optimizing and enforcing pricing policies is usually unplanned and ill documented. Pricing often varies depending upon the time of month of the deal, the negotiating power of the client, the internal political clout of the field sales staff and management and senior management intervention.

Pricing as a strategic issue

Think of pricing as falling into four "buckets":

1. Setting pricing strategy for an existing business.
2. Setting pricing strategy for a new business model.
3. Managing pricing for a new business model.
4. Managing pricing for an existing business model.

All these choices (Buckets 1, 2, 3, and 4) need to be addressed by firms. But Bucket 4, the apparently dull and unglamorous management and execution of prices for the existing business, should not be overlooked. If CEOs and other leaders make it a priority, companies can find surprisingly large opportunities by focusing upon pricing execution and the difference between the pricing set and the pricing received or "pocket pricing". [1] [2]

There are many strategic advantages to more systematic pricing execution management. One-to-one marketing, customized pricing, development of tailored pricing models, and tracking of demand elasticity are all difficult to manage without a centralized information source. Segmented pricing promotions, linking pricing to installed-base marketing and generational upgrade strategies are all made easier by having a systematic approach to tracking and displaying pricing experiences across time periods, customers, products, segments and sales staff. Information about failed bids and sales attempts provides intelligence about potential strategy failures.

Because pricing is intimately connected to customer perceptions of value, solid understanding of pricing execution can often reveal opportunities to reevaluate value chains and value propositions. The "noise" in pricing information from relatively random pricing execution often conceals emerging segmentation opportunities and shifts in value perception.

Exhibit 3: Four types of pricing issue.

Pricing and business strategy	1	2
Pricing execution	4	3
	Current business model	**Proposed or new business model**

Emerging best practices in pricing execution

The desire to simplify and systematically address the processes around order processing and pricing has lead to a new set of best practices in pricing. In some organizations, a new role has emerged with the title "VP Order to Cash," and the responsibility for focusing upon optimizing order and collection processes.

But the most important driver of change is the emergence of a new category of integrated pricing management software. The goal of such software is to make explicit four key processes in the organization:

1. **Setting pricing policy.** The documentation and standardization of rules for automating, assisting and providing feedback to field sales and sales managers of the list prices and suggested discounts for different categories of buyers, segments, industries and purchases.
2. **Optimization of the quote**. The optimization and speed up of the development of individual quotes and proposals by providing easy access to comparable price quotes to ensure that proposed pricing is consistent with policies, and consistent with other benchmarked data on a particular client, comparable clients and comparable orders. A typical system will show a regression line and scatter chart to make it easy to identify pricing trends by size or over time for a comparable selection of quotes.
3. **Enforcement of pricing policies:** The software manages explicit approval processes to ensure the "enforcement" of pricing policies within the organization. The software also manages approval of the inevitable exceptions to pricing policies, with different levels of supervisors having different ranges of approval authority.
4. **Analyzing customer profitability:** With detailed information available about individual transactions, relationships, segments, regional and product line profitability, resource allocation decisions should be driven by the actual profitability of transactions and relationship (based on the "pocket" price) rather than the less precise "theoretical" profitability of customers if they had been paying list price.

The pricing-software industry – what's out there?

There has been an explosion of applications in the pricing management space. Some are stand-alone applications. Some are add-on modules from large integrated vendors such as SAP, SAS or Siebel. A proprietary 2005 Deloitte study [5] of the available applications concludes that no one vendor offers a complete integrated solution. A detailed analysis of the leading vendors, ranking them on price analytics, price optimization, price execution, long term vendor viability, and product potential suggests clearly that different vendors have different areas of strength that vary widely in appropriateness for different industries.

Exhibit 4: Selected independent pricing management vendors

Acorn Systems	IRI	Metreo	Selestica
Advanous	KHIMetrics	Mimiran	Servigistics
Commergent	KSS	PROS Revenue Management	Soft Solutions
Firepond	Manugistics	pVelocity	Vendavo
i2	Market Analytics	Rapt	Vistar
i-Many	Maxager	Revenue Technologies	Zilliant

Disclaimer: Listing of companies and discussion of their capabilities does not constitute endorsement or recommendation of such by Deloitte Consulting. An assessment of the suitability of a vendor and its capabilities and software requires analysis of specific company situations, capabilities and requirements. The appropriateness of pricing policies implemented with such software and their compliance with relevant legislation should be reviewed with knowledgeable legal advisors.

In evaluating a potential vendor, client companies should address the following issues:

1. Check with the existing customers offered as references by the software vendors. Some vendors offering the software with the most features are small and less experienced.
2. As with many integrated software packages, vendors may claim more functionality than they can deliver. Validating the competitive claims of many vendors can be time consuming. But the biggest risk is that a pricing project will require expensive and time-consuming software customization to compensate for missing functionality in the vendor's product.
3. Software packages vary widely in their capabilities in terms of the three key areas: price setting, price optimization and enforcement. Some vendors are very good at one area, but few have superior capability in all three areas.
4. Beware of software that doesn't serve your industry-specific needs. Pricing software that was originally designed for other firms in other industries may not work equally well for your business.
5. Many pricing management software vendors have "share of revenue" arrangements with the consulting firms that implement their software product. This approach tends to bias the software selection process. A consulting firm that doesn't favor a particular vendor is likely to make better recommendations and be more likely to implement a tool that does not require extensive customization work.

What pricing software and tools can do for companies

A survey of 153 pricing management projects by AMR Research and internal Deloitte data found that successful pricing projects result in high rates of return. Typical reported annual outcomes [3] include:

- Average benefit: $3-45 million increased annual revenues.
- Increased revenues: 1-2 percent.
- Increased gross margin: 10-15 percent.
- Increased contribution margin: 20-50 percent.
- Project paybacks: 3 to10 times or more.

Improved pricing strategy and execution can also have capital market benefits. Many traditional manufacturers, at one time perceived by analysts as being in commodity markets with low growth potential, now are seen as being more aggressive about price management and therefore more likely to achieve revenue enhancement and growth objectives.

For example, David Burgleiter at Deutsche Bank made this judgment about Dupont this year: "Dupont's near term results should be stronger as pricing and productivity programs gain traction." P.J. Junkar, at Citigroup recently wrote, "7% price growth offset new materials [costs]. Pricing has begun to move downstream from commodity to specialty names and we expect it to continue throughout 2005."

How to realize value from using pricing software and tools

As with any change in the selling process, improving pricing execution is rarely successful without an integrated approach to change. Integrated pricing management software enables superior pricing performance, but it does not guarantee it.

Companies that provide incentives to field sales representatives for selling the most profitable products in their line need to tackle price increases in two steps. In the first phase, to achieve a dramatic improvement they must change the culture of the company by offering evidence that price increases won't threaten incentive compensation. In one project, the management team reframed the perceptions of the key sales representatives who develop quotes by using the pricing software to show the following kinds of information:

1. Average price paid for the product at this quantity level.
2. Average priced paid by this customer in the past.
3. Predicted price that the customer would pay.
4. Estimated highest price that the customer would pay.
5. Estimates of commissions based upon the four potential prices listed above.

Convinced by the data, over time a small number of sales reps became more confident that they could quote the higher prices and still win the sale. In the second phase, this core group was able to influence other sales reps and persuade them to abandon their more conservative quoting practices.

A systematic change management process can help companies make explicit the pricing procedures, the roles and responsibilities, the metrics and rewards, and the tools and technology required for improving performance.

Pricing model complexity in high-tech industries is increasing

The benefits of improved pricing execution are likely to be high in rapidly changing industries, such as high-tech segments where new business models appear frequently or old models get re-invented, and customers have a large variety of purchase options.

One VP at a major software company made a wry comment about its pricing approach: "We have never met a pricing model we did not like." A menu of high tech pricing options might include:

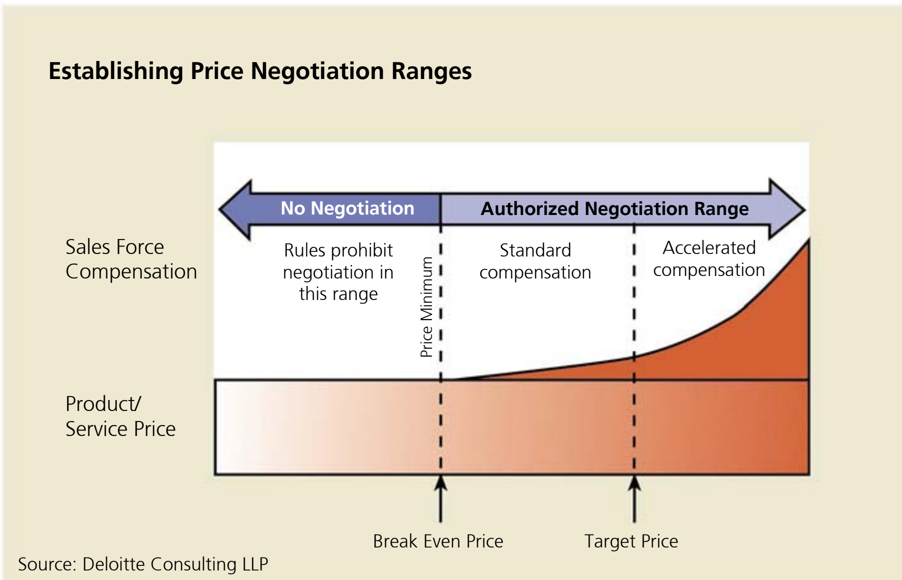
- **Named user pricing**. Each user in the organization pays a price based on usage, similar to the concept of a "personal copy" of MS-Office or Open Office. To confuse things further, over different time periods, the company may change the number and types of users that it licenses, making comparisons difficult. Users might be "read-only users," "developer users", "administrative users," etc.
- **Tiered pricing.** Price per user varies depending upon the number of users.
- **Hybrid pricing.** A combination of a fixed and variable cost for usage of the product.
- **Concurrent user pricing**. Pricing is based upon the number of users actually connected to the server at any one time.
- **CPU pricing**. Software pricing is tied to the number of computers on which it is running.
- **Bundled pricing**. The firm offers a lower price for a bundle of products.
- **Upgrade pricing**. A price on the upgrade from one generation of software to another.
- **Site license pricing**. A price the customer has negotiated for an overall enterprise license for the use of the software.

With such complexity, high-tech companies operating without pricing management software support have difficulty figuring out:

1. What the price elasticity is for its various products.
2. Where money is being left on the table or where overcharging might be occurring.
3. Where sales representatives are doing a good job of using discounting to create a bundle of products that fit into the available budget of the client in order to achieve an effective outcome and create high customer satisfaction.
4. Where pre-bundling of options might simplify customer-buying decisions and lock in customer relationships.
5. The potential impact of newer pricing approaches such as subscription and usage based pricing.

Clearly, tools for centralizing pricing information and policies – modeling, business intelligence tools, data-mining tools and integrated pricing management software – make sense for most industries with large sales forces. The tools make even more sense for companies with complex product lines and a variety or increasing number of pricing models. But pricing software is being used across a wide range of industries.

Exhibit 5:



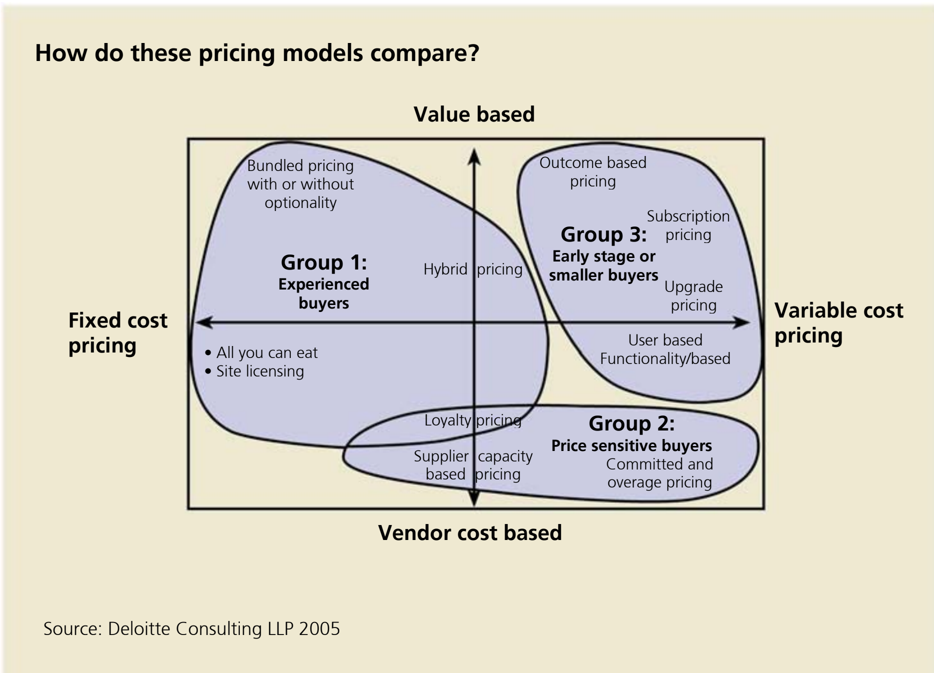
[2]

As companies start to tailor pricing and incentives (as portrayed in the Exhibit 5 above) to meet strategic sales and channel objectives, the analytical complexity can increase dramatically and increase the benefit of using integrated software for supporting pricing data. Without solid data on market test results to support modeling, management teams will disagree on the likely outcomes triggered by introducing different pricing approaches for different channel members and segments. Debates about predicted outcomes can slow down decision-making and implementation.

Strategic objectives

Different pricing models support different kinds of strategic objectives. While it is hard to generalize about every company and industry, the following graphics illustrate how different pricing approaches for a high tech company could support marketing and strategic goals for a company.

Exhibit 6:

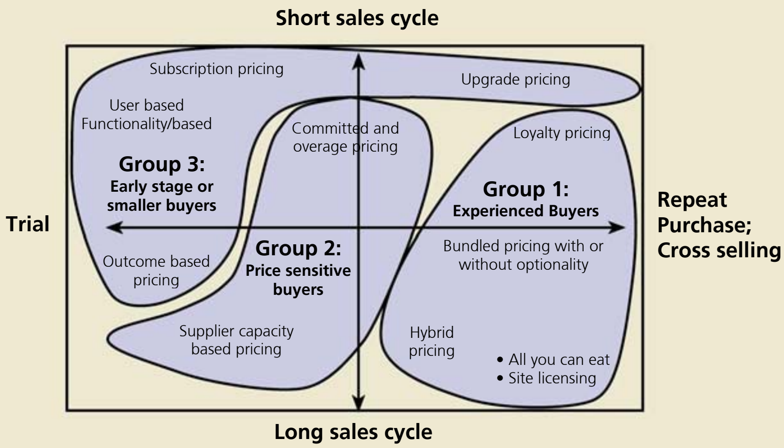


Terms defined:

- **All you can eat pricing:** a site license or enterprise agreement with a fixed price for unlimited usage (common in large software sales).
- **Bundled pricing:** combining products to offer a lower cost/higher value proposition.
- **Committed and overage pricing:** often used in cell phone pricing where there are different policies in place for committed minutes per month and minutes over your limit.
- **Hybrid pricing:** a mix of pricing models most typically a fixed and variable cost component.
- **Loyalty pricing:** a pricing scheme that rewards customers for frequency or total volume of purchases.
- **Optionality:** the ability of customer to reallocate their users between different products in a site license bundle or an "all you can eat" purchase.
- **Outcome based pricing:** often used in consulting firms for projects where the payment for the project is tied to results.
- **Subscription pricing:** purchase of product or service over a period of time with support and upgrades bundled into the relationship for as long as the subscription is current.
- **Supplier capacity based pricing:** where a supplier uses price to maximize revenues from a fixed resource like a supply of hotel rooms or airplane seats
- **Upgrade pricing:** different pricing for prior customers.
- **User based functionality pricing:** users can purchase sub-components of functionality at different prices.
- **Value based:** pricing based upon the value created for the client.

Exhibit 7:

How do these pricing models compare?



Source: Deloitte Consulting LLP 2005

So what should the CEO do?

1. Educate the senior management team on the opportunity that pricing management represents. Signal that turf wars are not an acceptable response to the pricing execution initiative
2. Make pricing a priority in the organization and provide visible CEO sponsorship.
3. Set up a Program Management Office to select, test, and implement a pricing execution management program. Such an office should have as its mission the task of introducing and making successful the software, processes, training and monitoring for improved pricing processes, and capabilities. A key task for the project office will be to select the right software, demonstrate early success and build upon such early successes.
4. Establish complementary business intelligence support to simplify the process of designing, testing, and refining targeted pricing promotions.
5. Establish a business-intelligence Center of Excellence to facilitate the use and improvement of pricing data in the organization.
6. Have the organization develop capabilities that will support one-to-one marketing, pricing, and sales.

Pricing execution offers both growing and mature companies a lower-risk approach to revenue, margin, profit, and shareholder-value growth than innovation and acquisitions. And where companies are creating innovative business models and making acquisitions, improved measurement combined with better pricing execution can help the organization generate better financial outcomes from these generally more uncertain initiatives.

Endnotes:

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Quotes:

"Pricing is now a dramatically different area than it has been historically. New software tools give companies a new way of setting, optimizing, and enforcing pricing changes within the organization."

"Because pricing is intimately connected to customer perceptions of value, solid understanding of pricing execution can often reveal opportunities to reevaluate value chains and value propositions."

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Key words:

Pricing, price optimization tools, pricing strategy, revenue enhancement, pricing variability, pocket pricing, strategic pricing, pricing software.

Technology article

Purpose of this paper	This article advocates putting pricing strategy on the CEO's agenda and considers the new concept of pricing execution – the development of pricing strategy and the implementation of the strategy through a combination of leadership, management practice, and software – from the point of view of the senior management team.
Design/methodology/approach	New software tools give companies a new way of setting, optimizing, and enforcing pricing changes within the organization.
Findings	There has been an explosion of applications in the pricing management space. Pricing execution offers both growing and mature companies a lower-risk approach to revenue, margin, profit, and shareholder-value growth than innovation and acquisitions.
Research limitations/implications (if applicable)	A proprietary 2005 Deloitte study of the available applications concludes that no one vendor offers a complete integrated solution.
Practical implications (if applicable)	Using software to improve pricing measurement, combined with better pricing execution, can help many organizations generate revenue rapidly.
What is original/value of paper	CEOs and other leaders can use the article to educate the senior management team on the opportunity that pricing management represents.

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