Five Rules for Pricing Excellence

Getting the Most for Your Services

Patrick Lefler

Pricing is critical, and short-changing your pricing strategy is the fastest way to leave cash on the table—money that will be lost forever and never recovered.

So after that initial spark of innovation and the completion of the design, development and marketing phases that follow, don't screw up the process by treating price as an afterthought. Have you spent as much time and resources on price as you have on your latest social media campaign? (Probably not.) The most successful organizations know that pricing is strategic and that it can affect top-line growth and bottom-line profitability faster and more directly than anything else.

Pricing is also a key element of your brand. It sends a message to the market and creates expectations about value. It's often the first impression you make, either attracting buyers or repelling them. And it can create the last, and lasting, impression, depending on perceived value for price paid. Think about it: Is your price sending the message you intended?

Master these five rules and you'll be well on your way to achieving pricing excellence, along with putting more coin in your pocket.

Rule 1: Anchors Aren't Just for Ships

A few years ago, Williams-Sonoma, the high-end American retail company, offered a home bread maker priced at $279. After a period of mediocre sales, they decided to add a second model—similar features as the first but slightly larger. This new item was priced at $429—more than 50 percent higher than the original bread maker. So what do you think happened?

Sales of the newer, higher priced model were a flop, but sales of the original, less expensive bread maker almost doubled. Clearly there were people charmed by the idea of a quality bread maker. The only thing that stopped them from buying was price. Once the store added the $429 model, the $279 machine was no longer seen as such an extravagance.[1]

This effect on sales illustrates the powerful effect of when you change alternative options associated with buyers' purchase decisions. When Williams-Sonoma offered just the one bread maker, there was no basis for buyers to determine value other than that single appliance. And with a price of $275, buyers judged the item to be relatively expensive. But when the store added the higher priced bread maker as an alternative, buyers used it as their "anchor" by which they now relied on to determine value. With the price of the bread maker now anchored at $429, the smaller model became a bargain in the minds of the buyers.

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1 William Poundstone, *Priceless* (New York, NY: Hill and Wang, 2010), 156.

While the anchoring effects unleashed by the placement of the second bread maker were unanticipated by Williams-Sonoma, it is well-understood and common practice among luxury goods retailers today. Have you ever gone to a Coach store and wondered why the $800 bag was displayed so prominently? It's there, not to be sold, so much as it is to make their large assortment of $500 handbags seem all that more reasonable.

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And it's not just luxury goods retailers who have caught on to this phenomenon. Most restaurants offering wine know that diners will generally not buy the most expensive bottle on the list; rather, they tend to buy the second- or third-most expensive bottle. Knowing this, restaurateurs usually plant an overly expensive bottle on the list to act as the anchor, and then list the next two bottles at a price that looks reasonable compared to the "plant," but priced high enough to deliver healthy margins to the restaurant.

Value always resides in the mind of the buyer. How price is presented and framed can be one of the most effective tools in your sales arsenal.

Rule 2: Never underestimate the power of FREE

FREE is said to be the ultimate discount. It influences buyer behavior in ways that make very little rational economic sense. This story by author and noted behavioral economist Dan Ariely highlights the real influence of FREE on our behavior.

> *A few years ago, Amazon.com started offering free shipping of orders over a certain amount. Someone who purchased a single book for $16.95 might pay an additional $3.95 for shipping, for instance. But if the customer bought another book, for a total of $31.90, he or she would get shipping for FREE!*
>
> *Some of the purchasers probably didn't want the second book, but the FREE! shipping was so tempting that to get it, they were willing to pay the cost of the extra book. The people at Amazon were very happy with this offer, but they noticed that in one place—France—there was no increase in sales. Is the French consumer more rational than the rest of us? Unlikely. Rather, it turned out, the French customers were reacting to a different deal.*
>
> *Here's what happened. Instead of offering FREE! shipping on orders over a certain amount, the French division priced the shipping for those orders at one franc. Just one franc—about 20 cents.*

This doesn't seem very different from FREE!, but it was. In fact, when Amazon changed the promotion in France to include free shipping, France joined all the other countries in a dramatic sales increase. In other words, whereas shipping for one franc—a real bargain—was virtually ignored by the French, FREE! shipping caused an enthusiastic response. [2]

When faced with a choice where one product or service is free and the other isn't, consumers more often than not respond to FREE. The Amazon free shipping story illustrates this point, but we also see it in our everyday lives.

When premium automakers like BMW and Mercedes Benz face pricing pressures, they, more often than not, throw in free scheduled maintenance rather than offer a similar discount on the car's sales price. And in most every case, free scheduled maintenance (typically a $1,500 value) resonates much stronger to buyers than a price discount that might be double the value of the maintenance offer. Do you think the message would be similarly powerful if, rather than free, they offered a 90% discount on scheduled maintenance. I don't think so. Proof again of the enormous power that FREE has on our psyche.

When faced with discounting pressures, think about the power of FREE and how it affects human behavior.

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2 Dan Ariely, *Predictably Irrational* (New York, NY: HarperCollins, 2008), 58-59.

Rule 3: Innovate with Price

Pricing and innovation are not normally associated together in the same sentence. Pricing is thought to be stagnant (and boring) and impossible to alter, replace or radically improve. Innovation, on the other hand, is....Well, innovation is radical and revolutionary! It's what drives growth and separates the market leaders from lagers. For many people, innovation is perceived to be everything that pricing is not.

But for most industries, the reality is that pricing is not stagnant; it's fluid and almost always changing. And sometimes even simple changes in a pricing model can lead to dramatic improvements in bottom-line growth. Pricing innovation—the creation and monetization of these pricing model changes that strengthen competitive advantages—is one of most overlooked aspects of innovation.

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The Boston Consulting Group provides a good example with the following description of how General Electric radically advanced its commercial aircraft engine business by means of a simple change to its pricing model:

> *A master application of pricing innovation was General Electric's reinvention of the commercial aircraft engine business. Engine manufacturers had traditionally used engines as a loss leader to secure the lucrative business of selling replacement parts. When several trends threatened that model, GE offered airlines the option of buying power by the hour—in essence, purchasing as a package engines, parts and MRO services (maintenance, repair and overhaul) and paying on the basis of uptime, or per hour of use. The strategy has allowed the company to make the most of its competitive advantages (its technical skills, diagnostic capabilities, financing expertise and scale, and end-to-end MRO services) against major competitors.*
>
> *GE's offering, which it calls Maintenance Cost Per Hour, aligns industry pricing with customer value (by tying prices to uptime) and aligns customers' interests with its own (by tying GE's way of making profits to uptime rather than maximizing the number of replacement parts its sells). GE's strategic use of the power-by-the-hour concept has helped it transform the competitive position and profitability of its commercial aircraft engine business: It now accounts for the lion's share of engine sales and has the highest margins in the business.*[3]

3 Philippe Morel and others, "Pricing Myopia," *Perspectives*, Boston Consulting Group, 2003: 9-10.

GE's wildly successful Maintenance Cost Per Hour model illustrates the power of innovation when applied to pricing. It's a powerful tool that can maximize profits and deliver a sustained competitive advantage. Have you incorporated it into your innovation strategy?

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Rule 4: Let price drive value

We're familiar with the axiom "you get what you pay for"—but can price alone factor into (and even change) buyers' perceptions of value?

In many cases, the answer is yes. This story from the Humane Society Silicon Valley illustrates how powerful price can be in driving the perception of value. Faced with an unacceptable return

rate for cats and dogs previously adopted from its shelter, Humane Society President Christine Benninger leveraged the axiom to successfully solve this major challenge for her organization.

For years, the Humane Society charged an adoption rate of $25 for cats and $40 for dogs. At those low prices, the adoption business was brisk, but the problem of animals being returned to the shelter was overwhelming the organization. At the same time, the California Veterinary Medical Association conducted a study that looked at the relationship between the rates of return for animals and the price that had been paid for them. The study showed there was a very strong correlation between the amount paid for the animal and the likelihood that it would someday be returned to the shelter: the lower the adoption price, the higher the likelihood it would be returned.

Armed with this data, Benninger went to her board to propose significant price hikes, raising the adoption price for both cats and dogs to $110—a 300 percent increase. Naturally, the board pushed back on the proposed price increases, citing the opinion that the price hike would negatively affect adoption rates. Their resistance could be summed up with one simple question: "Who's going to pay $110 for a six-year-old dog?"

Despite the resistance, the board approved the price hikes. Guess what happened?

Adoptions actually increased 10 percent and more importantly, their rate of return was cut by over 50 percent. As the perceived value of the adopted animals increased, so too did the reluctance of their owners to return the pets to the shelter. Today, 99 percent of the animals available for adoption find permanent homes; before the price hike was instituted, less than 15 percent found new homes. The Humane Society Silicon Valley continues to use price with great success as a major tool in instilling the perception of value among their customer base. [4]

Don't be afraid to raise prices when appropriate.

Are there ways that you can leverage or change your current pricing strategy to increase perceived value from clients?

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4 Stanford University Leadership Corner, online at http://ecorner.stanford.edu/authorMaterialInfo.html?author=276

Rule 5: Price wars are a fool's game

On April 9, 1992, American Airlines—hoping to stem the decline in air traffic that US carriers had been experiencing since before the first Gulf War—introduced a simplified pricing structure called "Value Pricing." While the intent was to simplify fares—internal findings had determined that more and more passengers were being turned off by the growing complexity of airline pricing models—to its competitors, the move was interpreted as the first shot in a new pricing war.

A month and half later, Northwest Airlines retaliated by introducing a promotion called "Grown-Ups With Kids Fly Free." It only took American Airlines a day to counterattack: prices were slashed 50% on every seat of every airplane that American flew. Within 24 hours, every major US airline matched American's price cuts. The war was on!

The events in May were unprecedented and the effects impressive. According to industry observers, it was "an electronic passenger riot—the telecommunications equivalent of shoppers tearing through goods in a sales bin." AT&T was said to have been overwhelmed with long-distance phone volume the days after as consumers jumped at the chance to take advantage of the lower fares.

Some were so determined to purchase tickets that when they couldn't get through by phone, they got in their cars and drove to the airport to buy tickets before the sale ended.

Paying passengers made out like bandits, but the airlines experienced different results. Despite record capacity over the next three months, record losses followed—some estimates pegged airline industry losses over that same three-month period at $1.5 billion.

This was just one of many price wars that the airlines self-inflicted on each other over a 20 year period that began in the 1980s and just recently ended. The death toll over that time period is noteworthy. Hundred of airlines declared bankruptcy, tens of thousands of employees were laid off or fired and losses exceeded $15 billion–erasing every dollar in profit that had been made by the airline industry from its inception.[5]

So what's the best strategy to survive price wars?

First of all, don't initiate them. The only way you can cut prices enough to increase market share and profits is if your competition is either (a) asleep at the wheel or (b) unable to follow suit. With today's competitive environment, neither response is realistic. In most every case, cutting price to gain market share will be unsuccessful because competitors will match your price—and sometimes they'll even undercut your price.

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5 David Besanko, "The Mother of All (Pricing) Battles," *Kellogg School of Management*, Northwestern University, 2004.

Just as important, prepare in advance to defend against any type of price war directed at you. Do everything possible to compete on dimensions other than price. Whether it be differentiated quality, customer service or the myriad intangibles that may separate you from the competition, you need to un-commoditize your offerings. Additionally, work hard to instill in your client base the perception that value indeed, does follows price.

Don't kid yourself—price wars are a fool's game.

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ABOUT THE AUTHOR | Patrick Lefler is the founder of The Spruance Group, a management consultancy that helps companies grow faster and dramatically increase profits through smarter pricing strategies and execution. He is a former Marine Corps officer, a graduate of both the U.S. Naval Academy and The Wharton School of the University of Pennsylvania, and has held leadership positions at a number of different firms including Goldman Sachs, Citibank and Wall Street Systems. He is a member of Innovation NJ, a coalition of New Jersey's leading businesses, trade associations and universities who share a commitment to fostering and encouraging innovation throughout the state. Patrick also serves as an advocate and mentor to returning veterans in conjunction with American Corporate Partners. To read more about pricing excellence, visit Pat's blog, Intrepid ideas and other musings...

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