

Burden of Proof

A Skeptic's Guide to the Value of Strategic Pricing

By Patrick S. Manning and Maggie Laird



A large building materials company was experiencing a significant amount of profit leakage due to overuse of various discounts – relationship discounts, competitive discounts, and promotional discounts, among others. By preventing even 20 percent of this leakage, the firm could have added nearly \$17 million to its bottom line. Yet the executive responsible for pricing worried that by aggressively moving to curtail the discounting, the firm could lose important customer relationships and therefore market share.

This company had built its competitive strategy on an “empowered” sales force that could make decisions in the field. By being more flexible than competitors in providing a rapid response on pricing and merchandizing decisions, it was growing at a rate far above the industry average. The executive was concerned that restraining the autonomy of the salespeople with a more rigorous pricing approach would destroy his competitive edge. The burden of proof he required before attempting a major price restructuring was therefore very high.

But when the executive asked his staff to investigate what might happen if the company controlled discounting more tightly, he couldn't get the proof he needed. When his concerns could not be adequately addressed, he backed away from taking definitive action – and missed a significant revenue-enhancing opportunity.

The case of the building materials executive is not an isolated one. Without compelling, quantifiable facts on which to base their decision, executives often rightly hesitate to change what they perceive as a “winning” pricing strategy, even when that strategy also has a significant downside. And at many companies that underutilize or lack pricing data, or that don't have the right tools and analytics to fully exploit the insights contained in that data, there just isn't enough information to meet the burden of proof executives need to consider when revamping the pricing strategy – which, too often, causes them to leave money on the table.

Facts, Not Fear

Fortunately, there is a better way to build a pricing strategy for executives who aren't satisfied with something that's just "good enough." In our view, an effective pricing strategy starts with a rigorous analysis of the relevant facts – information about customers, competitors, market dynamics, and more. These facts can then be used to develop an integrated strategic framework to both guide an organization's internal behavior and communicate actions to an external market. The result should be a pricing strategy that not only supports the organization's business strategy, but also offers executives reasonable evidence that pursuing the strategy will yield the desired results. Only then can executives feel comfortable embarking on the kind of truly transformative pricing initiatives that can produce measurable benefits.

Let's return to the example of the building materials pricing executive to illustrate the value a fact-based pricing strategy can deliver. Modern predictive modeling tools can help pricing professionals to predict, based on historical transaction data, how customers are likely to react to a variety of situations – higher prices, smaller discounts, longer lag times, and so on. In addition, competitive research and analysis tools can help clarify how the larger marketplace would be likely to respond to such moves. What if the executive's pricing professionals had been able to help him understand which customers would be most likely to change their buying patterns in response to greater controls over discounts, and quantify the changes in revenue and market share that could be expected if the company were to take such action? The executive might have discovered that only a small percentage of customers would spend less or switch suppliers, or that the company would only lose revenue and market share if discounting fell below a certain level, or that customers could be persuaded to accept smaller discounts in exchange for less costly concessions elsewhere in the price waterfall (such as shipping) – or that any attempt to curtail discounting would, in fact, have the negative consequences the executive had assumed. Whatever the outcome, the decision would have been based on facts instead of fear, and the executive may well have been able to use the information to develop a more nuanced pricing strategy that would have helped control margin leakage in addition to fueling growth.

A fact-based pricing strategy can not only help companies better align their pricing strategy with their overall business strategy but also identify and address a broad range of common pricing-related problems (see Figure 1). Appropriate analyses of historical transaction data, marketplace and competitive information, customer profiles, and other information can alert pricing executives to issues such as those listed in Figure 1, help determine their impact on strategic goals (whether those goals center around revenue, profitability, market share, or other objectives), and assess the probable effect of corrective actions before actually implementing them.

Figure 1. Common Pricing Problems

Symptom	Description of problem	Business impact
Maverick selling	More than 30 percent of transactions are closed below established discount guidelines or policies	Unwarranted discounts are issued, eroding profits
Price erosion	Lack of visibility into historical pricing results in deeper-than-necessary discounting	Unwarranted discounts are issued, eroding profits
Margin erosion	Below-the-line transactional expenses are not considered during a negotiation and/or not recovered after the deal closes	Revenue leakage and lost profits not visible to the sales organization
Slow response time	The time to respond to a customer's pricing request takes longer than the customer is willing to accept	Volume and market share losses to competition
Non-segmented pricing or discounts	Prices are not set at a level granular enough to capture the required profit from the transaction across different customer segments	Unwarranted discounts are issued to unprofitable customers, resulting in revenue leakage and lost profits from price-insensitive customers
Price agreement compliance	A single customer has multiple agreements for the same product, but consistently purchases the product at the lowest price	Unwarranted discounts are issued, resulting in lost profits
Customer volume compliance	A customer has an established volume commitment, but is not meeting it	Unwarranted discounts are issued, resulting in unrealized revenue

Elements of a Fact-based Pricing Strategy

Strengths of a fact-based pricing strategy

For years, academics and consultants have advocated taking a value-based approach to pricing that is based on a thorough understanding of the value an organization's goods and/or services provide to specific customers.¹ But although they can be compelling, value-based conceptual frameworks don't offer much practical guidance on ways to formulate actionable pricing strategies. Nor do they allow executives to see what tangible results the strategy can help deliver in their specific markets, with their specific products and salespeople, and against their specific competitors.

A fact-based strategy, while not denying the importance of a value-based approach, considers far more factors than the perceived value of a company's goods and/or services to its customers. It is grounded in extensive research into a company's customers, products, markets, and competitors, and it delivers concrete recommendations for action as well as quantifying the likely results of those actions. Indeed, companies can use data from hundreds of thousands of historical transactions to test different scenarios and model likely outcomes.

Because it can be tested and refined against the realities of a company's competitive and market landscape, a fact-based pricing strategy, in our opinion, is far more likely to yield the desired results than strategies based solely on pricing theory or conceptual models. In particular, a fact-based strategy allows companies to run "what-if" analyses to identify the key risk areas and uncertainties that could occur during implementation and develop proactive plans to deal with them. Questions to ask in these analyses might include:

- What if my competitors decide to take advantage of the pricing actions to capture market share?
- What if unexpected raw material costs increases occur?
- What if my competitor opens a new plant, resulting in significant supply increases?
- What if imports enter the market and put pressure on prices?
- What if I choose to implement the pricing actions in only a few segments?
- What would be the impact of delaying the pricing actions for a few quarters?
- What if my contracts do not allow me to take pricing actions on all customers or channels?

Exploring these and other risk areas, modeling possible scenarios, and developing plans to address these risks can go a long way toward giving executives the confidence needed to take meaningful pricing actions.

Five key elements of a fact-based pricing strategy

Every organization, of course, needs to develop a tailored pricing strategy that reflects its unique competitive position and business strategy. To do this, in our view, an organization needs to consider five key elements when developing its pricing strategy:

- **Market and competitive analysis** to understand industry and market forces that affect demand, competition, and potential profits
- **Customer and product value analysis** to understand how a customer perceives the value of a good or service
- **Customer and product segmentation** to develop prices that are specific to your customers and products
- **Multi-channel price management** to reduce channel and distribution conflict
- **Price positioning and pricing structure** to reflect the variations in value that different customers place on your company's offerings relative to competing choices

Market and competitive analysis

A market and competitive analysis can help a company understand the fundamental competitive forces at work in its industry and ways the company might be able to use pricing to take advantage of these dynamics. What are the key industry value drivers, trends, and growth rates? What alternatives to the company's offerings do competitors provide? How are they pricing them? What are the company's points of competitive differentiation, and what value do customers place on them? Answering these and similar questions can give a company a foundation for clarifying its competitive strategy as it relates to pricing. It also can help executives evaluate the alignment of their company's current pricing strategies with marketplace and competitive drivers, identify gaps, and develop overall guiding principles for price strategy decisions and policy.

Customer and product value analysis

A customer and product value analysis can help companies make more profitable pricing decisions by clarifying the value that different target customers and segments place on its offerings. By quantifying the value of different offerings for different customer and market segments and identifying and prioritizing product or service features that influence customer perceptions of value, a company can significantly improve profitability by setting prices based on the value customers receive instead of based on an internally generated cost calculation or markup formula. The information gained through this type of analysis can also help a company develop segment-specific value propositions, competitive positioning, product or service development, marketing communications, and selling tactics.

¹John Nagle and Reed Holden, *The Strategy & Tactics of Pricing: A Guide to Profitable Decision Making*, Prentice-Hall, 1995.

Customer and product segmentation

By identifying groups of similar customers and understanding their buying behavior, companies can prioritize sales and marketing efforts and develop prices aimed at extracting the desired value from each segment. Effective segmentation draws on market research to identify “clusters” of similar customers, and customer and product segments can be further refined based on value to customer and value to business. The company can then plan pricing actions based on segment-specific purchase behavior and buying processes, as well as develop strategies to serve individual segments.

Multi-channel price management

An integrated pricing strategy across all channels to market can support profitable growth in each channel while facilitating profitable channel partner growth and reducing channel and distribution conflict. To manage channels effectively, a company needs to understand the cost structure and margins associated with each channel, and align price, discounts, and incentives to drive desired behavior from channel partners. Often, too, companies find that developing region-specific pricing strategies that localize factors such as competition, Consumer Price Indexes, and customer demand can improve pricing effectiveness and boost profitability within that specific region.

Price positioning and pricing structure

Price positioning refers to setting prices that reinforce “price impression,” or what a company wants the price of its goods or services to communicate about its brand, quality, and style. Used effectively, price positioning can help a company use pricing to support the company's goals, not only with respect to revenues and margins, but also in brand communication, customer segmentation and targeting, channel management, and even operational efficiency.

Pricing structure refers to the way in which the company configures prices for its offerings. An effective price structure allows different components of the offering to be removed or added to meet the variations in value that different customers place on the offering relative to competitive choices. Techniques such as transactional analytics, price optimization, and customer value analysis can help companies quantify the value each element of the offering represents to a target customer segment or channel. This, in turn, can help the sales force trade off various features of the offering as appropriate when negotiating price concessions. A rich pricing structure, working in concert with a modular offering structure, is a foundational element in establishing a price strategy that drives value from each customer and market segment.

The Situation, Complication, Question (SCQ) Analysis

One simple yet powerful tool for integrating business and pricing strategy objectives is to use a technique called the Situation, Complication, Question (SCQ). This technique is designed to help the Pricing Leader align key business managers on the need for a new pricing approach and ways pricing can be used to support the organization's business strategy.

Using this technique, pricing leaders conduct qualitative interviews with leaders from each of the major business functions (and other key stakeholders important to the results of the program) to document their views on the need for pricing. After each of the interviews is complete, the pricing leader will consolidate the viewpoints expressed and cycle back with the business leaders on the findings. As a general rule, if you cannot state the complete SCQ on a single page, the chances are good that you don't have alignment on the critical issues and objectives for the pricing program.

Situation. Describe the business model of your company and how you seek to differentiate yourself in the market. What are the sustainable competitive advantages that make up the value proposition for your business?

Complicating factors. What has happened in the market over the past 12 months that is driving you to take action on pricing now? What are your most important stakeholders saying about their pricing challenges? What are the negative consequences of not taking proactive pricing actions at this time?

Strategic questions. What questions do you hope to answer by applying advanced pricing practices and analytics across operations, customers, and markets? What problems do you hope to solve by implementing a new pricing strategy? How will the new pricing strategy support and enable your achievement of the business strategy?

Bringing The Strategy to Life

It can be a challenge to collect and analyze all the information needed to do a “deep dive” into the five key areas discussed above. It can be even more challenging to synthesize it all into a workable strategy and keep that strategy up to date with changing marketplace and organizational conditions. And most challenging of all can be getting people to execute the strategy the way they’re supposed to – bringing the sales organization, marketing professionals, procurement and fulfillment staff, and other stakeholders all into line with the company’s agreed-upon pricing practices. Here are some tips for overcoming these challenges that we’ve found effective in our work as pricing consultants:

- **Understand where you are before you decide where you want to go.** Pricing projects that achieve the desired result generally begin with an insider’s assessment of the current state of the organization’s pricing initiatives. This includes analyzing qualitative as well as quantitative input from the internal stakeholders who are closest to existing pricing policies and practices. The business can then focus its plans for pursuing opportunities for improvement, concentrating on those areas that have the potential to yield the most significant returns.
- **Tailor your pricing strategy to your overall business strategy.** This may seem an obvious point, but we’ve seen a surprising number of companies at which the pricing strategy and the larger corporate strategy were out of sync. Pricing leaders may assume, for instance, that prices should be set to maximize profitability when the company’s higher priority is to increase market share. To guard against situations like this, senior corporate executives should be involved in developing the pricing strategy, and the pricing strategy should be regularly reviewed and revised as needed to account for evolving corporate goals.
- **Strengthen processes and information tools that enable rapid, fact-based decisions.** Does the company have the systems and software needed to gather, store, analyze, and report on historical transaction data? Does it have the necessary competitive and market research and analysis tools? Are there well-defined processes for getting the right information to the right people, and well-defined roles and responsibilities governing who makes what decisions? If not, getting these tools and processes in place is a crucial first step to developing a fact-based pricing strategy.
- **Get – and keep – executive buy-in.** No major strategic initiative can make much headway unless top executives support it. Leaders across all the functions involved in pricing, including sales, marketing, finance, and operations, need to not only agree to a single pricing strategy but provide support for major components of the pricing program, including discount and negotiation discipline for key customers and segments.

- **Identify key risk areas and red flags that trigger pre-defined response plans and actions.** A “what-if” analysis can help executives evaluate the risks of a new pricing strategy and create contingency plans. It’s a good idea to identify red flags – margins or volume dropping below certain thresholds, increasing salesperson turnover, new competitors entering the market, and the like – that can alert executives a risk has materialized and requires corrective action. Plan for these potential risks in advance, understand the appropriate responses, and execute with calm, cool actions when these threats materialize – and they will, so don’t wait.
- **Translate the strategy into tangible actions to be executed at the operational level.** Don’t assume that pricing analysts, salespeople, marketing professionals, and others involved in price setting and execution will figure out what they need to do to execute the pricing strategy on their own. Develop and communicate policies and procedures to guide all stakeholders’ day-to-day actions.
- **Use incentives and performance measurements to promote compliance.** There’s nothing like pay and performance measurements to motivate people to do what’s expected of them. It’s critical to carefully align compensation and performance metrics with the pricing strategy for it to produce the desired results.

Precisely because the stakes are so high, the burden of proof that executives require before taking definitive pricing action is heavy indeed. By understanding their competitive business strategy and developing a highly quantitative, fact-based pricing approach, organizations can finally meet this high burden of proof, and reap the rewards of a pricing strategy that satisfies their most important stakeholders and drives tangible results.



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