The Journey to Pricing Excellence

Many pricing initiatives get off to a great start; but, over time, the pricing process (which should be dynamic) can become mundane, control-oriented, and repetitive. This article explains how to keep that journey creative and fulfilling, while showing managers how to deliver business results that justify significant new investments in pricing. The authors of this piece are: Paul Hunt (president) and Jim Saunders (vice president, pricing management) of Pricing Solutions, a consultancy associated with the Advantage Group. For more information you can reach them at phunt@pricingsolutions.com and jsaunders@pricingsolutions.com, respectively.

The Roadmap

Every company has a pricing process, but it may be executed poorly or well. The World-Class Pricing Framework (Figure 1) outlines the stages of growth that pricing managers and their organizations must go through on the journey to excellence.

Each stage of this journey is a logical progression from the preceding one. A well-defined series of steps helps companies advance from one level to the next, a process that typically takes six to 18 months. More rapid progression is seldom possible because cultural change is often at the heart of the move to the next level. But, as the company evolves, so must the role of the pricing manager. Each level within the Framework provides an opportunity to add new tools, processes and capabilities that will improve the firm's bottom line *and enhance your role as a pricing manager.*

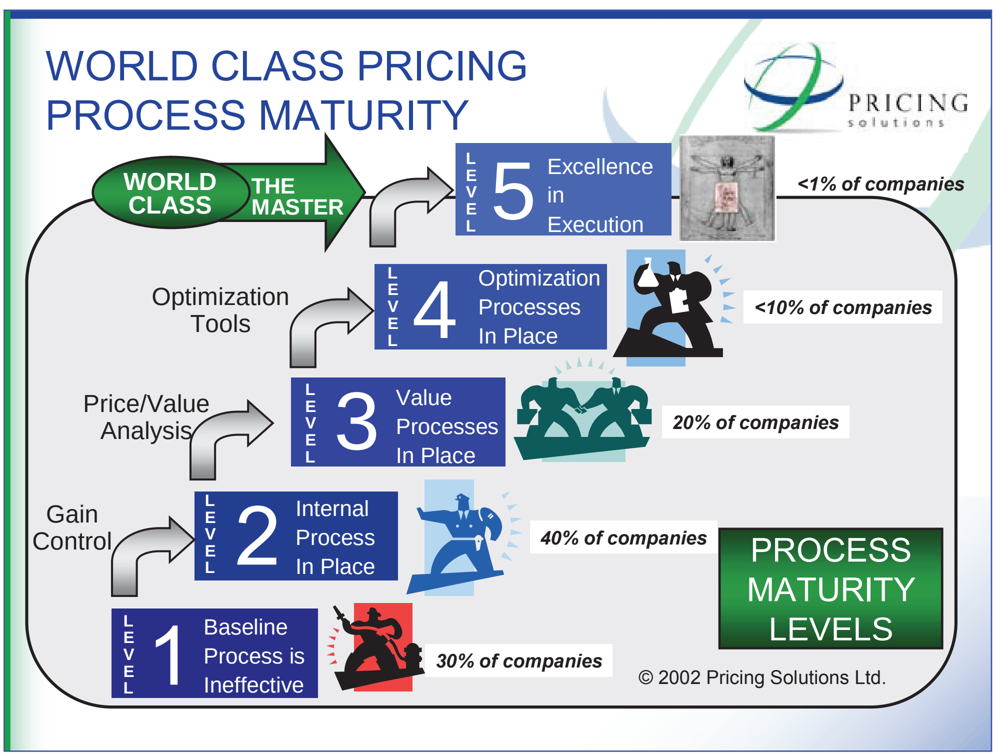
This article will describe each level, and summarize the role of the pricing manager and the key process benchmarks for determining whether a company has achieved a particular level of competency.

Level 1 – The Pricing **Firefighter**

About 30 percent of companies are mired at Level 1. Pricing managers in these organizations feel like firefighters, always struggling to control the latest flare-up. Pricing is highly reactive, and firms are constantly under pressure to lower prices. The sales department dominates pricing decisions, and threats of lost deals and unhappy customers lead to fear, which in turn leads to discounting. The processes in place have typically evolved over time. They are relatively "ad hoc" and rely on the experience of a few individuals—which puts the company at risk.

Mostly administrative, the job involves lots of paperwork (keeping sales up-to-date on contract renewals, changing price lists,

Figure 1: The Five Levels of World-Class Pricing



etc.). The analytical requirements are basic. The pricing manager in this type of organization is typically a "Type A" personality, thriving on stress and enjoying the feeling of "saving the day" by reacting quickly to an array of demands.

However, this type of role is unsustainable. Ultimately, the company will replace that pricing manager with someone of superior skills. However, if the manager is smart, he or she will *initiate the change*.

The way out of firefighting is to *gain control* of the pricing process. This means implementing tools and processes that replace reactive decision-making (and the fear that dominates it) with proactive decision-making.

Level 2 – The Pricing Policeman

The highest percentage of companies occupies Level 2 in pricing performance. Managers at this level behave more like policemen; they control pricing and enforce policies. The Level 2 pricing manager has implemented advanced analytics and guidelines that help create structure and process around pricing, while establishing the ground rules that the sales department must follow. Pricing is now fairer and less arbitrary.

However, the sales team may become frustrated and frustrating. Even though prices may be "fair" because policies are being applied rigorously, they will often view the rules as inflexible and not aligned with the market and their customers' needs. Hence, at many Level 2 organizations, the sales team calls the pricing department the "sales prevention" department. Consequently, adjusting compensation and rewarding the sales team for improving *profits* is a cornerstone of maintaining sales discipline (see Figure 2). Level 2 companies stop rewarding salespeople for winning deals that dilute company profits.

Level 2 requires accountability for pricing performance. Six Sigma is often used in the "gain control" phase of pricing; and performance objectives are established for the pricing process. These measures might include the degree of variation in negotiated prices, or the flow time to approve a quote. The tools used at Level 2 include dispersion analysis and pricing waterfalls, and are primarily focused on internal, rather than external, measurements of pricing.

Software that provides these tools can help a pricing department become "world class at Level 2." However, opportunities for creating and harvesting value from intensive knowledge of customers elude the Level 2 company. To progress from controlled to optimal, the organization must move beyond rules and guidelines, and into a deeper understanding of the value its products and services deliver to customers.

Level 3 – The Pricing Partner

At Level 3, a step that 20 percent of organizations reach, pricing managers behave more like business partners. No longer do approaches like "cost plus" or "last year's price plus" rule the day. Instead, the organization invests in understanding the value delivered and sets prices accordingly. The result is much greater harmony among sales, marketing, and finance (a true partnership) around the issue of pricing (Figure 3). No longer are factions focused on their own narrow agendas; everyone is now in the same boat because pricing is truly customer-driven.

The pricing manager is considered a business partner precisely because he/she is tuned into the customer. Often at this level, managers will be given budgets for conducting price-sensitivity research. Armed with customer information about price sensitiv-

Figure 2: Poorly-Aligned Sales Force Compensation

- **Paying salespeople based on volume is not in the company's best interests.**
- **Consider this example in which the salesperson is paid a 10% commission based on volume.**
- **By lowering the price to $800,000, the salesperson has increased her likelihood of winning and her expected commission (i.e., from $50,000 to $72,000).**
- **The company, however, has experienced a 67% decrease in profits.**
- **Clearly the pricing objectives of the salesperson and the company are not aligned.**

	Situation #1	Situation #2
A) Price	$1,000,000	$800,000
B) Total Commission (10% of sales)	$100,000	$80,000
C) Likelihood of Winning	**50%**	**90%**
D) Expected Commission (BxC)	$50,000	$72,000
E) Company Profit	$300,000	$100,000
F) Profit Change	--na	**(67%)**

Figure 3: Moving to a "Pricing Partnership"

Function	Perspective in Levels 1 & 2	Perspective in Levels 3-5
Sales	**Lower prices**	Adjust the offer, reduce the price
Finance	**Raise prices**	**Optimize the tradeoff between price and volume**
Marketing	**Trust me, the price is right**	**Measure the value, and then price it accordingly**

ity and the link to the company's overall value proposition, the manager is in an ideal position to integrate the views of sales, marketing, and finance, and to become a major voice at the table during strategic discussions about pricing.

Managers at Level 3 already have excellent analytical skills. (They had to develop those at Level 2). But they have also developed two more important skills often displayed by senior executives: change management and strategic thinking. The former is important because pricing managers must use their influence effectively. They cannot dictate prices to sales, marketing and finance. By using their skills of persuasion and letting the data lead, they can build a consensus around important pricing decisions.

Similarly, strategic thinking is an important skill because at Level 3, pricers are involved in devising pricing strategy. This necessitates that they connect the dots between pricing and the various goals and objectives of the organization. At Level 3 managers will also be meeting with more senior people, and will be asked for their opinion on long-term implications for pricing as it relates to major issues such as new product launches, new price structures, mergers and acquisitions, market forecasts, etc. Each of these issues requires a strategic perspective.

Managers at Level 3 companies have deep insight into what customers value and how much they are willing to pay for different offerings. However, their ability to predict customer reaction is still limited. They have not applied the science of optimization. To do so, they must bring a more rigorous and scientific approach to pricing that enables them to measure price elasticity with precision.

Level 4 – The Pricing Scientist

At Level 4, pricing managers intensify the degree of analytical precision they bring to pricing, and have honed their ability to tune company offerings to optimize profits by segment. As a result, the organization moves from value-based pricing into price optimization. The key phrases at this level are "profit optimization" and price elasticity (a cornerstone of economic theory, which is now being applied rigorously at a minority of organizations – less than 10 percent).

Two tools for measuring elasticity–price optimization software and price elasticity research (i.e., Discrete Choice)–have revolutionized the field of professional pricing (Figure 4).

Figure 4: Optimization Tools

Attribute	Discrete Choice	**Optimization Software**
Data Source	**Survey**	**Transactional Data**
Underlying Hypothesis	**Simulated purchase decisions are predictive of future behavior**	**Historical behavior is predictive of future behavior**
Strengths	**New products** **Price increases** **Product line price gaps** **Price structure**	**Price increases** Discounting **Price Structure**
Weaknesses	Not based on actual purchases	**The past does not necessarily reflect the future**

It is difficult to achieve this level of pricing process maturity without the right organizational structure. A hallmark of companies at this stage is the position of a VP Pricing or Chief Pricing Officer (CPO). This person will have significant authority with respect to pricing and will often report to either the CEO or another highly respected and powerful individual within the organization.

It's important to note that Level 4 pricers must have excellent analytical skills (developed in Level 2), but do not need to be statisticians. Rather, they must be able to hire and utilize individuals with deep statistical expertise. Level 4 pricers must excel at change management and know how to "bring data to life," so that it tells a story about the customer, the market, the competition, etc.

Another characteristic of Level 4 companies is the responsibility of the senior pricing person for creating the pricing culture. Therefore, he or she is deeply involved in training the sales and marketing teams on how to price effectively.

To reach Level 4 is a major accomplishment. It means you have achieved a high level of excellence, are in the top 10 percent of pricers and will be in great demand for a variety of projects. One of the most notable areas is business transformation. By bringing in an experienced pricer, an organization can often speed up the recovery of the business.

Level 4 companies have achieved excellence in measuring price elasticity, and have created a strong corporate culture around pricing. But they have not reached Level 5. To do so, they must refine their capabilities even further.

Level 5 – The Pricing Master

At Level 5 you have achieved pricing mastery, a feat that less than one percent of organizations have accomplished. We use da Vinci's "Perfect Man" to symbolize the balance of art and science in Level 5.

A company has reached Level 5 when it has met the following criteria:

1. The CEO recognizes pricing as a strategic capability.

2. The improvements implemented to achieve Level 4 are withstanding the tests of time; the company has maintained Level 4 performance for at least two years.

3. The company achieves substantially superior business results compared with its counterparts in the same industry.

4. The company has fully-designed and implemented a "Design-to-Price" process for new product launches (Figure 5).

One Level 5 company, for example, wanted to develop a robust pipeline of new products to propel it into the next decade of growth. Because the pricing team had historically played a major role in developing the new product pricing process, new offerings could be evaluated quickly, and either discarded or invested in further based on their ability to generate positive margin.

Figure 5: Design to Price

By determining willingness to pay before cost, world-class companies such as IKEA put the customer first. The benefit is a much higher probability of new products succeeding in the market place.

Of course, once a company has achieved this level of competence, it must consider the question: "How do we continue to improve?"

At this stage, the demarcation between pricing and other issues begins to blur. Firms will address pricing in the context of larger strategic issues and will engage the pricing team in helping to solve those challenges.

For instance, a company was considering a major investment in a new plant. The business strategy team, which was making a determination of the business case, requested that a senior member of the pricing team join the initiative. The pricing manager was assigned to this project and played a major role in this make-it-or-break-it business decision. By combining deep analytical strength (i.e., building forecasting models projecting the impact of the additional capacity on industry pricing) with the ability to link pricing to the value proposition (e.g., customer segmentation, price sensitivity, price structure, product offerings, etc.), the pricing manager was able to make a substantial contribution to the overall development of the business case.

It is not uncommon for Level 5 pricers to move on to other positions in senior management. Their history has typically been one of delivering dramatic improvements in business results; and therefore, they are often assigned to turnaround situations, particularly in companies that have good products, but are achieving sub-standard results.

Summary

The journey to pricing excellence is both rewarding and challenging. Pricers have the opportunity to deliver dramatic improvements in business results if they continue to develop their capabilities in analytical and change-management skills. This allows them not only to "let the data do the talking," but also to build support and alignment among different functional areas that often don't see eye to eye.

As the pricer evolves, he/she will move from a very reactive mindset (Level 1 – Firefighter) to a more proactive, control-oriented approach (Level 2 – Policeman). Once he/she has gained internal control, it is important to gather external information that builds alignment among the various functional areas (sales, marketing, finance) around the customer (Level 3 – Partner). The fourth stage is optimization, in which pricers gain an even deeper understanding of the customer segmentation and the value proposition (Level 4 – Pricing Scientist). The final leg of the journey is to achieve mastery (Level 5 – Pricing Master). You might say pricers at this stage are doing their "level best." But the quest continues; Level 5 is a never-ending search for improvement that often transcends pricing and links into the entire business entity.