Precision Pricing for Profit in the New World Order

Increasing Customer Value, Pricing Latitude, and Profits

Price too high and you lose the sale! Price too low and you can't make money! Competitors with different cost structures pummel your price structure. Customers batter your salespeople. List prices are meaningless. Discounts are rampant. The old rules of thumb don't hold. Cost-plus pricing never made much sense and now it seems stupid. Life is hard, and sometimes seems impossible—and pricing is often the hardest part.

Managers who understand how to price in the new era can prosper and grow. It isn't easy but it is profitable. And, most of it is necessary just to survive.

This article explains the sources of price pressure carefully so you can clearly understand them, and then provides an improved framework, and a powerful toolkit for pricing in the new world order.

I. THE FALL OF THE OLD WORLD ORDER

Among the more fundamental changes which create new price pressure are:

1. A profound shift from variable costs to fixed costs. In fact, for some companies, such as software providers, variable costs are very close to zero!

2. A sharp consolidation in the size of customers and individual orders. It is not unusual in today's concentrated account base world to find companies that do nearly all their business with a dozen customers. And, in many industries, long term contracts, global/national supply relationships, and complex multi-product and service outsourcing arrangements lead to unusually large orders. Orders of tens and hundreds of millions of dollars are increasingly more frequent. Locomotive manufacturers in the United States now have only four major railroads as potential customers down from many just a few years ago.

This note was prepared by Professor Benson P Shapiro, B.P. Shapiro, Inc., 91 Main Street, Concord, MA 01742, (978) 369-7599.

3. Competitors from different industries and with vastly different cost structures and "value propositions" regularly meet in the market place. Natural gas and diesel buses compete in city transit. Mainframe computers joust with networks of servers and microcomputers.

4. Almost no inflation and, in some industries, deflation, which makes it difficult to slip price increases by increasingly sophisticated and vigilant purchasing executives supported by advanced computer sentries. Flat pricing is the result of increased worldwide competition; lower transportation, communication and computer costs which increase the size of the "competitive set"; and high mobility of capital and knowledge which means that "focused monopolies" with high margins are "commoditized" much faster than ever before.

5. Electronic auctions and near auctions, often facilitated by the Internet, make it harder to survive because of much lower customer search and acquisition cost "friction." There is more fluidity in markets so that more suppliers can compete, and more buyers can shop prices across more suppliers. The prices of undifferentiated products and services will increasingly be bid down by this Draconian process.

In essence, we are in a worldwide, cross-industry buyers' market with few sustainable high-margin niches. Despite the challenges, there are better, evolving pricing approaches that help in many situations. Performance-based pricing is a prime example. It is helping sellers to create more customer value while being better compensated for their products and/or services. There are other such approaches as well. Before we consider them we need a firm foundation for improved pricing and a deeper understanding of the more important changes.

II. THE FOUNDATION: AN INTELLIGENT PRICING PHILOSOPHY

A good pricing philosophy must incorporate the customer's perspective, as well as the dual nature of customer-vendor relationships. These relationships have a cooperative component and a conflict-ridden component.

(Exhibit 1) is a real income statement that attempts to capture the whole relationship. It has three horizontal lines. The lowest is cost (at this point it is not necessary to specify what kind of cost – variable, total, average, etc.). The top line is the customer's perceived value. It is the total worth to the customer of all the tangible and intangible attributes of the product/service.

The range or area between the cost line and the customer value line defines the "Zone of Possible Agreement" (ZOPA). The customer will not pay more than the perceived value (they may pay less as noted below). The supplier should not knowingly sell below cost (on a regular basis). Price moves in the ZOPA range. Raising the price increases the seller's profits and decreases the "customer benefit". The seller's profit is the driving force to sell, and the customer benefit, the driving force for the customer to buy. As price goes up, the sale becomes harder, and vice versa.

Setting price in the ZOPA is only a small part of the total pricing decision. But, most managers focus on the zero-sum game[1] in the ZOPA and argue about how to balance supplier profit and customer benefit on the price pivot point (Exhibit 2). More important, however, is how to

[1] A "zero-sum game" is a two-part situation in which the winnings of one participant equals the losses of the other. It is impossible for both sides to simultaneously win.

expand the zone of possible agreement by increasing perceived customer value and/or decreasing costs. This process increases the spoils for **both** buyer and seller, and turns the zero sum game within ZOPA into a non-zero sum game.

The customer always pays less than the value they perceive, but sometimes they pay a great deal less. There are two causes for this. First, the seller has set the price too low because he or she did not understand (or often even tried to understand) the value the customer perceived. The second cause is competition. If your product/service is undifferentiated, your dumbest competitor will set your price. The dumbest will not focus on customer value and will price too low, destroying the market in the process. Thus, differentiation in the form of a unique provision of customer value provides protection from competition. A combination of customer value and differentiation provides the opportunity for the seller to extract value (Exhibit 3).

Understanding the "real income statement" (Exhibit 1) is particularly important with deflation or a lack of inflation, and the greater intensity of today's competition. Inflation provided an easy opportunity to reset prices and remedy mistakes. If you set the price too low, you could catch up in the next quarter. Without inflation, you live with your mistakes.

Further, globalization and the blurring of boundaries between traditionally separate industries (e.g., outlet stores, off-price retailers, and department stores) has led to much more competition. There is no respite. The easy availability of capital worldwide also means that most advantages are very temporary. This forces one to look for micro advantages. The easy macro advantages such as a unique product are more fleeting than ever before, however. So, transaction-specific pricing for each situation is a requirement to maximize short-term profits—and build long-term market position. Transaction-specific pricing requires a rapid, accurate pricing process built on a strong pricing philosophy. The real income statement provides a picture of the philosophy and the options.

The philosophy also requires a complete grasp of cost behavior, a careful specification of goals, and a detailed understanding of leverage. The next three sections will provide these.

III. THE SHIFT TO FIXED COSTS

As (Exhibit 1) shows, costs are an important factor in setting prices. The cost of a particular product line item or service interaction and the behavior of costs as volume changes have profound effect on pricing decisions. The movement from variable to fixed costs has enormous implications. Variable costs were in many ways easier to integrate into price making. High variable costs were one of the major assumptions of cost-plus pricing, a previously popular, but misguided pricing approach which is now totally obsolete. The appendix explains why cost-plus pricing is so dangerous.

The Impact of Cost Accounting on Pricing

Fixed costs produce two changes. First, it is exceedingly difficult to allocate high fixed costs to individual items in the product/service line. This is the classic problem of incremental costing and pricing. If each order does not need to absorb its "share" of fixed costs, one is encouraged to calculate costs and (using any form of cost-plus pricing) prices as lower than normal. Some orders are seen as "base loading" a facility and receive the fixed cost allocation. Other orders are viewed as "incremental" and don't "absorb" their "fair" share of fixed costs. One trouble is that different competitors view different orders as incremental. A typical outcome is that each competitor prices its existing customers' orders to absorb all costs, and its prospective customers' orders incrementally. In this scenario, the competitors attack each other's customers, eventually driving industry prices to unsustainably low levels. This is what typically happens during recessions in cyclical, high-fixed cost industries such as chemicals, paper and pulp, and petroleum. It happens less dramatically in many non-cyclical, fixed cost industries. And, again less dramatically, the fixed cost allocation problem clouds cost and profitability analysis even where it does not directly impact pricing.

How Volume Impacts Costs

The second change involves the relationship of costs to volume. With high fixed costs, total average cost drops precipitously as unit volume increases. In the past, when fixed costs were large plant investments, the range of unit volume over which prices dropped was limited by the plant's capacity. Now, where fixed costs are in product development and variable costs are often very low, as in the software industry, fixed cost absorption continues through infinity with no addition. This leads to enormous returns to scale for the leading firm. As unit volume increases, total cost hardly goes up at all. When teamed with increasing customer value as unit volume goes up, the pricing challenge and opportunity are extraordinary. These are discussed in Section V.

There are, of course, ways to change cost structure quite dramatically. Outsourcing is a clever approach to turn fixed costs into variable costs. Instead of building its own telemarketing center, for example, with high fixed costs, a company can outsource its telemarketing needs and pay for each call or each sale on a variable cost basis. This typically has been why companies use independent commission sales agents instead of a company sales force with at least some fixed costs. Outsourcing manufacturing, logistics, computer service, etc. does the same thing.

Getting Your Goals Right

Before we leave the fixed cost topic, it is useful to focus on appropriate goals and the tradeoff between higher unit volume, and higher prices on fewer units. We also must consider the relationship between cost structure and customer price sensitivity. In a high fixed cost situation, there is a great deal of temptation, and good logic, to cut price to generate incremental unit volume. After all, most of the revenue from the additional units drops to the bottom line as profit. The opposite is true in high variable cost industries. Incremental volume isn't very important there. (Exhibit 4) shows that a 10% increase in unit volume has almost no impact on profitability in a high variable cost business but that a 10% price increase has big profit impact.

If customers are price sensitive, it would encourage us as a supplier to cut price. On the other hand, if customers are not price sensitive, we are encouraged to raise prices.

Crossing price sensitivity and cost structure leads us to (Exhibit 5). The arrows in each box indicate the direction of the pressure on price. In the upper left-hand box we have high price sensitivity and fixed costs both encouraging lower prices. Tourist (quite price sensitive customers) airlines fit in this box. That helps to explain the vicious price wars among airlines in the early 1990s. The lower right hand box, with variable cost and low customer price sensitivity, is a kinder, gentler world. But, fewer companies live in that world. The off diagonals with mixed arrows are the more challenging decision making areas. The upper right is particularly difficult: it has high variable costs creating the need for higher prices and margins, and price sensitive customers who put pressure on getting lower prices. This is precisely where many suppliers live, and more and more are being pushed into that crowded, treacherous world by increasing customer price sensitivity!

IV. THE SHIFT TO A CONCENTRATED ACCOUNT BASE

Another significant change in most businesses is a shift to a more concentrated account base. Fewer customers comprise a larger share of the typical revenue base. In the "old days" it was said that 20% of a company's accounts generated 80% of the revenue. Now, even for many large companies, 20 accounts represent 80% of the volume. In the toy business, the neighborhood shop has been replaced by chains – three account for the preponderance of retail toy sales.

Two trends have led to account concentration. Mergers, acquisitions and strategic exit have eliminated many customers. And, the differential growth of successful firms has created fewer, larger prospects and customers.

As if more account concentration were not enough, some smaller and mid-sized buyers have turned to virtual account concentration – buying groups. Hospitals have joined buying groups to extract better prices, service, and terms and conditions from suppliers. Small retailers in many industries such as farm supplies and hardware have done the same. Some groups don't buy together, they "just" exchange purchase cost information, often for infrequently purchased capital equipment, and thus increase price pressure.

Astute buyers, furthermore, have amplified the account concentration process by concentrating their orders with fewer suppliers. Trends among sophisticated purchasers include longer commitments and more centralized purchasing. Thus, the larger customers provide even larger orders than their sheer size would dictate.

And, "dictate" is the operative word. The natural consolidation in customer industries has been accompanied by order concentration because buyers understand the clout of large orders. This represents a big issue for marketers. Business in terms of orders, and customers, and prospective orders and customers, is in bigger "chunks." The pressure to obtain the fewer, bigger chunks is high. And, the focal point for the pressure is price, and its close relative, terms and conditions. Terms and conditions (T&Cs in many industries) refer to such issues as credit and payment agreements, etc.

(Exhibit 6) is a useful way to consider the shifts in cost structure and account base. In essence, the movement has been toward the upper left quadrant—meaning that price setting is becoming even more important and even harder. The profit leverage in the upper left quadrant (fixed costs and concentrated account base) is in major account management, price making, and, of course, negotiation—which in a sense, is the combination of account management and pricing.

V. LIMITLESS LEVERAGE: INCREASING RETURNS TO SCALE

The old adage, "The rich get richer.." is truer in many more businesses than ever before. In some businesses, customer value increases with supplier unit volume. This phenomenon which economists call "network externalities," is clearest in a simple example of the old telephone system. If you are the first telephone on an isolated network, the phone is useless – there is no one to call you or for you to call. The value begins with the second telephone on the network. And, of course, it goes up rapidly with more phones on the network Thus, each succeeding customer generates more value for the previous customers.

The same thing happens in many "new age" businesses. Consider commercial software. As more users adopt it, there are more workers skilled in its use, more consultants and systems integrators are able to install and customize it, and more software and hardware are designed to be compatible with it. After a point, it becomes a de facto standard. This, of course, has happened with many Microsoft programs and its Windows and NT operating systems.

When this is teamed with high fixed costs/almost no variable cost (the cost of reproducing a set of diskettes or a CD-ROM is very low, and the cost of software distribution over the Internet is almost nothing) you have enormous returns to scale. (Exhibit 7) shows the shape of the customer value and average cost curves plotted against unit volume. After they cross, there is a great range in pricing discretion, and a wonderful opportunity for ever-greater profits. As unit volume increases, costs go down, customer value goes up, and profits skyrocket. Of course, it becomes increasingly difficult for a competitor to even survive let alone catch up. The walls of what otherwise might be defensible niches are breached by the overwhelming growth in customer value and the almost negligible incremental cost. This process, of course, has made Bill Gates apparently the richest person in the world!

VI. CROSSING THE QUADRANTS: THE CHALLENGE OF DIVERGENT BUSINESS MODELS

(Exhibit 6), the chart of cost structure versus account base concentration, is powerful because it considers both a primary marketing dimension and a primary cost accounting dimension. It focuses attention on the appropriate goals and leverage points, and goes a long way toward the definition of a business model (i.e., the collection of business decisions that defines the integrated way in which profits are generated in the company).

But, what happens when a company must operate in more than one quadrant? Banks, utilities, and airlines, for example, have some commercial businesses where accounts are concentrated and some consumer businesses where the number of customers is large and their individual size small. That makes it difficult for top management to exercise the right judgment and skill to respond to disparate businesses and their needs. How does the consumer banker learn to deal with giant institutional customers, and how does the utility executive with industrial experience learn to deal with consumers, advertising, etc.?

Perhaps even more challenging is the single company that has a high fixed cost business and a high variable cost business. Commercial software companies often exhibit the fixed cost-high return to scale profile described earlier. But, many also have consulting, systems integration, and customer training operations that have high variable costs embedded in expensive, hard-to-manage professional engineers. Most executives find it hard to manage such a disparate pair of businesses because their intuition needs to be "recalibrated" for each side of the operation.

Pricing in the new era is even more difficult than before. Now, we look at solutions.

VII. STRATEGIC OPPORTUNITIES FOR PROFIT-BASED PRICING

Price setting is a highly leveraged activity whose impact on profitability is profound. Thus it deserves care. And, in the new era, it requires care and work. Simple solutions implemented in a standardized rote manner and/or without care and thought lead to disasters – nothing less.

There are three ways to deal conceptually with price setting. (Exhibit 1), our "total" income statement, makes them clear:

1. Create more customer value at the top so that ZOPA expands. As a subset, clarify and emphasize the customer value so that it is better perceived by the customer.

2. Lower cost at the bottom so that ZOPA expands.

3. Move price within ZOPA so that your profit as a supplier is greater. Note that this is a zero-sum game in which your gain comes at the expense of the customer. Most pricing decisions are made this way. But, it is a very limited approach.

Value-Added and Transaction-Specific Pricing

We begin with pricing approaches that either create more customer value or that clarify the value. We might term these approaches **value-added pricing**. Value-added pricing will work best when one thinks of **transaction-specific pricing**—each transaction should be priced individually in a scalpel-like approach. A meat-cleaver standard uncustomized approach is unlikely to work well.

Economists call transaction-specific pricing "price discrimination" emphasizing that each customer pays a different price. Each customer and often each transaction represents a different customer value. This is the opposite of standard rote cost-plus pricing. There are limits to this approach, however. If customers purchase the same exact thing, and can learn what others have paid (through observations and/or discussion), it won't work. Thus, it is more suited to individual purchases such as those in the commercial and industrial market places than to mass merchandising. But, many of its benefits can also be achieved by pricing categories of transactions differently from other categories. The more customization you can achieve, the better it will be. Airlines have pushed the limits on this approach with yield management to maximize the price of a seat: each passenger on a flight may pay a different price for essentially the same seat. Profit results have been excellent although customer skepticism has soared.

While transaction-specific pricing works best in the commercial and industrial marketplaces, the ability to apply computers and sophisticated software to the calculation, optimization, and record-keeping tasks, combined with more non-store retailing such as on the Internet makes it applicable to some consumer marketplaces as well. Again, the airline example is a good one.

Product or service line pricing is a step toward a form of "mass" transaction-specific pricing. By offering several items in a product/service line at different prices, the seller lets the buyer choose the most appropriate fit of customer value and price. The classic example is the General Motors product line developed in the 1920s going from Chevrolet at the low end, through three intermediate nameplates or individual brands, to Cadillac at the high end. Another rich example is Sears' traditional "good, better, best" offering. But while product/service line pricing is a step toward transaction-specific pricing, it is only a small step. In essence it enables some choice by the buyer, but little opportunity for true customization by the seller.

Different Pricing Metrics

A powerful approach to supplement transaction-specific pricing is pricing by something other than the traditional or obvious metric. Two classic examples will help here. When Xerox introduced the plain paper copier, it brought a wonderful technology to market, much better than its liquid toner/coated paper predecessor. Xerox could have sold the machine, or leased it on a time basis. But instead, in a brilliant move, it charged per copy by putting a counter, called a "lease meter," on each machine. This enabled it to charge per copy thus "customizing" the price to each individual customer. The customer paid based on a measure of the individual customer value created by their machine. This also enabled Xerox to offer volume discounts to larger users.

Another example occurred early in the history of advertising. Rather than charge based on time and materials as a consultant would, early advertising agencies at the turn of the century charged customers a "commission" of 15% of the media buy. As mass marketing, national media, TV and radio, and huge advertising programs interacted with one another, budgets soared and agency commissions followed in linear progression. The whole industry would have been vastly different if the initial pricing had been viewed in a "consulting mentality" instead of a "sales commission" approach.

All too often companies implicitly "price by-the-pound" applying a cost-plus pricing mentality instead of something more creative. By-the-pound is easy and simple, but often doesn't relate to value. It only relates to cost.

Recasting Products and Services

Another step toward more creative pricing is to think of opportunities to either "servicize" a product, or to "productize" a service. Many years ago IBM did a wonderful job of selling large batch processing business computers to large companies. At the time, small companies found it hard to buy computers so IBM established the Service Bureau to provide primarily smaller companies with turn-key support. This "sell-it-by-the-slice" approach opened a new market. Automobile leasing is another fine example of making a product into a service.

Of course, one can productize a service as well. For example, an accounting firm could provide accounting software to replace expensive professional time. "Do it yourself" wills are a good legal example.

Often companies that supply a product are different from those that supply the competing service because the product requires different development, delivery, and marketing skills. But, the service and product meet the same needs for the customer and are thus quite competitive. It is useful for companies to expand their view to include such servicizing and productizing opportunities and risks for both pricing and product/service line management. Pricing the "obvious way that we have always done" considerably limits the opportunity for profit and revenue growth, and blinds a company to threats from different competitive approaches.

Bundling and Unbundling

Bundling and unbundling individual items in a product/service line is still another step toward expanding the pricing perspective to increase customer value, pricing latitude, and profit potential. For some customers there are a great deal of value creation possibilities by bundling a package of products and/or services together. This increases convenience and reduces acquisition cost and risk. Distributors often combine industrial repair parts into repair "kits." The buyer will receive parts they don't need, but the additional cost is more than offset by the single purchase replacing many smaller individual acquisitions and providing the convenience of a whole set of parts in one package. Suites of computer programs, such as Microsoft Office, represent another examples. The buyer gets convenience and assurance that the individual programs will be compatible.

Unbundling can offer the same opportunity in reverse. Here, the seller strips away the non-value-added parts of the bundle so that the buyer can purchase only what it wants.

Bundling and unbundling is a broader way of looking at productizing and servicizing. Automobile leases, for example, handle the car and its financing, and often insurance and post sales service. The leverage from bundling and unbundling comes because different customers value different components and/or bundles differently, and because costs vary across components and/or bundles. The logic here is to find the bundle size for each customer and/or transaction that maximizes the spread between customer value and cost, the ZOPA of (Exhibit 1).

Perhaps the ultimate step in the continuum toward value-added pricing (and related product/service decisions) is performance-based pricing. It deserves separate coverage because it is so powerful and useful.

VIII. PERFORMANCE-BASED PRICING IS MORE THAN PRICING[2]

Performance-based pricing is an arrangement in which the seller is paid based on the actual performance of its product or service. It is becoming much more popular. As we saw, in the advertising industry, agencies were typically paid 15% of the cost of the media they bought for a client. Now, more and more agencies are being forced to accept performance-based pricing—they are paid based on achieving certain client advertising and/or marketing goals. The contractor who rebuilt the 1995 earthquake damaged freeway in Los Angeles received enormous performance incentives by completing the reconstruction early. Other industries as diverse as consulting, trucking, and heavy industrial services are seeing the same trend.

An Example

Before explaining the benefits, drawbacks and applications of performance-based pricing, let us consider a detailed example involving ABB and Ford.[3] Ford needed a world class supplier to design and build a turnkey automotive painting facility in Oakville, Canada. Ford and ABB agreed to work together in an initial preparatory phase, rejecting the traditional approach of bids submitted based on incomplete information.

The initial preparatory phase involved a significant exchange of information and perspectives between the two firms, and led to a novel type of agreement. ABB would design and build the plant at a far lower cost than standard. Then, if ABB could reduce the cost even further, it would receive a pre-agreed percentage of the savings. This innovative, performance-based approach left both parties significantly better off than they would have been under conventional bidding or a negotiated price arrangement. Ford received a significantly lower cost plant at a lower level of risk: ABB received a share in the cost and design improvements it was able to create.

Advantages

One advantage of performance-based pricing is the often-mentioned alignment that can be achieved between the buyer's goals and the seller's goals. But, that is only part of the story. There are two other major advantages. Performance-based pricing is insurance. It insures that the seller does not undercharge the buyer. When the final performance of the service or product is in doubt, the performance-based arrangement guarantees that as the seller provides more, it is paid more. Significantly, the buyer also receives insurance that it will not overpay at both the institutional and the individual level. No person or organization wants to pay more for a product or service than it is worth. Again, when performance delivery is in doubt, performance-based pricing enables the buyer to pay only for the amount of performance that is actually delivered on a measurable basis. Most important, the individuals responsible for the actual purchase decision do not want to absorb the career risk of overpaying. In our personal lives, if we overpay for a product, we suffer some marginal consequence. In business, it can literally end the job security of a procurement executive. For its insurance role, performance-based pricing creates a greater sense of "fairness" for both buyer and seller.

The third benefit may be even more important than the first two. We often see performance-based pricing in highly uncertain situations, and where both buyer and seller must make complex tradeoffs among conflicting objectives. Simple contractual arrangements do not force the buyer and

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[2] My friend Adrian Slywotzky of Mercer Management co-authored the original version of this section.

[3] The example is described in detail in "ABB and Ford: Creating Value Through Cooperation" by Sherwood C. Frey and Michel M. Schlosser, *Sloan Management Review*, Fall, 1993, pages 65 to 72.

seller to communicate in-depth to one another. Performance-based pricing arrangements are generally very intricate. The parties are forced to deal with one another's limitations, objectives, and trade-offs. The very process of discussing, in precise detail and with great discipline, these issues develops "wide-band width" communication between buyer and seller. Each has the opportunity to precisely present its objectives, and to explain its own issues.

This process of open communication encourages a great degree of buyer/seller cooperation and coordination, and literally a much broader agreement. More issues are raised and factored into the high sensitivity problem-solving process. When the two parties involved are buying and selling committees representing different organizational jurisdictions within their organizations, and perhaps different levels of management, the necessity for precision and discipline in communication helps the process within buyer and seller groups as well as between them. It, in fact, leads to better agreements that provide more value to the buyer and lower cost to the seller as shown in Exhibit 8. Customers only get what they value and suppliers can reduce costs by removing non-value-added service and product components.

Applications and Limitations

Performance-based pricing is growing because its economic logic is so powerful, it provides new opportunities for buyer/seller communication and has been proven in practice. After successful deployment by credible players (e.g., EDS in systems integration and outsourcing, services such as waste cleanup and welfare recipient job placement for government agencies, and many advertisers and advertising agencies), it is clear that the approach is implementable. Even Proctor and Gamble, the last major consumer packaged goods advertiser to stay with a 15% fee, is moving in this new direction. It is sometimes a pragmatic pathway to managing risk, uncertainty, and performance for the long-term benefit of both parties.

Advertising has been a fertile field for performance-based pricing. The September 14, 1998 issue of *Advertising Age* reports that the percentage of marketers who compensate agencies on billings (media purchases) dropped from 71% in 1983 to 35% in 1997. The average profit margins of large agencies furthermore, according to a study by Morgan Anderson Consulting, went from 13% to about 19%. This demonstrates how profitable performance-based pricing can be. The trend toward broader agency involvement beyond traditional advertising has made it both possible and appropriate for the move to a new pricing approach—one that provides the agency with more opportunity in return for greater risk and broader, more integrated responsibility.

But, performance-based pricing is not for all pricing situations. In fact, it is appropriate in only a limited number of situations, albeit some very important ones. But, some limited variants can also be useful. "Point" guarantees such as penalty clauses which involve a discount when delivery is late are a simple form of performance-based pricing. These are typical in major construction projects.

Performance-based pricing is complicated. As with usage-based pricing and point guarantees, the actual amount to be paid can not be determined until after delivery, and often even after usage, of the product or service. Thus, for example, time of day pricing (e.g. restaurant "early bird" specials or cheaper cinema matinee pricing) does not fit into the performance-based pricing model. Neither does stratified service pricing such as first class and economy in air travel. This is similar to product line pricing, and can be considered service line pricing.

Performance-based pricing differs from usage based pricing in that it charges for the quality of performance as well as the quantity of usage. If the telephone company charged a performance premium for better sound quality or faster connections as measured in use, these would become performance-based prices. Both performance-based and usage-based pricing, however, set price after service/product delivery when the customer value is clear. These are both wonderful examples of using the pricing approach to clarify customer value and expand the ZOPA between customer value and cost.

Finally, it is useful to consider the risk embodied in various pricing approaches. Pricing that is openly based on costs plus a predetermined profit margin, and is often referred to as "time and materials," involves no vendor cost risk or price risk. The customer pays for all cost overruns and the profit is clear at the start to both seller and buyer. Typical fixed price sales involve cost risk only for the seller. The price is set before the product or service is made or provided. Performance-based pricing moves both the cost and price risk to the seller. Neither is clear when the deal is made. But, the vendor then obtains the opportunity to better manage the spreads among value, price, and cost to its advantage. With risk comes added opportunity. The vendor who uses performance-based pricing must thus be willing to accept greater, two-sided (price and cost) risk for added reward opportunity.

Application Guidelines

The complexity and custom nature of the performance agreement mean that performance-based pricing is only applicable to relatively large, important transactions/relationships for both the buyer and seller. The up-front cost of exchanging information and negotiating the performance goals and measures as well as the cost of applying the measures mean that this isn't for small or trivial situations. The power of the approach really comes to bear only when there is a mutual need to focus on joint objectives, and the abilities to meet those objectives are fraught with significant uncertainties. Performance-based pricing must be implemented with care and vigor. It is not a half-way solution.

Experience provides pragmatic guidelines for implementing performance-based pricing:

1. Invest the time up-front to carefully and fully define the objectives of the project and exchange all the relevant information. Both buyer and seller must understand their own and the other party's situation, including overarching business goals and strategy. If there are serious functional and/or other internal fractures on either side, the process won't work.

2. Broaden the negotiation perspective to encompass all elements of the situation. That way each party can bring to bear its most complete arsenal of tools and approaches.

3. Explore a wide range of outcomes and consider what is controllable by the seller, the buyer, and neither. The exploration of outcomes, and the broadening of the negotiation perspective (number 2 above) require substantial creativity.

4. Take the time to negotiate completely. Do not rush because important details can and will be lost in haste.

5. Develop clear measures of achievement for each objective. Specify precisely what "performance" means.

6. Enumerate an explicit formula to relate payment price to performance outcomes.

7. Specify a mechanism to adjudicate disagreements over outcome measurement.

A Closer Link Between Value Provided and Payment Received

The emergence and growth of performance-based pricing is part of a larger phenomenon that is altering the landscape of business. Chief executive officer compensation is shifting towards a higher level of risk and reward. The trend is spreading to top management teams (naturally enough), and even extremely large employee groups (GE's top 10,000 managers are participating in the company's stock option program). Professional service firms are seeking (or being asked to accept) remuneration based on performance. Contractors, long accustomed to cost-plus pricing, are now confronting penalties for lateness and rewards for acceleration. The old fixed-price world is giving way to a variable-price world, with different levels of performance driving different levels of price realization.

The paradox in applying performance-based pricing for both buyer and seller is that it is most appropriate where outcomes are fairly cloudy, and thus where the performance-based agreement is often hardest to negotiate. But, the process of carefully specifying objectives, performance, and measures; and of broadening the negotiation perspective is what makes the approach so powerful. It enables the parties to shed light on the sources of the uncertainties and to illuminate new ways in which they can cooperate for their mutual benefit.

IX. ADDITIONAL OPPORTUNITIES FOR VALUE-ADDED PRICING: TERMS & CONDITIONS

Terms and conditions provide another opportunity for creating customer value and simultaneously making more money by expanding ZOPA at the top. Terms and conditions include volume discounts, credit and payment terms, etc.

The simple rule here is to provide what is dear to the customer and cheap to the supplier. For example, dating, i.e., extended payment terms used in highly seasonal businesses such as toys and nursery stock, enables the downstream retailer or wholesaler to accept delivery months before payment is due. This enables the supplier to level production and distribution demands on their facilities while still ensuring timely delivery to customers.

Of course, these are all two-edged swords because they incur cost. Thus, they must be analyzed on a transaction-by-transaction basis.

The previous three sections have focused on using pricing to increase and/or clarify customer value. That is where the preponderance of new opportunities in price-making lie. While no one approach for every situation, there is a wide menu of opportunities. And, ignoring the opportunities presents a substantial risk from competitors and customers. The last section of this article helps to match each pricing approach with the most appropriate applications. Before that, however, we must explore all the approaches. So we now move to two more traditional approaches that offer less opportunity but are still important.

X. NON-CUSTOMER VALUE ADDED APPROACHES TO PRICING

ZOPA, as we have seen, can be expanded at the bottom end by cutting costs. Many suppliers provide things that some customers do not need or want. These are obvious candidates for removal. Unbundling and productizing a service are two approaches already considered. Performance-based pricing provides the kind of intensive and extensive buyer-seller communication that enables the supplier to remove all non-value-added components from their offering to minimize costs while maintaining or increasing customer value.

When one considers each transaction on its own as is, the opportunities for cost reduction are numerous. In the past, the complexity of the transaction-specific approach was so great that it overwhelmed the analysis and delivery tools. But, as computing power decreases in cost and software grows more sophisticated, the balance is changing. In addition, as opportunities for less detailed, fine-grained approaches are depleted, the astute competitor is forced to look for these harder-to-tap opportunities.

Of course, the least attractive opportunity is to work in the already defined ZOPA. This limits the supplier to a zero-sum game with the customer. Suppliers' gains are customer losses. Not an encouraging alternative! The best approach here is to price on a transaction basis so that the zero sum game in the ZOPA can be varied to meet each customer, prospect, and transaction situation. In that way, each situation can be considered on its own merits including such concerns as the existing relationship between buyer and seller, other opportunities for doing business together, and industry conditions such as the demand/supply balance and its dynamics. Working in the ZOPA is limiting but sometimes necessary.

XI. APPLYING PROFIT-ORIENTED PRECISION PRICING

There have been thirteen pricing approaches presented here. In this last section, we look at where each is best applied.

The first two approaches are to **understand the customer value** you provide, and to **clarify that customer value** to the customer. Indeed, these should be the first steps in any and all price setting programs. They are not simple or easy. They are hard and highly leveraged. But the process of understanding the customer value you provide will enable you and your team to do a better marketing and management job in general.

Where possible, the process of clarifying customer value should be separated from price negotiations. When customers experience both together, as in the typical American automobile buying process, they lose trust in both. An explicit process of value clarification with a well-trained salesperson can by itself create significant customer value.

Transition-specific pricing is most appropriate where customer value and cost differ across transactions, and where buyers do not exchange price information. It works best where buyers place few, infrequent orders; the supply/demand balance shifts rapidly; and customers can't easily delay purchases and/or switch from one product/service to another. Notice how well airline fares meet these conditions. This explains why it has been applied so universally there.

Product/service line pricing such as first and economy air fares works best when different market segments have different views of customer value and price. The greater the disparity among market segments, the greater is the opportunity for this form of pricing.

New pricing metrics (not pricing "by the pound") is most useful when value differs by transaction and is not linearly related to the cost of each transaction. It is applicable in a surprisingly large number of transactions.

Servicizing a product and productizing a service are applicable in many situations. Even where they do not yield a new pricing approach, the exercise is useful to understanding and clarifying customer value, and more completely defining the competitive set.

Bundling and unbundling works where the transaction involves a collection of product and/or service components, or where components can be combined in a single transaction. Knowing the customer's usage and acquisition process in detail is critical here.

Performance-based pricing works only on relatively large transactions where performance is unclear at time of purchase but where the relationship between customer value and delivered performance is clear. There is an interesting and useful relationship between bundling and the use of performance-based pricing. As more product and/or service components are bundled together into one package, the vendor offers a more integrated service/product. This offers the opportunity for the vendor to accept more sole-source responsibility. And, the broad responsibility that integrates many piece parts is particularly appropriate for performance-based pricing. Thus, broad bundles are generally easier to sell with performance-based pricing than are narrow offerings.

Point guarantees, penalties, and incentives are useful where true performance-based pricing is too complicated, and/or the transaction is too small to justify the necessary communication and coordination effort. They also limit risk and vendor responsibility.

Usage-based pricing is appropriate where usage can't be determined at time of purchase but only at time of delivery and/or use. Telephone service is a fine example. Performance-based pricing; point guarantees, penalties and incentives; and usage-based pricing all share the important attribute that the price is set after the product/service is delivered, and the value is clear. Thus, all of these are applicable when there is uncertainty concerning amount of usage or level of performance, but not the value of any given usage amount or performance level.

Terms and conditions are almost always worth considering. They make good additions to many of the other pricing approaches.

Cost reduction is almost always worth considering too. It is often useful in conjunction with unbundling and/or performance-based pricing. In both of these approaches, the vendor gains enough knowledge to remove superfluous cost elements that add no customer value.

Pricing within an established zone of possible agreement (ZOPA) is a last resort when the ZOPA cannot be expanded. But, it works best in conjunction with transaction-based pricing.

The new pricing menu is full, but it begins with a strong understanding of customer value and the ability to demonstrate that value to the customer. The variations evolve in many ways, but the foundation in customer value endures.

APPENDIX A

THE FALL OF COST-PLUS PRICING

The fastest way to commoditize a product or service is with cost-plus pricing. Cost-plus pricing essentially gives away any special ability your company has to create customer value. It makes the playing field between you and your competitors, and among the items in your service or product line, so level that it destroys your competitive advantage. Cost-plus pricing never made a great deal of sense. Now it makes even less! But, it still remains popular so it is worthwhile to explain why it is so bad.

Cost-plus pricing was based on a number of usually unstated assumptions:

1. All relevant competitors had about the same cost structure.

2. Products and services were generally undifferentiated from one another. So, value for the customer from different competitors' products and services differed little.

3. Costs were relatively easy to assign to particular orders, products, and services because the really relevant costs were variable factory costs. Fixed costs were not very important; neither were customer-related sales and service costs that were subtracted from gross margin. Thus, gross margin percentage was a good measure of profitability.

4. It was impossible to make individual, intelligent assessments of prices. The computation effort in a multi-product/service company would be more expensive than worthwhile.

In most current situations, these assumptions do not hold up:

1. Competitors with vastly different business models and cost structures regularly face one another. Thus, your costs are not the same as your various competitors, particularly for the individual items in a long product or service line. If you cost plus price, your prices will not reflect the general market place. Customers will choose competitors with the lowest prices, and put great overall pressure on all prices. The smart way to price in such a situation is to carefully consider your competitors' cost structures and pricing policies, as well as many other factors including particularly customer value, so you emphasize your competitive strengths.

2. Much of the value in today's products are embodied in intangible attributes such as brand names, value-added services, and intellectual content. These represent opportunities for differentiation and unique positioning. Cost-plus pricing reduces their value and turns specialties into commodities.

3. Variable costs directly related to individual products and services are much less important in general, and in some cases are nonexistent or close to nonexistent. More costs are fixed. And, more of the variable costs are customer-related service and sales costs that occur "below" the gross margin level. Thus, it is

more difficult to ascribe specific costs to specific products and services. If costs are not accurately known, how can one effectively do cost-plus pricing?

4. Fast, cheap computers, running intelligent well-designed software makes the effective pricing of individual items even in long product/service lines possible. This depends upon having a robust, powerful foundation for smart pricing. That foundation lies in understanding and communicating transaction-specific customer value.

In many service businesses, cost-plus pricing is known as "time and materials" because the customer agrees to pay for time and materials plus a profit margin. This encourages the customer to be more concerned with the vendor's costs, and thus less concerned with their value from the transaction. This is the wrong basic focus for the vendor to engender in the buyer. The seller should encourage the buyer to think selfishly about customer value, price, and customer benefit (see Exhibit 1), and to leave the cost-price spread (profit) to the vendor. The astute vendor who is really good will accept the opportunity and the attendant risk.

Exhibit 1

A “Total” Income Statement

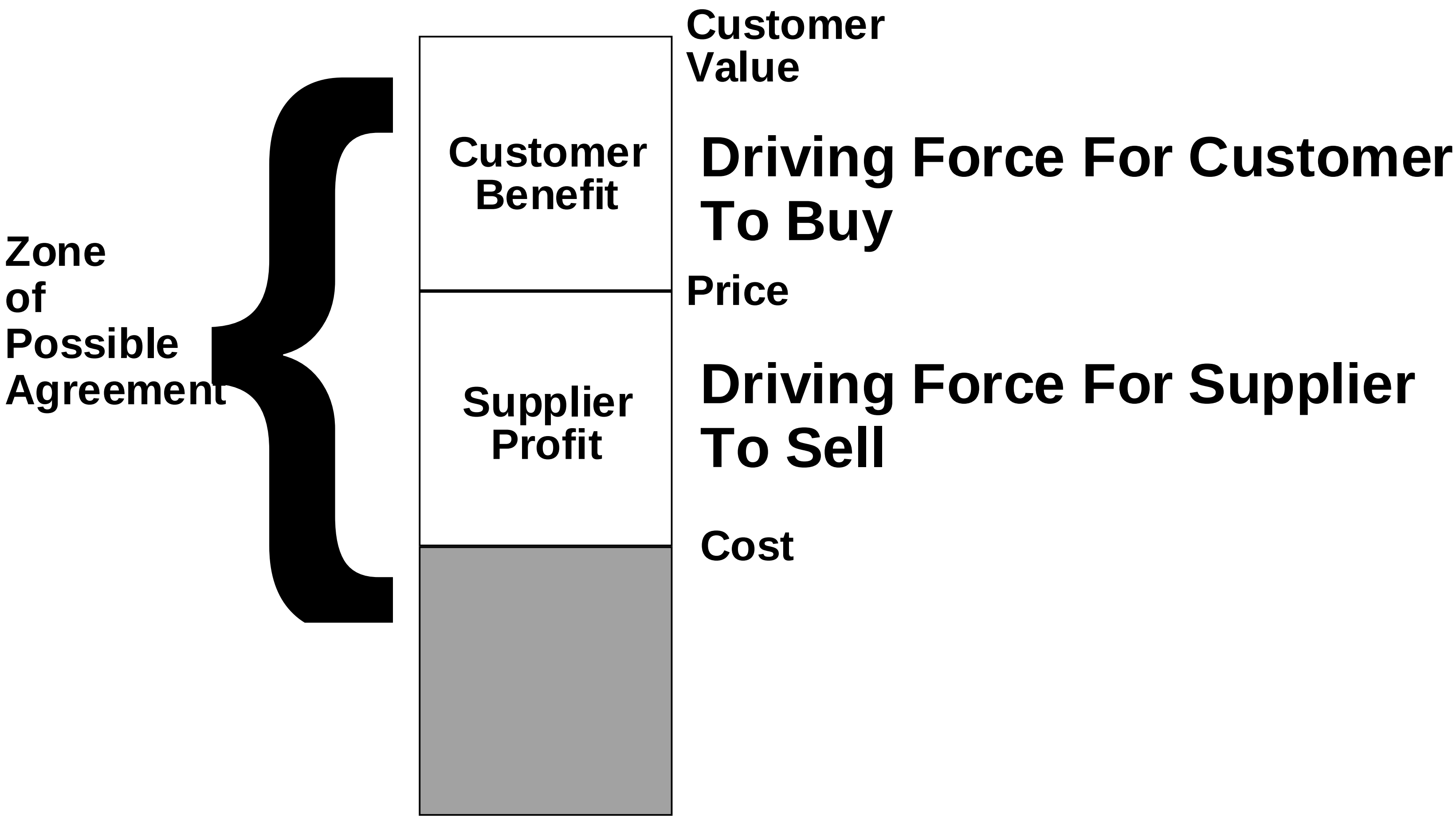

Exhibit 2

Price is the Pivot Point

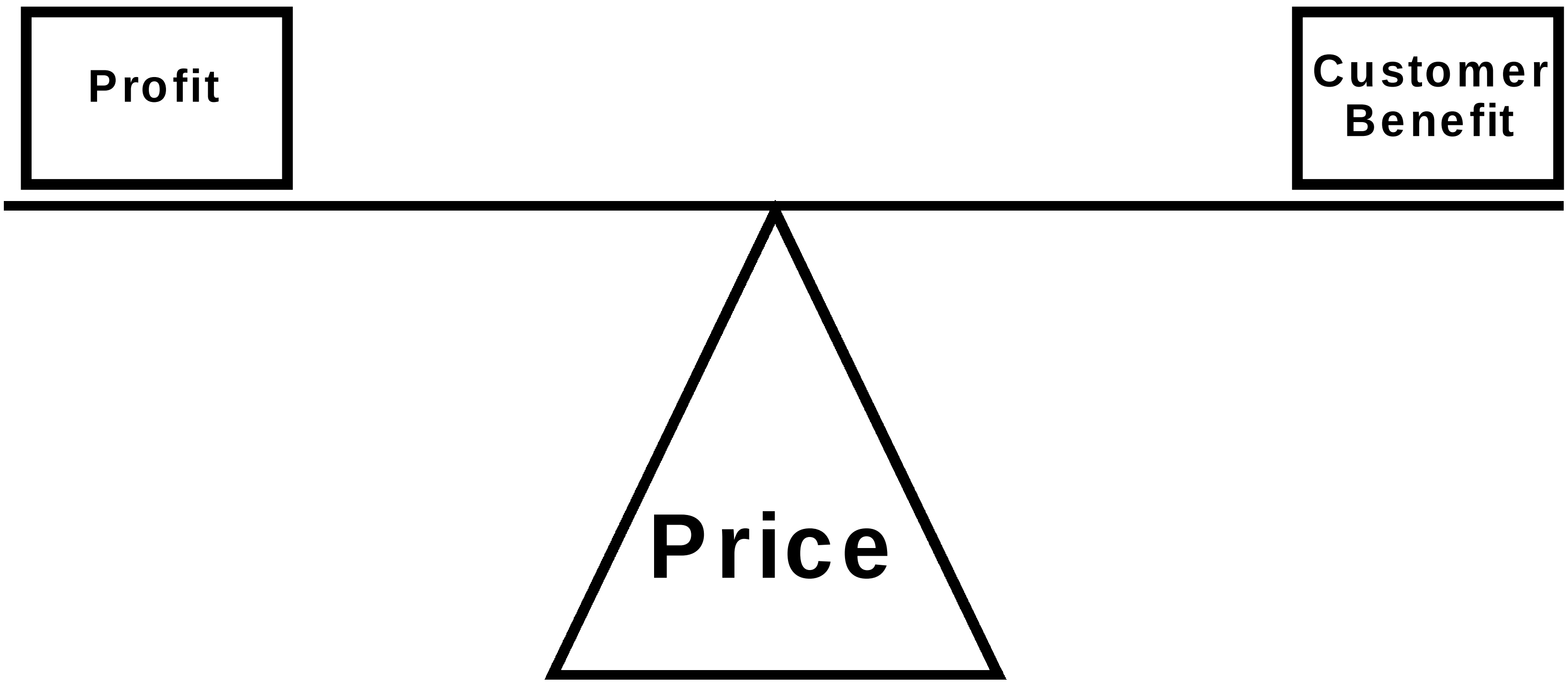

Exhibit 3

The Balance

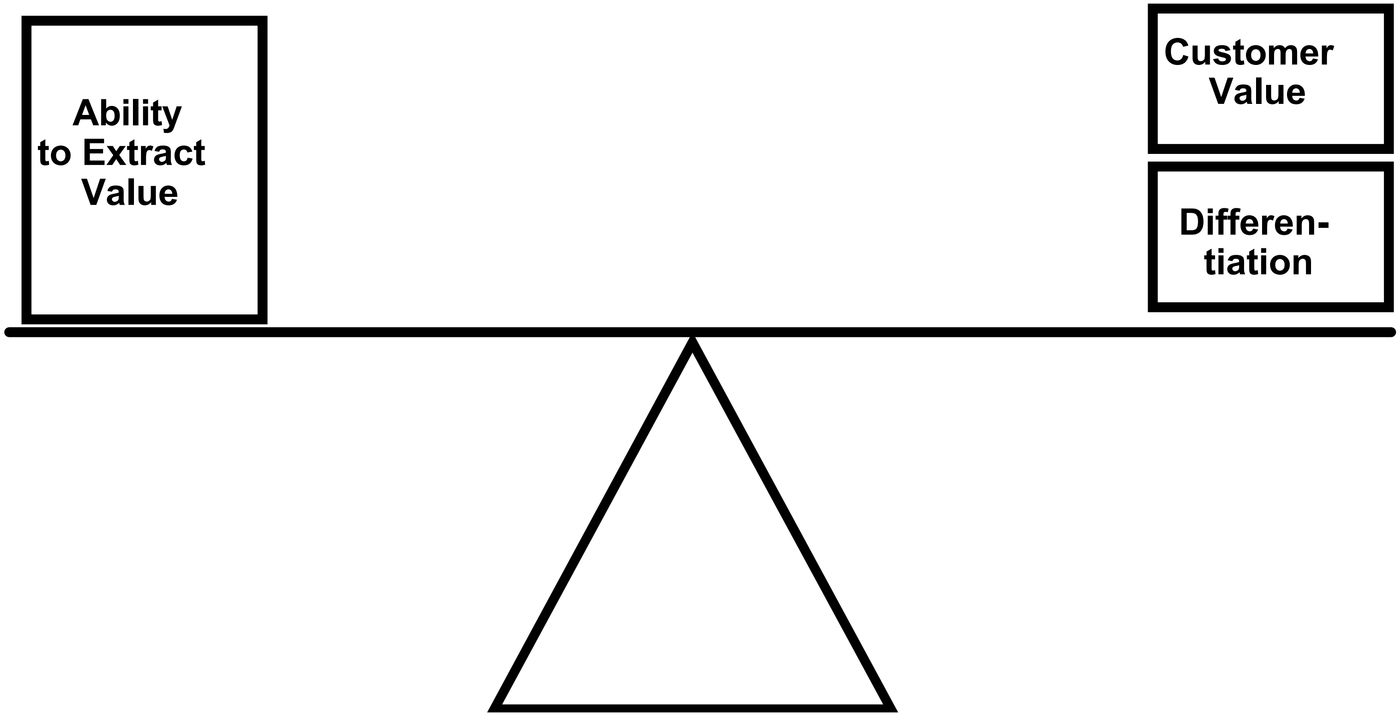

Exhibit 4

The High Impact of Price on High Variable Cost Businesses

	Base Case		10% Unit Increase		10% Price Increase	
	Fixed	Variable	Fixed	Variable	Fixed	Variable
Units	100	100	110	110	100	100
Unit Price	1.00	1.00	1.00	1.00	1.10	1.10
Revenue	100	100	110	110	110	110
Unit Var Cost	.10	.80	.10	.80	.10	.80
Variable Cost	10	80	11	88	10	80
Contribution to Fixed Costs & Profits	90	20	99	22	100	30
Fixed Cost	80	10	80	10	80	10
Profit	10	10	19	12	20	20
% Increase from Base	--	--	90%	20%	100%	100%

10% unit increase in variable cost company gives a 20% profit increase (10% contribution increase).
10% price increase in variable cost company gives a 100% profit increase (50% contribution increase).

Notes:

1. Cost structure is assumed to be:
   High fixed is 80% fixed cost as a % of revenue and 10% variable cost.
   High variable is 80% variable cost as a % of revenue and 10% fixed cost.
2. Assumes that there is enough available capacity to absorb a 10% unit volume increase.

Exhibit 5

Pricing Tendencies

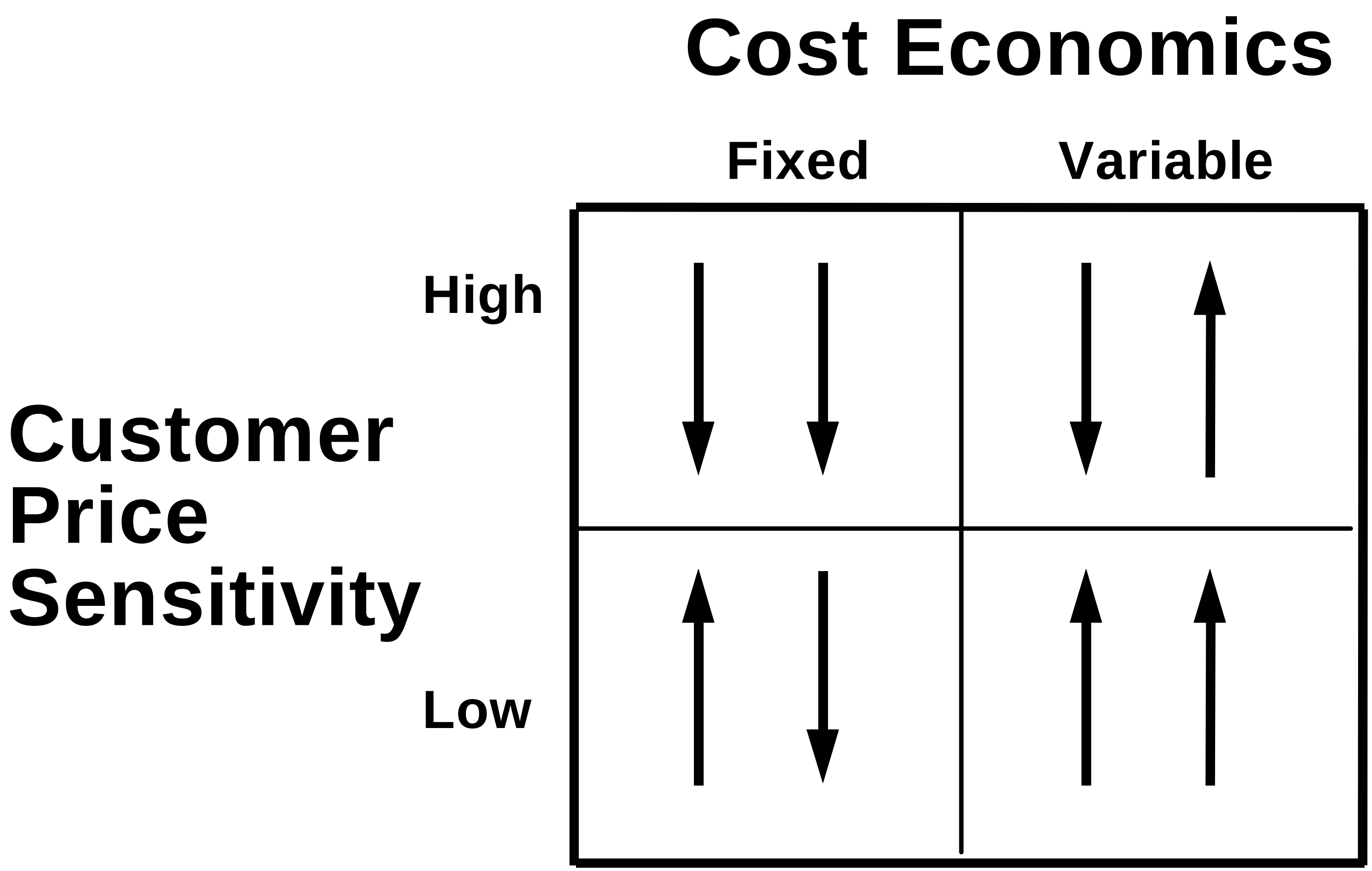

Exhibit 6

Cost Structure

Account Base	FIXED	VARIABLE
Concentrated	Goal: Higher Sales Levers: Major Account Management	Goal: Higher Prices Lower Costs Levers: Major Account Management Pricing/Negotiation Cost Management
Dispersed	Goal: Higher Sales Levers: Market Segmentation Communication(Mass) Price Distribution	Goal: Higher Prices Lower Costs Levers: Market Segmentation Pricing Distribution Product/Service Management Cost Management

Exhibit 7 New AgePricing

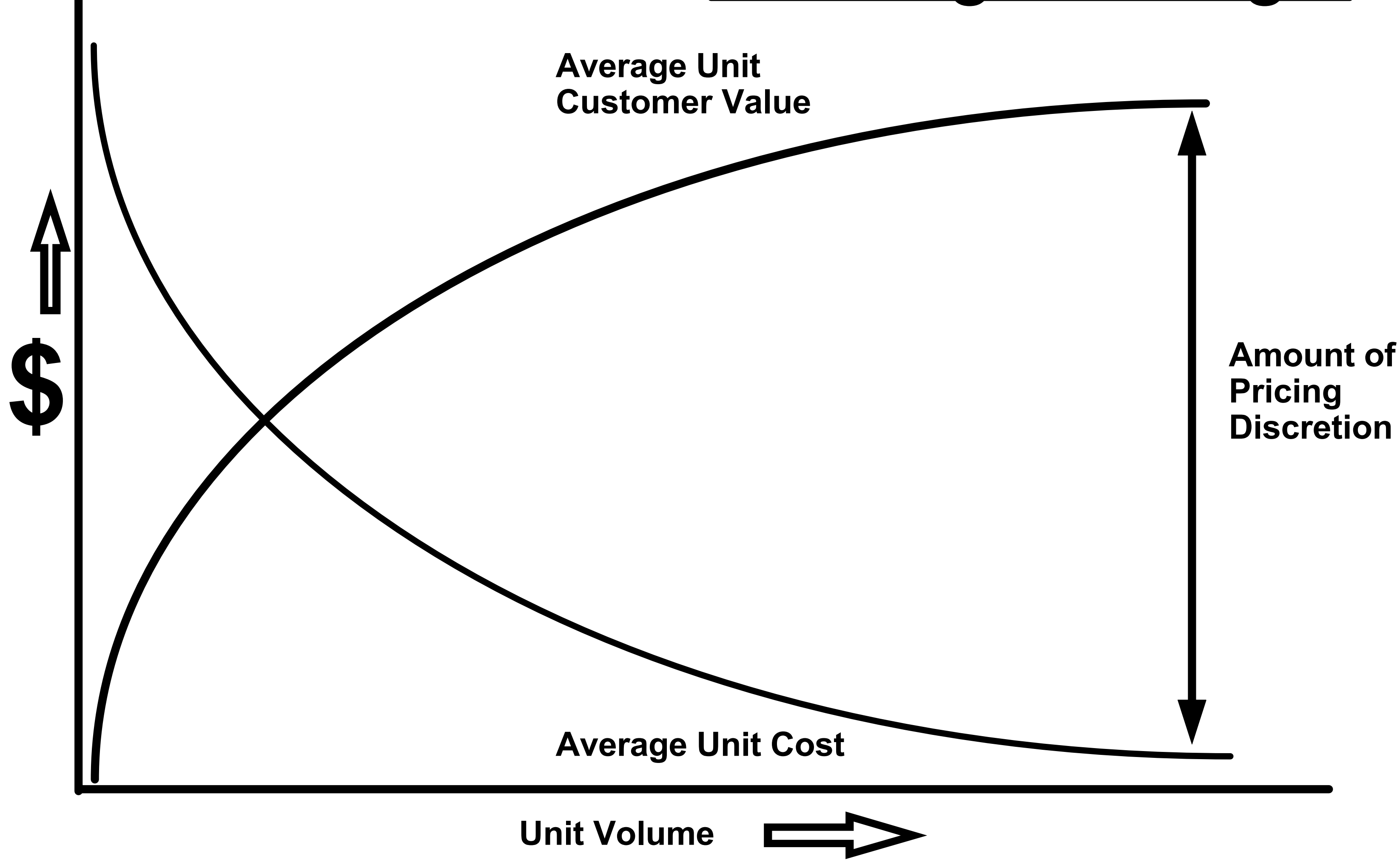

Exhibit 8

Performance - Based Pricing