The Price i$ Right

What Price Really Means to Enterprise Agility

By Aaron Shidler, Siebel Systems

Interested in increasing profits? The quickest way to fatten the bottom line is with precise pricing. According to an article in *McKinsey Quarterly*, a one percent increase in price results in an eight percent increase in operating profit. Conversely, increasing your sales volume by one percent delivers less than three percent increase in profits. And decreasing your variable costs by one percent yields only a four percent increase in profits.

So why do most companies focus so much of their management efforts on increasing sales and decreasing costs, and very little on pricing? In an environment where global competition is fierce and many products are becoming commoditized, price management can become a competitive advantage, and make the difference in profitability.

However, in many enterprises, the sales organization can't answer simple questions such as, "What is our pricing strategy?" and "What is the margin at each price point?" This paralyzes the sales process.

In a capitalist system, price is said to be set by market forces. Most mainstream economic textbooks agree with the Subjective Theory of Value, which says that the price of a commodity is determined by its marginal utility to the consumer and producer. This system is usually termed "marginalist economics." In practice however, consumers think of price as the value for the good or service. Notice the shift in definition, where suppliers set the value of the good or service through the price they assign to their product.

On the supplier side, the main objective is profit maximization. Most companies pursue this goal using a cost-plus model. Companies calculate their direct average cost of production and add a margin for overhead and profit. This price is often used as the retail price for the goods companies sell.

This method of calculating price is too simple and has too many gaps for companies to calculate the proper price. First of all, this model completely ignores the demand side and the behavior of customers and competitors. For example, if competitors lower prices, sales volume will fall, which will increase cost per unit. Using a cost-plus model may actually lead a company to increase prices.

Additionally, the aggregate of all allowances and discounts, which lower the price, are not accounted for, and do not allow a company to calculate true margins per deal. This method of looking at price makes it more difficult for companies to determine the proper price to achieve corporate goals.

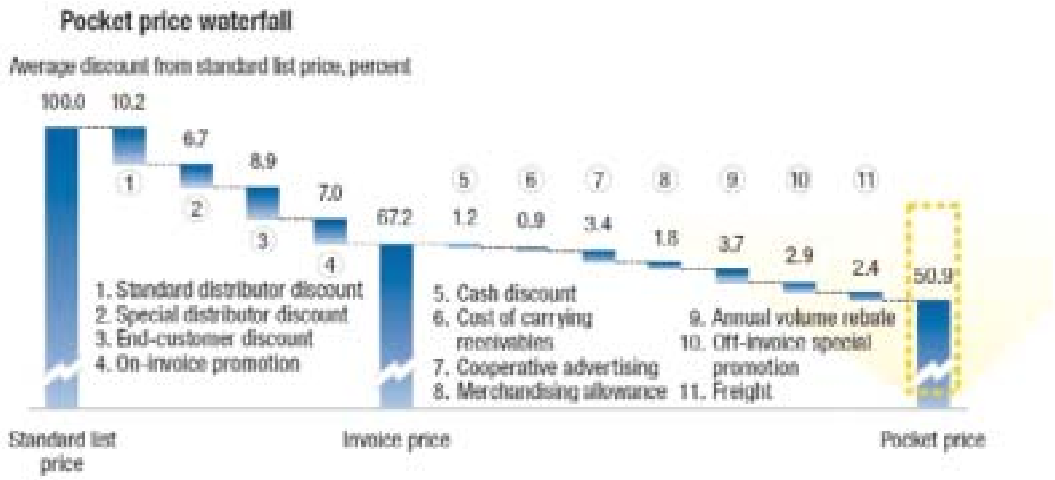

Figure 1

SOURCE: MCKINSEY & COMPANY, 2003

Pocket Price

Pricing is a complex process, influenced by numerous costing factors. A standard list price can include all or some of the following hidden or additional costs:

- Standard distributor discount
- Special distributor discount
- End-consumer discount
- On-invoice promotion
- Cash discount
- Cost of carrying receivables
- Cooperative ads
- Merchandising allowance
- Annual income rebate
- Off-invoice special promotion
- Freight

Accounting for all these costs leads to pocket price, which is the total cost of a sale after all on- and off-invoice costs are taken into account. For companies to calculate their margins, they must know their pocket price—what they pocket in the end. And for companies to increase profits, they must focus on the pocket price, not the invoice price. In a nutshell, pocket price is the real price charged after deducting discounts, rebates, and allowances. When viewed graphically, it resembles a waterfall. (see Figure 1)

Pocket price allows a company to look at price holistically, taking into account all factors that lower margins and develop a process for analyzing and determining the price that will advance company goals. This new definition also changes price from an end point to a process and allows a company to view price strategically.

But getting to pocket price can be difficult. Few companies have the visibility into their business to truly account for all costs and all discounts that should go into determining pocket price. And even if they did, they probably don't have the infrastructure in place to analyze all the data and act upon it. Also, because of globalization, different sales channels and regions can have inconsistent or inaccurate prices in different currencies, which adds complexity to the process.

Another one of the major barriers to accurate pricing is the lack of a pricing strategy. Lack of discipline and defined approval processes leads to revenue leakage from maverick and inappropriate discounting.

Finally, even once those obstacles are overcome, making use of the new data and insights may be too complex or expensive. >>

Inability to create and introduce promotions, product bundles, and offerings because of data complexity can render the analysis useless.

Closed-Loop Pricing Process

Sabarnes-Oxley requirements have encouraged visibility into pricing and have served as a catalyst, pushing many companies into establishing a comprehensive pricing strategy. Effective pricing management enables companies to plan, deploy, execute, and analyze pricing and contract policies throughout the enterprise.

Recent technology advances have allowed companies to pinpoint pricing to ensure the highest revenue levels through dynamic pricing. As companies squeeze the last drops of cost from their enterprises, they are turning to the topline to optimize their pricing models in order to extract the greatest revenue possible.

Price optimization can maximize profits and revenues, but to get a grasp on its complexity, a closed-loop pricing process must be established. The process should be made up of price planning, price administration, price negotiation, and price enforcement. Each of these tasks achieves a set of business results necessary for visibility into the full pricing process.

Price Planning

Price planning applies to the process by which companies optimize their pricing strategies. This is critical in achieving vital company business objectives, such as maximizing profits, revenues, and market share. During this stage of the pricing process, historical sales, market share, profit data, price elasticity, promotion effectiveness, competitive trends, customer segmentation, and buying patterns are analyzed to determine the optimal prices and discounts.

Price Administration

The price administration process enables a customer-driven enterprise to be agile in introducing new products, prices, and pricing policies in response to market conditions, and reduce time-to-market for new products and services. Price administration ensures consistent execution of pricing policies across all customer touch points including: direct sales, partners and resellers, self-service channel, and electronic data interchange (EDI).

Analysts can then use the information to maintain various types of pricing data in price lists and discount matrices, check consistency of prices and discounts, and obtain relevant approvals before releasing the price lists and discount matrices. Finally, administrators can define and maintain consistent enterprise-wide pricing policies.

Price Negotiation

The price negotiation process increases sales velocity by increasing the speed of price discount negotiations, reducing order errors, and maximizing cross-sell and up-sell opportunities. By speeding up deal closure and the accuracy of quotes, as well as giving margin visibility at each price point, the price negotiation process can maximize revenue and profit.

In a closed-loop process, sales people will have price history information readily available, which makes them more effective negotiators.

Price Enforcement

The price enforcement process minimizes profit and revenue leakage by ensuring that predetermined pricing and discounting guidelines are adhered to. At this stage, it is important to ensure that customers receive the most accurate prices based on existing contracts or agreements to ensure that pricing execution and enforcement is consistent and accurate for customers, partners, and employees, regardless of sales channel.

As enterprises struggle to create pricing strategies, an enterprise solution that can pull together all the disparate pieces can help manage the overwhelming amount of data analysis involved in price optimization.

Deploying a pricing strategy and a closed-loop process can increase sales velocity and maximize profits. By analyzing the data, executives can create programs to effectively manage sales efforts. For example, if managers can accurately determine margins, they can tie compensation to that measure and motivate sales people to sell profitable deals.

Also, a closed-loop solution process can take complexity out of a sale by making key data available to the sales people and customers, which leads to faster decision making. This information also empowers sales people to make profitable decisions. With more insight at their disposal, they can also increase the top-line with effective product and price promotion, cross-selling and up-selling capabilities. |s|

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PRICING STAGE	QUESTIONS YOU NEED TO ASK
PRICE PLANNING	■ What is your current and desired pricing process? ■ Do you have a clear view of "pocket" price and margin? ■ How do you monitor your competitors' pricing? Is it possible to spot trends? ■ How quickly can you analyze the impact of a price change? ■ What opportunities exist for price and margin improvement? ■ How does customer segmentation affect your pricing and terms? ■ How does your sales organization negotiate and justify deal terms? ■ How do you link your pricing strategy to your contract and deal negotiation? ■ What are the root causes of lower margins, bad deals, and unprofitable pricing policies? ■ Where can your company achieve the greatest impact in the near term?
PRICE ADMINISTRATION	■ How easy is it to create and introduce product bundles, promotions, etc.? How long does it currently take to do this? ■ Are you able to quickly update prices as often as needed to respond to a market or company conditions (excess inventory, new product introduction, etc.)? ■ Does your current system allow you to make and communicate price changes as often as needed? ■ What is the revenue impact from lack of pricing flexibility? ■ How do you communicate price changes to account managers, customers, and distributors/resellers? ■ How do you check pricing data for accuracy and consistency? ■ How do you define rules for cross-sell and up-sell? ■ How do you define rules on which products are eligible to be sold through which channels, regions, customers, etc.
PRICE NEGOTIATION	■ Do your sales people know how profitable their current deals/ transactions are? ■ Do you provide sales people guidance on the target price for each product? ■ Do you provide sales people with any cross-sell and up-sell recommendations? ■ Do your sales people have visibility to the types of discounts being applied for each line item in the quote/order? ■ Do you check for errors before the quote/order is submitted? ■ What is the cost/time required for order re-work?
PRICE ENFORCEMENT	■ How much time does it take to create and maintain contracts with the latest pricing? ■ What is the process for routing quotes/contracts for approval? How much time does it take to get the approvals? ■ What percentage of your quote/contracts require approvals?