BUILD A PRICING TOOLKIT

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Most marketers are familiar with the three Cs of pricing: customer, competition and cost. Also, most understand the basic strategies of market-driven versus cost-plus pricing. Yet, when it comes down to the nitty-gritty, hands-on tools of pricing, many continue to do what they have always done without much experimentation. They haven't assembled a new toolkit to test when faced with unexpected changes in circumstance, nor do they check the pricing against a checklist of relevant questions.

That's the purpose of this article: to help marketers think differently about pricing. While the focus will be on tactics and tools, that doesn't imply a disconnect from strategy. Rather it simply implies *more creativity* in implementation to achieve desired goals, and to more appropriately align price with perceived value. If you charge by the hour, but customers derive value from completed projects, consider changing the basis of your pricing. If you charge by the number of tires sold but customers value the number of miles traveled on the tires, consider changing the basis of your pricing. If you charge a bundled price for product plus prescribed services even though customers don't value the standard package, consider changing the basis of your pricing.

Here is a starter kit of pricing tools that have been used by various companies and industries. Some of them are mutually exclusive, while for others there is a visible overlap. As you come across new pricing approaches, add them to the list. Continue to ask yourself how you can combine or adapt the various tools for new ideas to achieve your objectives, or how you can use them as circumstances change.

Incentive pricing

Let's explore *selected tools* from the kit, starting with the incentive pricing. In this category, marketers attempt to incent buying behavior through variations on discounts. Order-size, cumulative-volume and product-mix are all types of volume discounts, but they should be evaluated differently depending on the goals to be obtained. Providing an order size discount encourages customers to buy more at one time. This is useful when the goal is to spread processing and shipping costs over a broader base, to "take customers out of the market" so as to minimize the threat of defection to competitive products, or to shift inventory. On the other hand, a *cumulative*-volume-discount (with either a rebate or a retroactive discount at the end of, say, the quarter or the year) attempts to lock customers into a specific supplier and gain loyalty. The product mix discount is appropriate when the marketer desires increased share-of-wallet. Don't be afraid to question your standard discount schedule if there seems to be a disconnect between your overall strategy and the results from the specific tool.

Discounting may encourage immediate purchase of products, but there is a downside. Constant price-cutting can damage brand equity and encourage customers to focus exclusively on price for all but radical innovations. Use other instruments in the pricing toolkit to reposition price and reframe the way customers connect price to the overall marketing program in making a purchase decision. Think about how you can use the selected tactic to call attention to a specific form of customer value.

TABLE ONE: PRICING TOOLKIT

Price variation category	**Example tools**	
Incentive pricing	Rebate Coupon Promotional pricing Sales Price match guarantee Package pricing Penetration pricing Every-day-low-pricing	Order-size discounts Cumulative volume discounts Product mix discount Step (or block) discount Deductibles Preferential terms Buy one, get one free
Ownership variations	Leasing/renting Licensing Layaway Metering	
Pay now, benefit later	Membership Subscription Retainer	Pre-payment Lock-in pricing
Buy now, pay later	Financing programs Credit	
Consumption pricing	Peak and off-peak Metering/hourly rates Price-per-project	Usage Two-part pricing
Product line variations	Versioning Private label Good-better-best Portfolio pricing Bundling	A la carte/menu pricing Free offers Life-cycle pricing Loss leaders
One-size-fits all	Flat rate / fixed fee All-you-can-eat	
Real-time price variations	Negotiation Dynamic demand Competitive bid pricing Auction pricing	
Customer engagement	Loyalty pricing Guaranteed rate Priority access Location-based Goal attainment Yield management No haggle pricing	Protection pricing Enhanced warranties Bartering Customer segmentation Price assurance Minimum order size Psychological pricing
Non-standard revenue generation	Market expansion Sponsorships/advertising fees Controlling price leakage	

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Pay now, benefit later

The retainer, a work-for-hire contract where the customer pays in advance for work to be specified later, is generally associated with lawyers, consultants and other professionals. This can be quite useful for high-demand services where customers want assured access to select individuals or firms. While some retainers cover the actual work performed, others simply guarantee access as necessary. Pre-paid service programs, such as is now common with phone cards and credit cards, are more relevant when customers are attempting to manage expenses and risk more effectively. Lock-in pricing allows customers to lock a fluctuating rate or fee at a specific point in an effort to minimize future risk. This has been used in the airline industry, for example, to lock fuel prices at a specific level. Each of these tools could be used to point attention to future customer value.

Consumption pricing

While consumption pricing has long been used by utilities, other marketers haven't heavily experimented with it. Many service providers improve their throughput by charging higher prices for peak time periods, thereby shifting some of the demand to off-peak periods. Metering can be used to bill for actual consumption of a product such as electricity, whereas hourly rates (a form of metering) can be used to bill for consumption of a service such as consulting.

The question is whether this latter type of metering carries any value for customers. Instead, it may be useful to think about consumption from the perspective of project completion rather than hourly rates. Proposing a total "package price" for a project forces a more careful assessment of time and resource requirements to complete it (and carries risk of over- or under-estimation), but it simplifies both billing for the supplier and budgeting for the customer. As suggested earlier, this approach may provide more value to the customer by focusing on results rather than time spent providing a service.

With usage pricing, different prices are charged for *how* the product or service is consumed. Most e-books, for example, are priced lower than their hard-cover version. This suggests that the electronic version does not convey as much value. However, companies are experimenting with variations. The publishers of "Fall of Giants" by Ken Follett and "Don't Blink" by James Patterson and Howard Roughan (published in late September 2010) charged slightly more for the e-book versions on Amazon. Even a year later (September 2011) the Kindle price is higher than the paperback price. It must be remembered, however, that unless customers perceive an advantage of the electronic book over the print version, they will not continue to pay a higher price for this usage.

Two-part pricing refers to separate charges for different *categories* of consumption, e.g., an entry fee to an amusement park plus fees for individual rides. Customers pay only for the level of the service consumed. Health insurance pricing is frequently implemented as premiums coupled with co-payments – another example of two-part pricing. The attempt with all types of consumption pricing is to explicitly link the value of the consumption to the price charged – preferably without curtailing the act of consumption.

Product line variations

Versioning is a broad category that covers many product modifications that result in different prices. In general the term refers to different variants of a product that provide different price/value combinations to customers. Sometimes there are slightly different feature sets with corresponding differences in pricing. For example, customers purchasing oxygen may have different needs for volume, purity, safety, and pressure. Therefore, *industrial* purchase of oxygen for combustion satisfies different needs than *medical* purchase of oxygen for its respiratory aid attributes. It's clear in this example that different versions would carry different value propositions even though the core product is essentially identical. Whether the same or different brand names (often known as flanker brands) are used in situations like this is dependent on a host of marketing decisions.

Another approach to versioning is to create a continuum of quality levels from good to better to best. By establishing a high-low range, marketers help "anchor" customer perceptions so that a wider set of options might be considered. Pioneer car speakers, for example, range from the G-Series (good), to the A-Series (better) to the D-Series (best). Customers select the quality they prefer or can afford – some want basic functionality whereas other look for superior performance or "elite" features. For a few customers, simple awareness of a higher-priced alternative provides the *intellectual rationale* to shift from the low to mid-grade option. Sometimes different brand names are used to define quality positions, as with Acura and Honda. And private labeling is an additional option for manufacturers to sell a version of their product under the name of (usually) a channel partner.

Portfolio pricing refers to decisions based on an entire product mix rather than an individual offering. The quality continuum mentioned above is one example of portfolio pricing, but there are others. Think about the role complementary products and services play in providing complete (or unique) solutions to customers. Equipment manufacturers of items from air conditioners to printers to razors often charge a price with a lower margin for the initial product to ensure higher-margin sales of future components and consumables.

In other situations the complete solution might require bundling products with complementary services. If target customers place a high value on assembly, installation, delivery or other activities, marketers should determine whether bundling these items into one offering with one price point is a profitable alternative.

On the other hand, *unbundling* (or a la carte or menu pricing) may be more valuable to some or all customers. For example, Dow Corning provides silicones under both the Dow brand and the Xiameter brand. In 2002, Dow discovered than many customers were interested in buying standard silicone products online at market prices without significant attached services (referred to as the naked solution); so the company created a business model under the Xiameter brand name exclusively for that purpose. Silicone sold under the Dow Corning brand focuses on customized services and technical support, while silicone sold under the Xiameter brand focuses on more "commodity" purchases. This allows Dow to appeal to customer segments that may desire either innovation (Dow) or efficiency (Xiameter) under different circumstances.

Portfolio pricing could also be used to improve overall profitability by selectively setting lower prices on competitive products while setting higher prices for more unique offerings. Last year Starbucks introduced a new price architecture that included comparatively high prices on complex drink orders while offering lower prices on products such as brewed coffee which faces stiffer price opposition. Similarly, auto parts manufacturers commonly charge "competitive" prices for components that face direct challenges from the big box stores, but maintain higher margins for products available exclusively through dealers.

Part of portfolio pricing occasionally includes the role of *free* – as in introductory samples, online informational downloads, and/or a free version that is weighed down with hassles. The first two roles of *free* anticipate future revenue-producing alternatives after customers have tried out part of a product line. Food companies hope to sell more, say, yogurt after consumers have tasted it, and consultants hope to sell advisory services after prospects have downloaded white papers or viewed webinars. McKinsey, the Boston Consulting Group, PricewaterhouseCooper and others use free research and reports to position their "thought leadership." In these cases, marketers must determine how much to extract from customers (in terms of contact information) and what follow-up efforts will be taken to make the free strategy a win-win proposition. The last category of *free* includes, for example, websites for news providers (such as the *New York Times* or various aggregators) or for community interaction (such as Facebook or LinkedIn) where customers accept the intrusion of advertising in exchange for free use of the product.

With lifecycle pricing, marketers prepare for pricing changes over the course of a product's existence. In general, companies typically attempt to extract higher prices (a process called skimming) early in a product's life, and then gradually reduce the price as competition grows. But there are situations when low penetration prices are more appropriate. Microsoft, long known for its monopoly power to set high prices, has begun to charge lower prices in emerging markets to reduce the intensity of piracy.

With any of the product line variations in price it's important to minimize complexity. Unbundling—and then charging for – necessary components of a product (such as charging for luggage when you take a flight) is not only cumbersome but can also cause resentment. And charging dozens of prices for products that can be easily be put into price categories results in frustration and potential accounting errors.

Customer engagement

Charging differential customer prices can take many forms. Key customers might be given preferential prices to gain long-term loyalty. Or customers may be given the option of paying a fee (or type of surcharge) to guarantee a specific future price, to gain priority access to breakthrough products, or to simply be put at the front of the line at a theme park. These are quite common, so I would like to discuss a few that are less common.

Goal attainment pricing shifts attention from widgets to results. It can be risky for the supplier but – if successful – it can be a differentiator. Advertising agencies have historically generated revenue from charging a percentage of media costs. However, that method was unrelated to successful campaigns. So a few firms have tested fees based partially on whether their efforts helped the clients attain their goals. Monsanto has used another variation of this pricing method. According to an October 4, 2010 *New York Times* article by Andrew Pollack, Monsanto introduces "new seeds at a price that gave farmers two thirds and Monsanto one third of the extra profits that would come from higher yields or lower pest-control costs." While different ratios have been tested, the ultimate price is related to specific customer goals. Some consultants have modified the concept of this pricing approach by charging a base project fee, with a built-in contingency bonus for attaining mutually agreed-upon goals.

Protection pricing programs have sprung up during the recession. Several car companies agreed to repurchase cars if the buyer lost his or her job before the vehicle was paid for – providing a "peace-of-mind" protection. Other companies, such as Best Buy, offer to refund the difference in purchase price if the same product is advertised by a competitor at a lower price within a stated period after the purchase (a price assurance guaranty).

Non-standard revenue generation

The last category of pricing tools deals with revenue that may or may not be generated directly from product pricing, yet contributes to the bottom line. Market expansion refers to the effort to keep price as a *neutral* part of the marketing mix; growth is pushed through enhanced promotional efforts and/or product presence in different channels. Efforts might include sponsorships or advertising revenue, sometimes from a website.

Price leakage refers to the lost margin that comes from discounts, rebates, promotions and allowances. McKinsey introduced this concept many years ago as the *pocket price waterfall*: an examination into "how price erodes between a company's invoice figure and the actual amount paid by the customer – the transaction price." Managing this leakage can directly impact profitability even without top-line price changes.

You're not done yet

After creatively considering the different pricing tools that may be available, the next step is to evaluate your choices using the checklist in Table Two. This is your reality check. Do the tools make sense in terms of their overall context? The eight questions provide a high-level analysis of fit between strategy and tactics. Most of the questions should be answered with a solid yes. Proceed with caution if the answers to several questions feel weak.

In the final analysis, the toolkit provided in this article is not a comprehensive list of all available pricing alternatives, but provides a starter kit for marketers to build into an adaptable set of tools. With appropriate modifications and tweaks, new ideas will emerge that can have a positive impact on bottom-line profitability.

TABLE TWO: PRICING CHECKLIST

Have you clearly stated the goals for the pricing tactic?	Yes No
Is there a high probability of the tactic accomplishing the stated goal?	Yes No
Is the timing right?	Yes No
Is the tactic consistent with the strategy and branding of your firm or business unit?	Yes No
Will the resulting price cover all relevant costs related to the decision?	Yes No
Have you evaluated the price sensitivity of different customer segments and incorporated that knowledge into your decision?	Yes No
Did you consider potential competitive reactions to your pricing?	Yes No
Have you built in potential contingency actions if the tactic is not working?	Yes No