

The real value in setting the right price

By Simon London, Financial Times

11 September 2003

The real value in setting the right price - PRICING - The tricky job of what to charge the customer is getting easier, thanks to an academic approach, writes Simon London.

It is 20 years since Glaxo made one of the riskiest marketing bets in history by pricing Zantac, its new ulcer treatment, at a whopping 50 per cent premium to SmithKline Beecham's Tagamet, which was then the world's biggest-selling drug. The result? Thanks to fewer side-effects, notwithstanding its premium price Zantac powered past Tagamet to become the market leader for the next decade. The blockbuster revenues transformed Glaxo from a mid-sized UK company into a global powerhouse.

The story illustrates two points. First, the price customers are willing to pay for goods and services has little to do with what they cost to produce. The marginal cost of manufacturing pills is, after all, negligible. Glaxo based the price of Zantac on an assessment of its value to doctors and patients. Second, setting the optimum for products can have an immense impact on profits. So why do companies expend so much energy on the first part of the profit-making process - creating value for customers through research, product development, manufacturing and so on - and so little on setting prices? For every Zantac-style success story there are a dozen tales of missed opportunity, over-optimism or worse. "Pricing is a neglected discipline," says Shantanu Dutta, professor of marketing at London Business School.

The good news is that this is starting to change, thanks to the efforts of a new breed of academics, consultants and technologists. Sophisticated pricing methods once used only in the airline and hotel industries have started to migrate into other sectors.

The bad news is that setting the "optimum" price remains fiendishly difficult - whether you are selling ulcer pills or piston-rings. Most companies lack the information systems and management processes to get it right consistently. Perfect pricing was an integral part of the e-commerce vision. With an increasing quantity of goods sold through internet-based auctions (one seller, many buyers) or reverse auctions (one buyer, many sellers), pricing would become much more efficient.

In 2001 Scott McNealy, chief executive of Sun Microsystems and a cheerleader-in-chief for the new economy, wrote a Harvard Business Review article in which he declared that the "list price" was a doomed concept. The future lay with "dynamic pricing". Certainly, auction-style

pricing is now more prevalent. The success of eBay, one of the few consistently profitable e-commerce companies, is the most visible sign.

For most goods and services in the economy, however, producers are still burdened with the responsibility of setting a "list" price and then deciding when - and to whom - to offer discounts.

Auctions aside, technology can help. Software to help manufacturers and retailers set prices has been one of the few growth sectors this year in an otherwise dep-ressed technology industry. Specialist revenue management software companies such as Profitlogic (whose clients include Bloomingdales, the department store, and Gap, the fashion chain), Demandtec (Longs Drugs) and Zilliant (DHL) now compete against bigger business software groups such as SAP and Manugistics.

While every software package has unique features, the broad principles are the same. In go vast amounts of data about past sales, prices, market conditions and inventory. Out come sophisticated guesses about the price at which profits will be maximized for every product line in every location for every category of customer. For example, Gap is using Profitlogic software to help judge when and how far to mark down items that need to be sold to make room for new lines. The company attributed margin improvement in its latest quarter to, among other things, better mark-down management.

"When people think about dynamic pricing they think of blinking LCD screens and prices changing every 10 minutes. In fact, the most successful deployments happen behind the scenes so that the consumer doesn't even see them. It is evolution rather than revolution," says Bob Phillips, co-founder of Talus, a pricing software company acquired by Manu-gistics and now a visiting scholar at Stanford Business School. Software is no panacea, however. Complex software packages cost millions of dollars to license. They need to be customized and integrated with a host of other information systems. Even if they work properly, there is no guarantee managers will be prepared to accept what the computer has to say.

Prof Dutta's research has revealed that pricing decisions within companies are usually the result of a messy interaction between marketing, sales, production, accounting and finance - not to mention business partners such as distributors, wholesalers and retailers. Price changes usually involve an investment of time and energy by each of these parties.

Says Mr Phillips: "It is not unusual to find that there is no one person in charge of what a customer is paying. It is a management issue as well as a technology issue." "Software on its own is not the answer," agrees Prof Dutta. "The real challenge is making pricing a strategic capability within companies. That is something that will take a long time but should pay off in the end because it is not easy to imitate." Even so, a more sophisticated approach will not rescue a business that is failing to create value in the first place. Ford has the most sophisticated "promotions optimization" systems among North American car companies, using

Manugistics software to help target the discounts and interest-free financing offered to customers. Yet the group's financial performance has been miserable, mainly because of its failure to develop desirable new cars.

Similarly, Gap's turnaround is founded on a back-to-basics merchandising strategy that has seen the company abandon attempts to chase street fashions. A smarter approach to mark-down management is just the icing on the cake. So will smart pricing improve financial performance? In the short term, perhaps. In the long term, the danger is that all retailers and carmakers will end up using similar pricing technology, leading to complexity for customers and no net gain for companies.

The airline industry could offer a taste of things to come. While the big carriers use sophisticated "yield management" techniques to maximize revenues, profits are elusive and customer satisfaction is low. The most profitable US airlines are JetBlue and Southwest, low-cost operations that have largely rejected yield management in favor of simpler, more transparent pricing. Customer service and customer satisfaction are rated consistently higher than at larger competitors. "People want simple products that they can connect with emotionally," says Tim Thorne, chief executive of Edengene, a London-based product development consultancy. He points to the simpler phone tariffs introduced by BT Group and the popularity of simpler investment products as other examples of the trend. All the more reason for companies to pay closer attention to how they price their products - and not let computers call the shots.