# Building a Forward-Looking and Effective Pricing Function

Where do you start when it comes to building an effective pricing function within your organization? The kind of pricing organization top management envisions is likely to be what it will get. That vision is determinative as it impacts the caliber of talent recruited, the titles and clout assigned, and the share of mind accorded to the new department. In this article, the author explores best practices for building an effective, forward-thinking and profitable pricing function. Rob Docters is a principal in BCG's Singapore office and head of the Pricing Enablement Center there. He can be reached at docters.rob@bcg.com.

Building an effective pricing function, or upgrading an existing one, is increasingly on the top of the management agenda. Pricing is the next management lever to grow profits and revenues, and companies with a centralized pricing function often enjoy higher margins than do peers with decentralized pricing.

But, not all pricing organizations are created equally, or enjoy similar success. What is required for success?

**There are many decisions to consider in designing a pricing function:**

- What goals to set?
- What should be the scope of the function?
- What should the organization look like?
- What skills and staff are required?
- How should its mission mesh with adjacent functions such as sales, marketing, finance and operations?
- How to begin?

There are some decisions which are frequently troublesome, with misaligned answers being a major force in limiting the success of a pricing organization. The key to success is that the pricing organization should avoid acting like "old generals fighting the last war." *Pricing needs to be a forward looking function*, which addresses the most important pricing issues, not clean-up from past mistakes.

As a pricer, you would think that this is pretty obvious, right? Actually, most pricing organizations are primarily focused on correcting the past. The past includes enforcing out of date list prices, revising past sales negotiations, supporting the wrong pricing structure, correcting past messaging to the market, overcoming bad data gathering, and living with cumbersome pricing processes.

The reason it is important to focus on the future is that there is much greater leverage and higher returns in being forward thinking. There is no greater opportunity to introduce the right price structure and the right price level than upon a product or service launch. The launch may be a completely new product, or a bundling of existing products and services. In either case, there is a necessary set of expert skills and methodologies which will outperform even expert intuition on pricing. Getting pricing right at the beginning is critical because you are setting market expectations. Once set, expectations are hard to adjust. Lifetime value is set largely by launch success and initial pricing.

Not only are past mistakes hard to correct in the market, they are difficult to correct internally. While sales reps are often blamed as a renegade pricing force, discounting is actually often a symptom of the company's failure to properly assess the value of the product, and wide variations in discounting are a symptom of pricing's failure to understand buyer segments and changes in the market. This is why many companies find enforcement of list price and discounting standards difficult.

There are many ways discounting rules can be thwarted. For instance, at one leading energy services provider the number of "free" and unrecorded transactions increased by over 25% after discounting was forced into rigid parameters by a new pricing organization. At a leading data equipment manufacturer, bundles of software, hardware and services were constructed by line management where the bundle price was a fraction of the individual components—in part because top management had forbidden discounting of individual components.

Bad? Not necessarily. Actually, subverting pricing rules is natural, even logical, if the rules do not conform to market reality. Many kinds of sales subterfuge are signs that your pricing managers do not have the analytic horsepower to develop a strategy which optimizes market dynamics and corporate goals. With bad pricing, enforcement often becomes impossible because offenders form a majority, and because customer-aware managers will realize that the company cannot survive if pricing is too disjointed

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from market context and product value.

Sadly, incomplete performance measures can reinforce the belief that success lies in mere enforcement. Most success measures used by top management relate to prices recorded in the general ledger, from which average discounts are calculated. Given that measurement approach, indeed a pricing organization has only to be tough to succeed. Yet, while it is enjoying that measured success, market share and win/loss ratios may be deteriorating at a pace which overshadows the gains from discipline. This does not lead to good year-end results, unless the company enjoys under-exploited market power or the market is very slow to respond.

So, in creating a pricing function, one risk to be avoided is consistently focusing on past mistakes. Instead management should seek out the highest opportunity and highest ROI pricing initiatives.

### The Pricing Organization as Part of Overall Pricing

Pricing happens, with or without a pricing organization. One large telecom equipment manufacturer surveyed the company and found that more than 750 managers were "heavily" involved in the pricing process, but only a hand-full of them had "pricing" in their titles. Pricing is required throughout the product development cycle. This company found that consolidating pricing practitioners into an integrated department resulted in headcount efficiencies, in addition to faster, better and more tool-based pricing. Most importantly, it allowed the company to rapidly adjust its pricing to meet market evolution. In that case value had migrated from an older technology to a new one, so prices had to be lowered and raised in sync with each other.

Driving change is not easy. There is a need for departments to work together, which may involve a debate between the pricing function and line management. Line management is understandably conservative in its view of price opportunities. Not only are they relatively unfamiliar with major pricing change options (new price structures, pricing tools, multi-year strategies, etc.) but their personal financial welfare often depends on ongoing revenue growth, not price-led gains. Therefore, unless they are convinced that "doing more of the same" will not meet goals, they will naturally resist unproven (to them) changes in functional control and influence.

Without consolidation, or if the pricing organization does not have enough intellectual firepower, or budget, to develop real pricing prescriptions then often there is inaction due to a fear of change. Often that manifests itself in a focus on the wrong analytics (e.g., price elasticity). A sign that your analytic muscle is insufficient is often indicated by a useless focus on price elasticity.

On its face, price elasticity would appear to be universal and useful tool. After all, if we raise prices, customers will buy less, right? Not so. Price elasticity (the change in quantity divided by quantity, divided by the change in price divided by price) only works in specific circumstances. Only where there is a transparent market, with low vendor switching costs, is elasticity meaningful. Should either of those two conditions fail, then elasticity cannot be measured, and may not mean much. For instance, a leading tax-preparation service was frustrated in its inability to measure consistent elasticity for its consumer services. Further examination showed that tax preparation is neither transparent (since there is a wide range of complexity in preparation), nor are switching costs low. For the purposes of consistency and defense against audit, customers see clear advantages in keeping the same preparer over multiple years.

### So, a pricing organization needs to contribute analytic horsepower. What else?

A good role model for a pricing organization for many companies might be the airline industry. Many leading airlines have divided their pricing into three parts: strategic (e.g. new routes and capacity planning), transactional (e.g. revenue management/ticket prices) and segment marketing (e.g. leisure vs. business travel). In generic form, applicable to a wide range of industries, the structure looks similar to Figure 1.

The pricing organization must reflect its various pricing missions, which are diverse. Hence there is a need to support both transactional and strategic missions. Building in some rudiments of executional capabilities is also useful.

The mark of a high performance pricing department is that it will understand what shapes price sensitivity, and will influence message, channel, product and price to capitalize on that understanding.

Without some executional capabilities, the pricing function is a prisoner to groups who may be indifferent to pricing needs and, worse yet, can simply declare pricing changes "impossible." A pricing organization ideally should have at least one manager with general IT expertise and expertise specific to the firm's systems, particularly its billing systems. Having some capability in this area can make all the difference. For instance, at one online services provider a new price option was sent to the CIO for expedited development. The CIO, who did not feel this option was a priority, said that development would take almost a year.

However, when pricing end-ran the IT head by creating a "skunkworks" solution, the new option was available to the market inside one month. The new option sold well, and the primary competitor trailed its competitive counter by over six months.

The mark of a high performance pricing department is that it will understand what shapes price sensitivity, and will influence message, channel, product and price to capitalize on that understanding. This understanding will make customer migration to new offers lower risk and faster. This will also steer the internal and external focus away from price tags, and towards factors often collectively known as "value."

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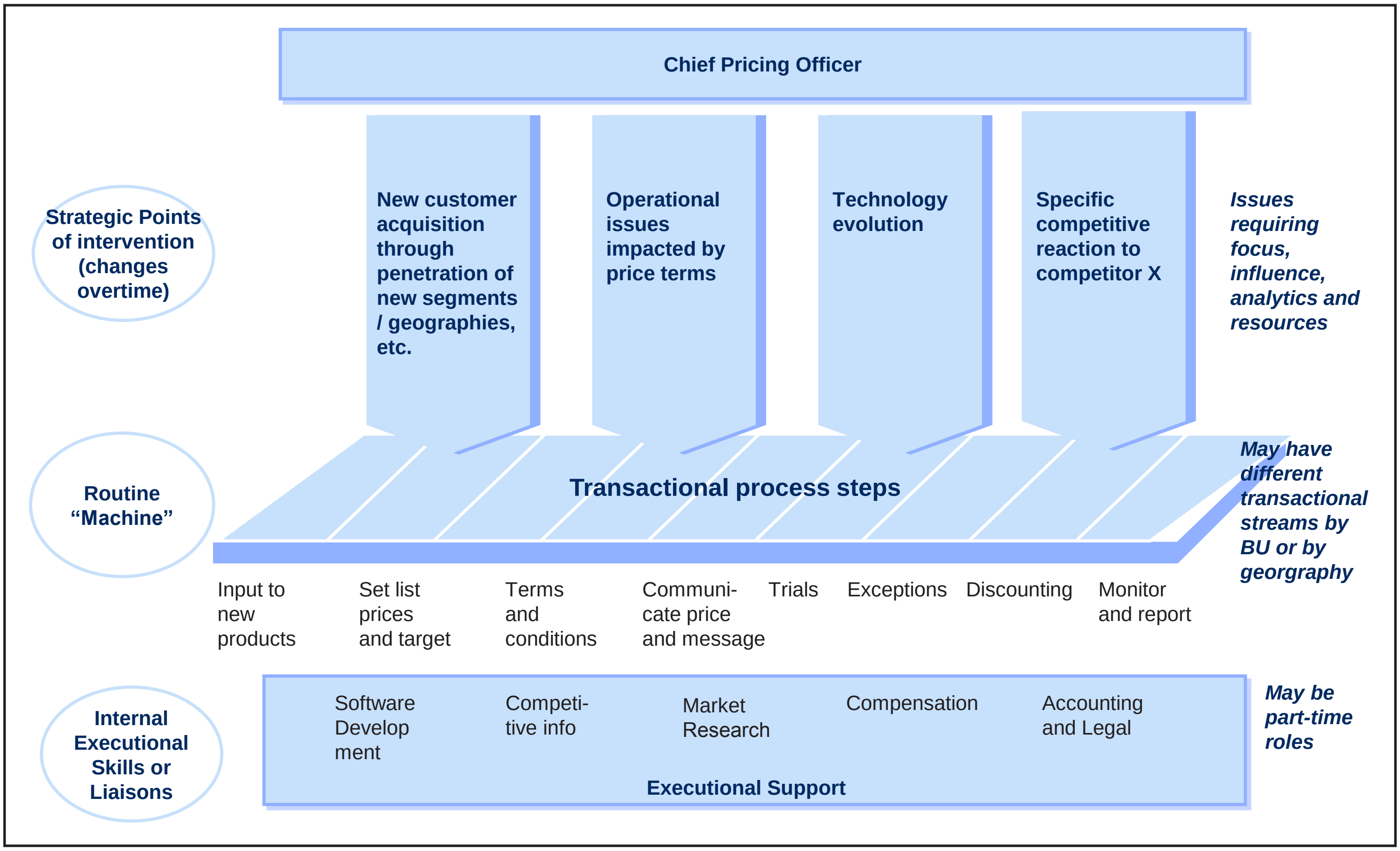
Figure 1: Pricing Organization




Value creation usually requires coordination across departments. For instance, a leading legal publisher established that when judges quoted its publications, lawyers appearing before judges were more likely to value those publications. The strategy therefore was to penetrate judicial chambers with low prices, and then raise attorney prices as quoting became more common.

The result was a material uplift in price and share, as a result of pricing-driven changes in channel, product, messaging and price levels. The willingness to reduce prices to the judiciary represents strategic pricing, rather than commercial maximization. Leading with a price reduction can be strategically useful. As self-made plutocrat Joseph Kennedy Sr. noted, "Only a fool holds out for the top dollar."

## "Okay, but I want to hear more about commercial oversight!"

There is a strong attraction to commercial oversight, partly because the results can be immediate and they appear to be measurable. Benefits are the lift from "low" prices to some norm.

Additionally, the approach promises results within a reasonable range: overall revenue lifts of 1 – 3 % is a typical target. Best of all, applying the 1 – 3% to a large revenue base produces a big payout. Hence, a common starting point in building a pricing organization is creating commercial oversight. Commercial oversight almost always includes:

- Approval of new list prices
- Salesforce requests for price exceptions
- Customer compensation in the event of poor service, defective product, discontinued offers or warranty issues
- Credit issues
- Approval of change in terms
- Profitability (usually based on saturation costing)

In each case, a revenue optimization calculation should underlie the decision. The tricky part is understanding the likely market behavior and reaction, but this volume/share data can be difficult to assemble. Useful volume learnings require judgment, and can face institutional resistance to a frank appraisal.

Less universally included in the commercial charter are some other components which help measure how the market is reacting to the commercial management. In order to actually measure whether commercial insight has helped the company, however, there are another half dozen organizational components required:

- Bid win/loss
- Lifetime customer value (and churn)
- Upsell rates and customer referral rates/net promoter scores

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- Product lifecycle management, including price structure evolution

- Future customer loyalty

- New demands from other customers who may learn of concession

- Pilots and price trials

What is decisive is having a working win/loss database. Such a database can show market acceptance and power of new pricing strategies. It will also close off many pricing arguments, and suggest precise answers. *Sadly, few win/loss databases are kept up or are organized with sufficient detail (e.g. the close price on losing bids).* Therefore it is up to the pricing organization to build such a resource and keep it usable.

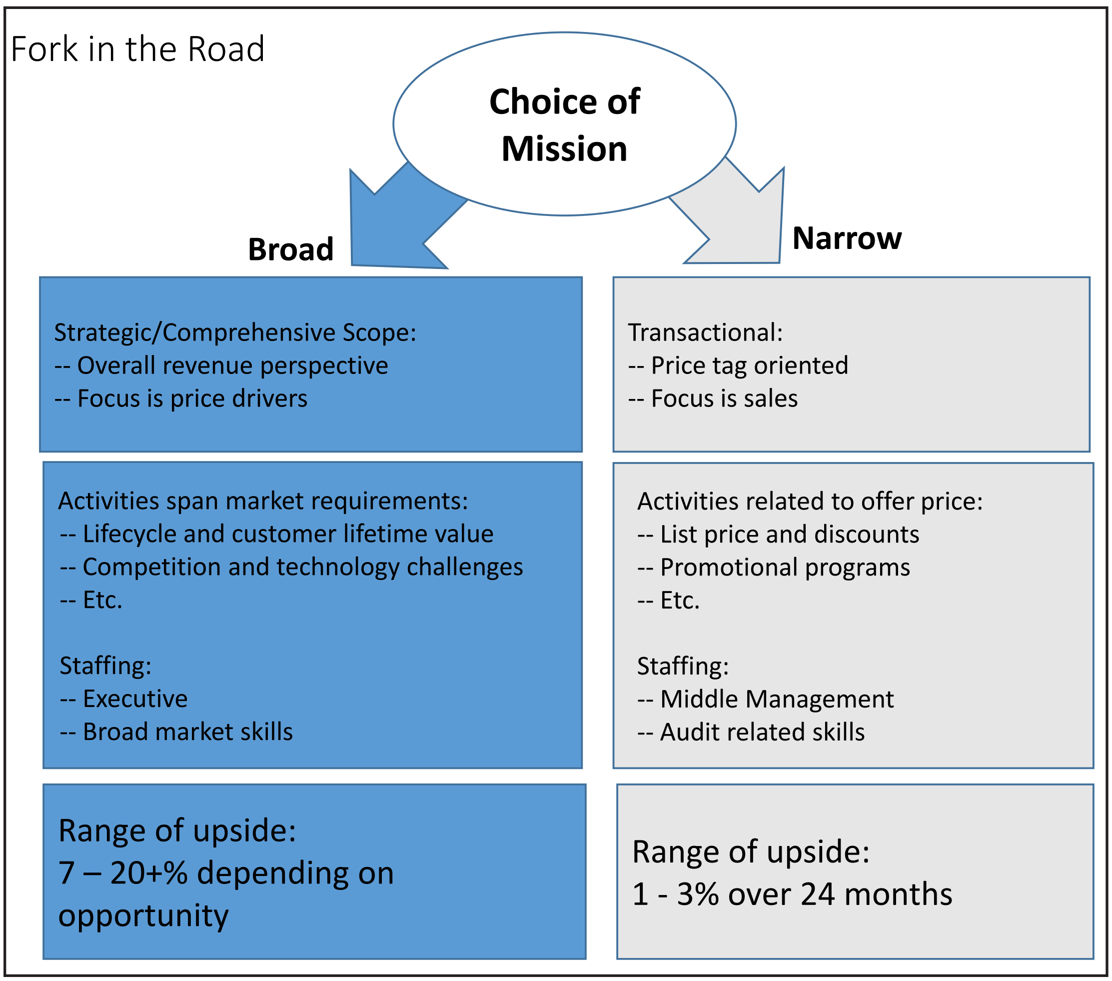
may include finding that some valuable services are not being charged, or that some products can be charged for in advance rather than in arrears. However, the primary challenge and pay-off will come in pricing and re-pricing a broad array of products and services.

The outcome of that battle will not be known for as long as 24 months. The reason for this is that switching vendors in most B2B markets, and some B2C markets, may take at least one budget cycle to manifest itself. Therefore if your company raises prices in December, but customers have already done their annual budgets and supplier evaluations in August, many customers may not have time to find alternatives to your products in time for the next budget, and so will retain the higher-priced products for the next year. However, come the following year, they will be set to cancel in December. So, any declaration of victory after the initial price rise would be premature.

A better understanding of the market is not the same as pricing simplicity. While senior management may sometimes be frustrated in grasping the price dynamics driving the company's top line, a call for "simplicity" is not always the answer. The trouble is that simplifying pricing can be very expensive. As customer prices are forced into fewer bands, all the drivers of price sensitivity such as customer economics, bundle buys, and competitive differences tend to be ignored.

Optimizing prices to segments and maximizing sales volumes is messy. In the case where J. C. Penney CEO Johnson insisted on simpler pricing, and limits to promotional pricing, the results were painful. Revenues fell by 28%, and *The Wall Street Journal* estimated that this program cost J. C. Penney $4.3Billion after 12 months of seeking pricing simplification.[1]

Figure 2




## Two Key Principles to Building an Effective Pricing Program

So, the challenge when building or developing a pricing function is twofold: how to build a pricing organization which goes beyond simple policing of past list prices, and how to position that organization so it is effective in working with other (established and powerful) functional areas?

**Product specific gains over the next 24 months**

As the new pricing organization does its first review of the status quo, there will be a number of quick-hit wins identified. Examples

Similarly, time is needed to evaluate the success of other potential pricing initiatives. New product pricing takes time to manifest success or failure. New pricing tools are always used when first rolled out under close scrutiny, but may languish unused a year later. Most pricing strategies take more than a year to work out.

Finally, managers with price responsibilities will improve results when attention is paid to their decisions by management (the "Hawthorne Effect"). This effect is not trivial. Various (non-price)

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studies on this effect have suggested a lift of 30-50% is possible in a wide range of human work spheres. Without careful study, the 2 – 5% lifts often attributed to some pricing initiatives (especially exhortations that "confidence" will "unlock value") can be revealed as temporary upticks driven by the observation effect, not permanent changes in the company's commercial posture (such as new price structures).

**An organization with the right positioning and clout**

Where a pricing organization sits must reflect it mission. A transactional organization can typically report into finance or sales, as its primary mission is maintaining financial integrity and price discipline. These are tactical decisions, and need to be in step with the financial and/or sales missions. Any linkage to top management agendas can be relayed down the line. Similarly, transactional issues need not be directly communicated up the line or occupy senior management agendas.

In contrast, a strategic pricing organization is, well, strategic in nature. It drives market performance and has a point of view which requires the full attention of market messaging/branding management, sales strategists, product developers, legal and other functions. The exact nature of the influence varies, but the main point is that only through a seat at the executive table—reporting to the CEO or COO—will pricing get the attention it needs in a timely fashion. It merits this time and attention in return for a material revenue and profit uplift. While the idea of direct representation in the "C" suite may seem surprising, it has worked well in the handfull of cases when it happens.

Failing that, direct senior pricing leadership is important if a company wishes to capture the benefits of a broader scope of pricing organization. The price level required will vary with the company culture, but it is essential to design a function which has the smarts and enough clout to accomplish its objectives. Your pricing organization can be an economy sedan, a turbo charged sports car, or a cargo van. Which do you want? The choices drive different outcomes (see Figure 2).

Recently, a leading food-service provider concluded that it had a $2.5B/year revenue opportunity through better pricing. However, against the advice of consultants, it concluded that a Senior Director title would suffice to head the function, and a handful of staff would suffice to oversee a highly distributed line management structure. The gains were viewed as "easy to accomplish." Not surprisingly, the predicted uplift is taking longer to realize than originally hoped.

Nothing is easy, but picking the wrong staffing model will result in delays, under-performance, possibly total failure of the initiative, or even market share deterioration. A typical failure scenario has an ineffective and under-resourced pricing department fail to set pricing direction, but simultaneously stymie pricing initiatives from outside the department

Why does management sometimes fail to properly develop pricing organizations? In part because existing management is not familiar with the art and science of pricing. Given the arcane nature of some pricing challenges, management may shy away from understanding those challenges in depth, and not invest the time required to obtain a deep understanding themselves. Time pressure and other issues lead them to believe that they can address the opportunity by bringing in someone who has done it elsewhere. This "checks the box" for pricing and frees up senior management to address challenges with which they are more familiar. That does mean, however, that they will judge pricing organization requirements based more on non-pricing implications—and that will always lead to allocating resources in favor of familiar functions such as sales or product, etc.

A common response to the proposition that big gains are possible if pricing is properly resourced is "My industry is different! Its more complex/regulated/weak/commodity than others." Yes, the strategy will vary by industry and even market position, but the application of functional pricing expertise can still make a useful contribution to that industry or market position. What may not be possible is radical change. Often companies within an industry are reluctant to innovate pricing, even if a better approach beckons. Such hesitation is often sustainable if competitors are equally reluctant and have a uniform cost position, market transparency, common customers, and face similar technological change.

Yet, over and over again what was once a uniform industry will show diverse results once one company breaks from the pack. Some industries have a strong consensus on pricing structures and strategies. For instance, the property/casualty insurance industry, music publishing, telecom, pharma, and brokerage industries once had a strong consensus on pricing. But eventually a player broke from the pack and gained share through new pricing and promotion. For example, Progressive Insurance and GEICO moved from a secondary players to the auto insurance leaders through new pricing. Progressive borrowed techniques from other industries to tailor rates to individuals, and GEICO used loyalty techniques previously developed in other industries to cement relationships and reduce marketing expenses. Again, forward looking pricing offers the largest rewards.

**Initial Steps:** As management grapples with the question of how to shape a pricing function so it meets its goals, there are two steps which represent "no regrets" undertakings:

**1. Fix some sick products and practices.**

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This will provide the new department with early successes and show it can be an ally to other departments:

**New Product Development:** Best practice is to require sign-off by pricing in an early stage of development so as to alert and involve the function. Common worst practice is to run to the pricing department shortly before launch, when all that can be done is jointly guess at a particular price tag. This may be all new product development expects of pricing, but in fact it neglects the opportunity to offer a new price structure. Apple has shown this to be the case in many of its new products, e.g. iTunes, iBooks, etc. A best practice is to require pricing sign-off for phase 0 development projects, so that pricing has advance warning of future pricing needs.

**Market Management:** New market opportunities are viable, or not, based on price. A good pricing function should be able to better answer question like 'what is segment x willing to pay?' than typical marketing generalists who tend to focus on channel, product and messaging. In particular, a demand curve can often illuminate opportunities and competitive positions, which will help marketing (and senior management) select the next initiative. Best practice is to include pricing strategists in the investigation of new markets, segments or opportunities.

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**Financial planning:** While pricing may not offer much in planning skills generally new to Finance, a close interaction may help set more precise financial goals and more realistic contingencies. For instance, in case of a revenue shortfall, pricing should have some contingency plans and can help guide how much of the gap will be addressable through pricing.

### 2. Influence incentives and provide choices.

Sales compensation and planning, and other incentive structures should be part of any pricing function's charter. If sales compensation is currently geared to simple revenue maximization, rather than a combination of revenues and margins, then this is a good place to set up linkages. Where companies have structured compensation to encompass margins, there is usually great harmony of purpose between pricing and sales.

Part of this evolution is the ability to create trade-offs for the salesforce. If the only tool available to pricing is 'yes' or 'no' on a particular deal, the role will reinforce the traditional complaint of pricing being the 'sales prevention department.' On the other hand, linkage to compensation can help sales own the tradeoff. Best practice: a leading information service would periodically, on important deals, offer reps the choice of a lower sales price in return for lower compensation. Frequently, after saying that a lower price would be required to consummate the deal, sales would nonetheless accomplish the sales at the normal price once their compensation was implicated.

## Conclusion

The objective of any pricing organization is to improve revenues and margins, but that falls short of the crisp definition needed. The mission of a pricing organization is often murky, because many stakeholders hold very divergent views of pricing. Some see pricing as the strategic interface between the market and the company, while others see it as a police force over sales and (other renegade) customer interfaces. Yet others are unfamiliar with the pricing science and discipline, and their main concern that this new function may interfere with their work.

The kind of pricing organization top management envisions is likely to be what it will get. That vision is determinative as it impacts the caliber of talent recruited, the titles and clout assigned, and the share of mind accorded to the new department. A comprehensive organization (strategy + transactional responsibilities) will always outperform the narrower transactional administrative mission, but if senior management sees the potential for only administrative gains that is likely to be all it gets.

Sadly, it is difficult to move from a narrow mission to a broader one. While in principle, the strategic mission is a superset of the transactional one, in fact the talent, the reporting relationship, and the resources differ dramatically. It is difficult to migrate from one to the other without major dislocation and—often—strong institutional resistance. Also the problem of making room at the senior management table will be compounded, as all the stereotypes of pricers as clerical, academic and detached from the market will have been confirmed. In contrast, beginning with the strategic is easier because this approach offers intelligent support to other departments, and higher returns to the company overall. If you import talent, you can let them run.

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