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Collaborative and Dynamic Pricing for Product Manufacturers

In this article, the author explains how, using a price waterfall, we can identify specific pricing decision areas that should be led by individuals in marketing, sales, and finance; and other pricing areas where the decision should be made collaboratively. Tim J. Smith, PhD is the founder and CEO of Wiglaf Pricing, adjunct professor at DePaul University, and Academic Advisor for the Certified Pricing Professional designation. His most recent book is Pricing Done Right: The Pricing Framework Proven Successful by the World's Most Profitable Companies *(Bloomberg Financial, 2016). He can be reached at tsmith@wiglafpricing.com.*

Treating the practice of pricing as a verb, not as a noun, applies pressure to the management of pricing decision making. But who makes pricing decisions? When and how should the latitude for pricing decisions be constrained for individual agents? While a general answer for all companies would be rather lengthy, a specific answer for product manufacturers selling through distribution channels has become clear.

Decision Makers

While the ultimate decision maker on any pricing issue is the business unit leader with profit and loss responsibility, that leader will often rely on subordinate agents and processes to drive most decisions. Since pricing impacts the entire organization's performance, it adheres to different agents secondary to the profit. Each leader should have responsibility for, or contribute to, different aspects of pricing.

In particular, three subordinate agents, all of which are supported by the pricing analysis function, are important in pricing for product-oriented firms. These are the marketing, sales, and finance leaders. Others may be involved, such as operations or legal depending on the decision making needs of the firm, but the three aforementioned are a constant.

Marketing, sales, and finance leaders each have specific domains of decision making which they lead, and others where they only contribute. There are even some decisions that must be made collaboratively through a pricing council, which includes all these leaders –and

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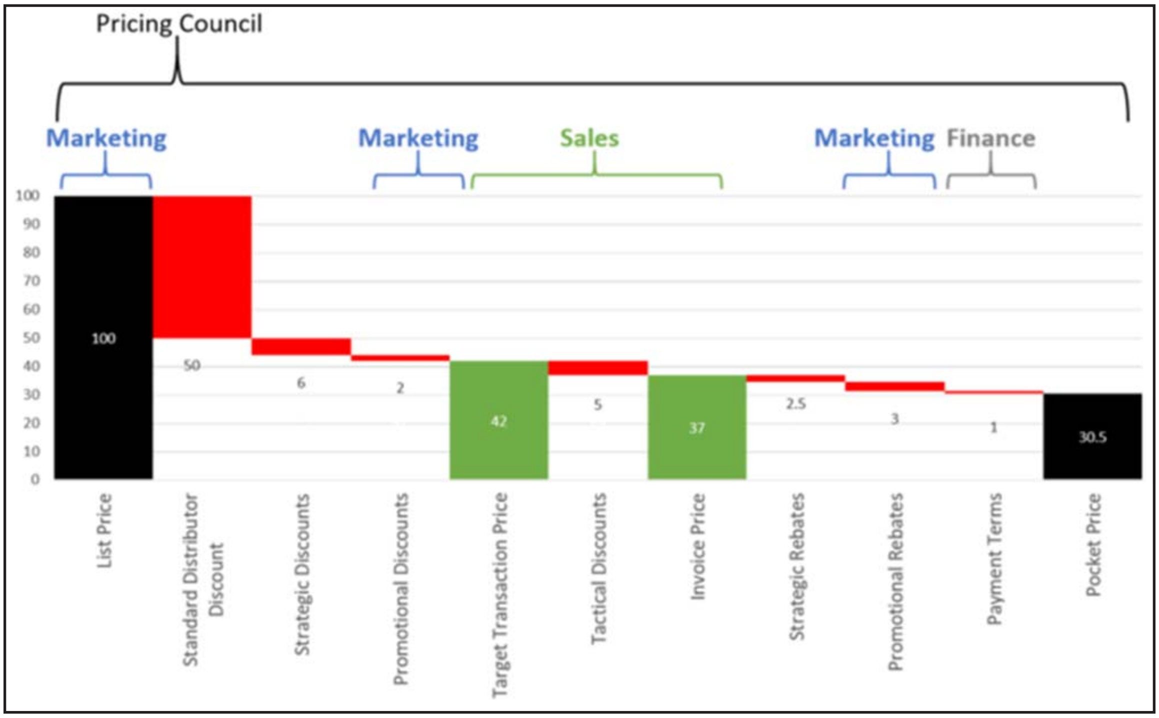
perhaps a few others.

Let us map these decision areas into the price waterfall. In a price waterfall, we can identify specific decision areas that should be led by individuals in marketing, sales, and finance; and other areas where the decision should be made collaboratively.

Figure 1: Price Waterfall



Price Waterfall

The price waterfall tracks pricing decisions and sources of price variance between the list price and the pocket price. As such, it can be used to delineate not only the pricing decisions, but also the responsibilities of different agents that contribute to pricing.

At a high level, we can classify price variances into seven different types, with four important price points along the way. While we do so, we will also indicate who makes decisions and who informs them. (A template price waterfall is shown in Figure 1.)

The starting price point is the list price. The list price represents the aspirational price for a product: the highest price a company expects an end customer to pay for that product.

In general, **marketing should make the decision on the list price** using market research and value-based pricing, with the advice and consent of other members of the pricing council.

From this end-customer aspirational list price, companies generally offer distributor discounts to ensure distributors can make a profit from selling the product, and therefore encourage distribution. This is denoted as the standard distributor discount. **Standard distributor discounts are generally industry norms.** Here, we come to one of the first decisions that is often made collaboratively by the pricing council, or at least by marketing and/or sales leaders aligning.

Other forms of discounts and rebates may also be offered. Discounts appear on-invoice while rebates appear off-invoice as credit notes. While the discounts and rebates encourage or enable different behavior, we will focus herein on the decision management aspect of these price variances.

Strategic discounts and strategic rebates both have the common attribute of being somewhat long-term price variance policies. By “somewhat long-term,” we mean they typically last for a year with annual review and adjustment. Examples may be an order volume discount, an annual purchasing volume rebate, or shipping terms.

Like standard distributor discounts, **strategic discounts and strategic rebates decisions are generally made collaboratively by the pricing council**, or at least by marketing and/or sales leaders with the approval of the pricing council. Specifically, shipping terms may be set by logistics or operations again with the approval of the pricing council.

Promotional discounts and promotional rebates both have the common attribute of being somewhat short-term price variance policies. By “somewhat short-term,” we mean they typically last for a day, week, month, or season. Examples may be an end-of-year promotion or seasonal promotion.

Promotional events are generally marketing driven yet their execution is dependent on the sales force. **As such, promotional discounts and rebates are usually best structured by marketing with the advice and consent of sales leaders and the approval of the pricing council.**

After applying all standard distributor discounts, strategic discounts, and promotional discounts, one arrives at the target transaction price. **The target transaction price represents the best price at which a company should expect a salesperson to close deals.** Most product companies allow salespeople to negotiate with distribution customers.

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During negotiation, distributors may extract additional tactical discounts leading to the invoice price. These tactical discount decisions can be managed through escalation policies and incentive alignments. **As a tactical sales decision, the sales leader manages them.**

Because they impact the profitability of products, the amount of price variance that could be allowed in a tactical decision should be managed collaboratively with leadership by marketing, and approval of the pricing council.

Payment terms, a credit note often applied to invoice, are often extended to encourage early payment of invoices. **As payment terms directly impact cash flow and the need for financing, the finance leader – with the approval of the pricing council – generally determines these terms.** Once all discounts, rebates, and payment terms have been applied to an order, one arrives at the pocket price.

Working Collaboratively

By tracking decisions through the price waterfall, pricing decisions can be brought under management control collaboratively. This solves several management challenges:

By tracking decisions through the price waterfall, pricing decisions can be brought under management control collaboratively.

1. The pricing council has overall responsibility for the pricing decisions as captured in the price waterfall.

2. Every member of the pricing council has clear and direct responsibility for some elements of the pricing policy while contributing to others.

3. Pricing decisions are aligned across the marketing, sales, finance, and other departmental leaders through their participation in the pricing council and their direct collaborative input.

4. Business unit executives can manage the pricing decision making process through their direct reports while avoiding unnecessary entanglement. (Most of the time in larger companies, the business unit executive doesn't even participate in the pricing council meetings on a regular basis, but rather evaluates outcomes and contributes only to important or contentious decisions.)

True, this paradigm doesn't cover every issue. Some known areas for further inquiry include:

- There are some pricing decision areas that have not been a priority assigned to an individual specifically, but they are under the responsibility of the pricing council. For these areas, we suggest using management's best judgement for assigning responsibility of drafting the plan while using the pricing council for adjustments and approval.

- The above paradigm doesn't address annual contracts and many other types of price variance. These variants can be accommodated through the price waterfall and decision responsibility can be assigned. We have left out these variants to keep the article somewhat brief and general.

Collaboration in price management is a ruling principal. Assigning decision making rights across members of the pricing council while requiring cross-functional input and alignment enables collaboration to occur with minimal friction and maximal efficiency.

Through a combination of standard, strategic, promotional, and tactical price variances, prices can be managed dynamically while the impact of specific pricing decisions, along with decision makers' responsibility, tracked and measured.

Nota Bene

Not all product oriented firms can or do follow this approach. It is provided as a template informed through research into practices of leading companies. There are many variations to this template. While we hold this to be a good practice, we do not believe every company should follow this practice because every company is different. We are providing it as a roadmap, a standard to which you can compare your company against and adjust appropriately.

What is deliberately missing from this essay is a singular assignment of the complete pricing responsibility to one function or another. Instead of stating that marketing, sales, or finance should own pricing decisions, we have made them each responsible for a set of decisions that impact pricing and demand that they work collaboratively through a pricing council to manage pricing overall. For some, this may be upsetting as it suggests taking control away from any one department or another. For others, you realize that this is just a template. Implementation is always contingent on the company.

Because a decision that is the responsibility of all tends to become the responsibility of none, it can be imperative to assign specific decision responsibilities to individual agents. And, because pricing decisions are intertwined and impact the performance of all, neither one agent nor decision can be made in isolation.

To reconcile these conflicting challenges, leading firms have adopted an approach that assigns decision-making responsibility to individual agents while requiring them to seek advice and consent among the other lead agents.