

First Deconstruct for Cost Then Reconstruct for Value

Deconstructing and identifying all the costs incurred by company operations can make companies more competitive as they eliminate unnecessary activities to lower costs and focus on delivering value in line with their competitive advantage, as the author explains. Navdeep Sodhi is Vice President of Pricing at Ceridian, Managing Director at Six Sigma Pricing, and author of the Six Sigma Pricing Blog. He can be reached at navdeepsodhi@gmail.com.

Value-based pricing is acknowledged to be the ideal pricing scenario for businesses, yet few companies have put it in practice. Most companies struggle with cost-plus pricing which simply requires charging a set margin over incurred costs. Companies also try other approaches, such as, competition-based pricing or willingness-to-pay, but without knowing their costs, these are equally or even more likely to lead to lower revenues and even losses.

But what does the cost pertain to? Depending on the industry, the physical costs can vary as a percentage of the total costs, as do the mix of its various cost components such as activities required to support the customer directly or indirectly.

To identify these activities, one approach is activity-based costing (ABC). **Over time, costs of activities change for better or for worse. ABC uncovers many activities taken for granted but never priced because their cost is considered “negligible”.** Then there are activities

that may have been outsourced but now these are out-of-sight and out-of-mind for the purpose of costing (and pricing). There is also a “hidden factory”¹ of activities such as rework that never attain visibility – and are therefore not priced – but nonetheless incur cost.

To figure out whether or not to price something we should first know all the costs and then figure out whether or not they need to be bundled. Consider the example of airline pricing. Many activities go into supporting a passenger and usually these are priced with the ticket. But some airlines are pushing the unbundling envelope by separately charging for even activities like the passenger’s use of toilets on the plane!

Consider the example of Ryanair. The carrier charges £30 to check in a bag, £10 to pay for flights with a debit or credit card, £60 to check in sports or music equipment, £15 for each kilo of excess baggage, £50 to change a flight and £100 to change the name on a ticket. It now plans to charge for £1 for using the toilet.² All this to keep the ticket price competitive!

But before companies start charging customers for using the restrooms on their premises, they need understand the activities supporting different customers. This would require:

1. Activities-based costing, at least for customer-supporting (and related) activities

2. Find if any activities related to customer were outsourced where, directly or indirectly, your company is incurring cost

3. Uncover the “hidden factory” of activities that are not “standard” in terms of ideal business processes but nonetheless occur and incur costs.

Whether the costs of these activities are bundled into the price or not, knowing these activities and their costs may reveal a clear competitive advantage that can be the source of confidence in explaining to your customers why your prices are what they are and where and how you add more value to them relative to competition. Now such a cost-plus approach supports competition-based pricing and even value-based pricing.

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Endnotes

1. Miller, JG and Vollmann, T.E., The Hidden Factory, HBR, 1985. See also, Kaplan, R., One cost system is not enough, HBR, 1988.

2. <http://www.telegraph.co.uk/travel/travel-news/4861505/Ryanair-may-charge-1-for-toilet-use.html>