



While Six Sigma methods have been used by manufacturing firms to implement quality initiatives in many areas, they have not generally been applied to pricing processes. Drawing on one company's experience, author Navdeep S. Sodhi shows how this can be accomplished. Navdeep is a pricing practitioner and thought leader with 12 years of global experience, spanning the airline, medical device, and manufacturing industries. This article was reprinted with the permission of Quality Digest Magazine. The case history described here is more fully explored in Six Sigma Pricing: Improving Pricing Operations to Increase Profit (FT Press, 2008), which Navdeep co-authored. For more information, please email: navdeep@isixsigmapricing.com.

Improving Pricing Quality with Six Sigma Methods

Quality in pricing has become increasingly important in many industries as the costs of raw materials skyrocket; the U.S. dollar plunges against other currencies; and companies face stiff competition worldwide.

The difference now is that, for many manufacturing firms, the tool set for implementing and deploying quality initiatives is quite sophisticated. What's lacking is a means for targeting and adapting these tools for pricing.

This article describes a situation faced by a real company—we'll call it Acme Industries Inc.—which was compelled to adapt

its Six Sigma manufacturing expertise to improve its pricing processes.

Red Alert at Acme

Executives at Acme Industries Inc., an industrial manufacturer, called an emergency planning session. Unless they could improve profits within one or two quarters, the company's profit projections to Wall Street would seem foolishly optimistic. The firm had already cut costs as much as possible. Now it would have to increase prices without losing sales. The question was how to do that.

In the past, the company aggressively pursued market share by allowing sales representatives great flexibility on price. However, Acme's dollar sales grew only

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The Psychology of Pricing

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marginally in a bullish market, while profit plummeted. Then, over one year, drastic inflation in the cost of critical raw materials motivated the company to push for higher prices, even if it meant losing some business. The firm's dollar sales remained flat. Operating profit grew by more than 10 percent, but the stock price remained below expectations. Management reverted to capturing market share through lower prices, even though raw materials costs were rising. Annual sales, operating profit, and stock price were all down.

In addition, Acme had internal issues due to its complex manufacturing processes, as well as several pricing functions that contributed to price leaks. Marketing owned pricing strategy; sales was responsible for fixing the customer's price; and finance was responsible for all reporting.

The different incentives in different functions led to variations in basic processes, shortcuts, double approvals, and a "buddy system," even in the same product line and sales region. When someone tried to lead a discussion on price improvement, it degenerated quickly into a "blamestorm" rather than a brainstorm.

Six Sigma for Pricing

During the emergency meeting, the pricing manager showed two slides (see Figure 1, below) that reflected the wide variation in discounts—from 5 percent to 95 percent—offered to customers within a single stock-keeping unit (SKU), regardless of the customer's size or even the transaction.

Senior managers began to understand that this variability was a problem. Acme had enjoyed considerable success in reducing manufacturing variability by applying Six Sigma, so they agreed to pilot a similar project for pricing in one of the company's North American subsidiaries. They appointed the pricing manager to lead the project and the five Six Sigma DMAIC steps: define, measure, analyze, improve, and control. A Master Black Belt was recruited from manufacturing to help.

Define

The project was limited to one product line. The manager proposed that a defect be defined as a transaction invoiced at a price lower than the one approved by pricing (or lower than the current blanket guidelines, when approval hadn't been sought).

The project would have to deliver both a better understanding of the existing pricing process *and* a modified process to improve and control final transaction prices or discounts.

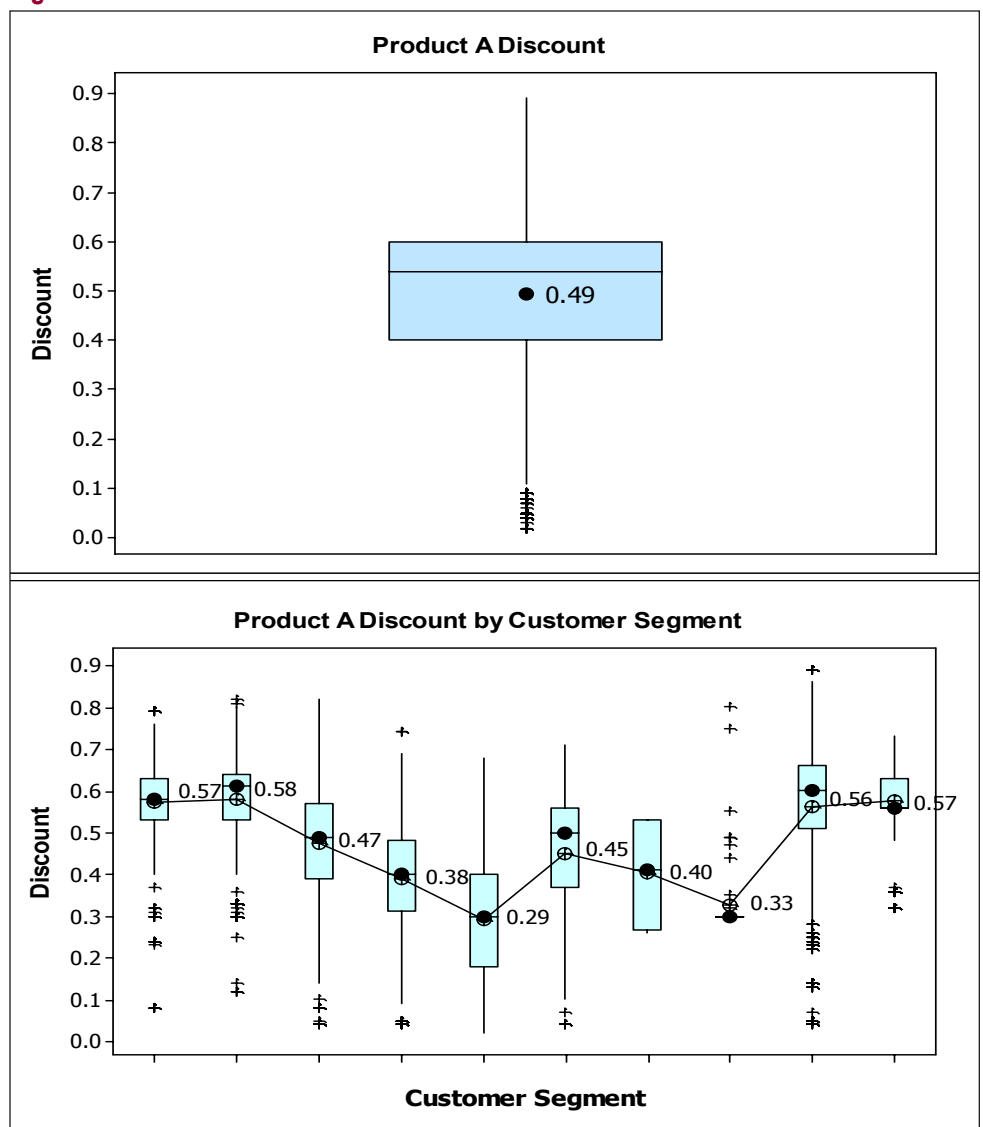
The project manager then enlisted people from pricing, finance, marketing, IT, and sales for the Six Sigma team. He

also chaired a steering committee which included the director of sales and vice presidents for IT, finance, and marketing. The committee set a project goal for the first year (following implementation) that revenues should increase by \$500,000 without incurring losses in market share or unit sales volumes.

Measure

The project manager interviewed colleagues from IT, sales, pricing, finance, and marketing. He also sought informal feedback from other people in these functions to draw a high-level diagram of the entire process and to show how information flowed from one step to the next. The map revealed a pricing process

Figure 1



with six main steps. In practice, however, the sequence was replete with exceptions and shortcuts.

Step 1: Perform Initial Price Assessment with Customer. The inputs for this are: the list price, the blanket-discount guidelines for sales in the particular market, and the customer's product and pricing requirements. The output is a discount taken off the list price. Approval is needed from pricing if the discount is deeper than the maximum authorized for the particular market.

Step 2: Request Pricing Approval. For pricing personnel receiving such a request, the inputs are: the price the sales rep has requested and the guidelines for pricing analysts. In practice, sometimes a sales rep offered a final discounted price to the customer without prior approval.

Step 3: Compile Quotation Information. The inputs are the information about the customer and the order provided by the sales rep to support his or her request. The outputs are the complete details of the transaction. In practice the sales rep didn't, or couldn't, provide enough information about the quotation.

Step 4: Review and Analyze Quote. Inputs are the completed quotation information generated in the previous steps, including the tentative price that the sales rep requested, reports summarizing the history of similar transactions in the particular market; and, when available, reports of similar transactions with the same customer. In practice, with information scattered in different computer systems, the guidelines available to the pricing analyst could be quite poor, or the sales rep might request a quick turnaround, leaving little time for an analyst to carry out this step effectively.

Step 5: Communicate Approval to Sales Office. The inputs are the tentative approved price from the analysis in the previous step and any additional information regarding the order and the customer. The output is the approved price. In practice, this could be the beginning of a prolonged negotiation between sales

and pricing. A senior sales or marketing manager might weigh in at this point as well, and the final approved price could end up quite a bit lower.

Step 6: Submit Price to Customer. The input is the approved price. The output is the tentative price for invoicing that the sales rep submits to the customer. In practice, the price that the rep actually offers to the customer could be quite a bit lower than the approved price.



The team also assessed the quality of the input data that supported the pricing process and found the sales transaction data to be reliable.

Analyze. The team, with the help of the Master Black Belt, used a cause-and-effect matrix to guide discussion toward identifying and prioritizing problems. This exercise suggested the defects arose largely from problems in steps 1, 4, and 6, and from failures in reporting.

Step 1. The team found that sales reps' ability to help customers select the right products and features was critical in managing their buyers' price expectations. Unfortunately, salespeople's failures in assessing customer requirements couldn't be easily detected or controlled.

Step 4. Reps sometimes wanted discount approval within hours of forwarding a request, which made it difficult for pricing analysts to determine whether the discount was reasonable.

Step 6. Sales reps sometimes offered final prices to customers without prior approval, leaving pricing with little choice but to agree to them after the fact.

The information reported on these transactions was neither gathered nor presented consistently. This led to further variability in how analysts made decisions about prices.

A study of all transactions occurring in the two years before the project started determined that the discounts awarded were bell-shaped in distribution. Using analysis of variance, the project manager concluded that different pricing guidelines had to be set for various transaction sizes and territories within the same market—and possibly even for customer groups.

Improve

Speedy responses were critical for salespeople to close deals, but this was a challenge for pricing personnel. Clear guidelines were needed when granting deeper-than-usual discounts.

The project team proposed giving graduated discount-approval authority to individuals in three levels of the organization's hierarchy: sales reps or managers, pricing analysts, and the pricing manager. Making the guidelines and the escalation process clear sped up the transaction process.

In cases where sales reps had already offered a customer a price and needed after-the-fact authorization, a new process required that the rep involve her boss for approval. The price already offered would still be honored, but now representatives could be held more accountable for making unauthorized commitments. Exception codes enabled Acme to track the reasons for price variations and who had been involved in deciding to deviate from the guidelines.

Control

Acme set up a monthly review during which executives—mainly the vice presidents of marketing, sales, and finance, along with their direct reports—looked at the company's overall performance, as well as particular geographic markets and transaction size.

They determined whether the new process resulted in higher average transaction prices, fewer exceptions, and no loss in market share. If prices were under control but the firm lost market share, then the group would review pricing guidelines. The team also checked exception codes to see who was deviating from the process.

Results

The initial goal of generating \$500,000 in incremental revenues during the first year was handily exceeded in only three months. More importantly, a subsequent across-the-board list-price increase was fully reflected in the top line for this product.

By contrast, other product lines realized less than half the increase. That list-price increase, together with the tighter controls the Six Sigma team developed and implemented, resulted in \$5.8 mil-

lion in incremental sales in just the first six months of implementation, all going straight to the bottom line.

Organizationally, the Six Sigma approach considerably reduced the friction in the pricing-sales relationship. Systematically collecting and analyzing transaction data gave pricing analysts hard evidence to counter the more intuitively based claims used by the sales staff when negotiating discounts. A frequent claim, for instance, was: "My customers want just as high of a percentage discount for a \$1,000 transaction as they would get for one of \$100,000."

Knowing now that Acme's customers tend to accept lesser discounts on lower-priced transactions, and that some are willing to pay higher prices, analysts can more easily push back when negotiating price approvals with sales personnel.

Salespeople, for their part, are less likely to feel that the pricing team is driven by political motives or a desire to assert control. Moreover, they can use the same data to press their own points. For example, some sales offices that had been under scrutiny for aggressive pricing practices were shown to have been

acting reasonably given their local market conditions.

In light of the project's success and its low cost, Acme is rolling out Six Sigma pricing across the organization.

Why Six Sigma Pricing?

This success story doesn't fully reflect the challenges of applying Six Sigma. Pricing processes have many stakeholders and not all of these will perceive this kind of project as a win-win situation, even if it adds significantly to the company's bottom line. Some may even try to sabotage it at the first possible opportunity. Moreover, a number of key customers for pricing are internal, and their requirements may not be clearly stated. Additionally, processes (when they do exist formally), are notable mainly for the lack of discipline or effort shown in following them. Therefore, Six Sigma tools, such as failure mode and effects analysis, are critical in a successful control plan.

Overall, the benefits from applying Six Sigma or other quality-based approaches to pricing are huge compared to those brought by more traditional manufacturing or services projects.

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