PROFESSIONAL PRICING SOCIETY

The PRICING ADVISOR

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Current events can provide valuable pricing lessons. Using excerpts from The Wall Street Journal, *Holden Advisors first discuss pricing strategy's "Red Zone," sticking to your guns when raising prices and the fallout in a drug-pricing case study. These excerpts are being reprinted with permission from the newsletter produced by Holden Advisors principals Reed Holden and Mark Burton. You can find more information at the Web site holdenadvisors.com or by calling the firm at (978) 405-0020.*

In This Issue:

Have a pricing article, case study or story to share? Send articles to editor@pricingsociety.com.

Practical Pricing Advice From Holden Advisors

Watch Out for the Red Zone

Observations by Dr. Reed Holden, from "Profits Likely to Slow in '07" by Constance Mitchell Ford and Rafael Gerena-Morales, *The Wall Street Journal*, Jan. 2, 2007:

Well, it's been a great run of profit and sales increases for a lot of businesses. But if you listen to some of the leading economists, the party might be over for a while. Projections for 2007 are for slowing growth in many markets and declining profits. Price increases, which have been used to cover increasing compensation and components costs for the past few years, are going to be tougher to make stick.

Unfortunately, most sales and pricing managers have a terrible habit of overreacting when this happens and use price discounts to solve the problem. The real problem is that the more they discount,

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Workshop attendees will be whisked directly from the hotel to the aquarium and will have tickets to tour the aquarium before the fabulous celebration reception starts. The reception itself takes place at The Oceans Ballroom, which features a spectacular aquarium viewing window. A heavy hors d'oeuvres meal will be the highlight of the evening and will be provided by Wolfgang Puck Catering.

The festivities are open to workshop attendees only at no extra cost. We wish to thanks the Deloitte Pricing Center of Excellence for exclusively sponsoring and making this wonderful event possible.

For details on the five CPP workshop choices being offered and to sign up, go to www.pricingsociety.com.

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the more competitors will discount, all to the joy of customers. **The net result is that profits don't just decline, they disappear during what we call "the Red Zone" of pricing strategy.**

The Red Zone occurs when market growth slows, price increases don't stick and price discounts don't buy you any more volume; it's just not there any more. These tactics work great in growing markets, but the longer managers use them in slowing markets, the more damage they do to the company and the market.

The problem gets worse when managers get desperate and begin offering price discounts on high-value products and services. This undermines pricing leverage and causes commoditization of those products and services. That commoditization is almost impossible to stop once it starts.

So what is a manager to do? The first step comes out of an old fire-safety book: Don't panic. Easier said than done? Yes. But when a manager panics because he or she isn't going to hit their quotas and begins to use price discounts, the value proposition that the firm spent years building evaporates faster than you can say "price war." This is a bad price war.

The simple advice is:

♦ **Don't confuse elasticity of demand with cross elasticity of demand, where customers just switch back and forth between competitors** without increasing their order size.

♦ **Understand likely competitor strategies and target them in weak feature areas** with high-value products and services, and in competitive strongholds with low-value products and price discounts.

♦ **Understand customer negotiating strategies and move the discussion from price to value – learn how to play better poker.**

My guess is that this year we'll be hearing about more price wars than ever. The sad thing is that they could have been avoided with a little advance thought and planning.

You Have the right — No the Responsibility — to Raise Prices!

Observations by Mark Burton, from "Profit In Mind, NASDAQ is Raising Fees – and Brows" by Aaron Lucchetti and Kara Scannell, *The Wall Street Journal*, Dec. 8, 2006:

> Often the only real barrier to a price increase lies within the minds of the team trying to carry it out.

One of the major stock exchanges, the NASDAQ, is taking hits in the press because, horror of horrors, they are raising their prices.

Last time we checked, that's a pretty good way to make more money. Some would say the trading data that the NASDAQ generates is a public good as timely, accurate information is a key ingredient for well-functioning financial markets.

Gee, that sounds nice, but let's not forget that data are generated using NASDAQ assets, and that it is also a public company with profit and growth goals.

This problem isn't unique to the stock exchanges. We find a similar pattern in a lot of businesses that create and sell high-value data. Customers depend on it, and the really good stuff is usually only available from a few sources.

As a result, they feel uncomfortable and raise a stink, because they don't have alternative sources for a critical business input. **Complaints about fairness make many executives very nervous** about raising their prices.

Our advice? Get over it and play hardball. What customer in their right mind is going to be happy about a price increase? Define what the increase is going to be and stick to it.

The worst thing that a firm can do is announce an increase but have an internal goal that is actually much lower. Everyone knows that game, and you just increase the perception that your prices are negotiable.

If you have a high-value offering, customers may complain, but they will pay you. Often the only real barrier to a price increase lies within the minds of the team trying to carry it out.

Drug Pricing: Much Ado About Something

Observations by Dr. Reed Holden, from "Inside Abbott's Tactics to Protect AIDS Drug" by John Carreyrou, *The Wall Street Journal*, Jan. 3, 2007:

I've long been a believer that pricing of pharmaceuticals is similar to pricing of other products, even BTB products. But the story of how Abbott Laboratories has recently re-priced its AIDS drug Norvir points to a big difference that's worth noting.

The difference is when pricing drugs, it's often a matter of the public trust. Something that Abbott underestimated when

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they raised the price of Norvir. **Fortunately, the pricing move does have a number of learnings for us all.**

With the introduction of protease inhibitors over 10 years ago, drug makers moved AIDS from a deadly disease "into a chronic, manageable illness for many patients."

The poster person for this result is former basketball star Magic Johnson. The initial lead drug in this effort was Norvir when used in conjunction with drugs from other makers to achieve this terrific result.

Then Abbott developed a new drug three years ago that could replace the cocktail and, coincidentally, eliminate the need for competitive products. Reflecting this value, Kaletra was introduced with a yearly price of $7,000, which was $5,000 more than the Norvir cocktail.

Good idea? On the surface, yes. They priced to reflect the value. This is how you price products in early phases of a product's life-cycle. But once users begin to adopt the new "technology" over older ones, that strategy should change.

Called product migration, this is what Intel did years ago when they established their 386 processor initially at a higher price than the 286 processor, which had competitors. But once the 386 processor got established and entered the growth phase of adoption, they dramatically dropped the price to encourage users to switch to the faster processor.

Rather than drop the price of Kaletra and undermine its franchise, Abbott decided to raise the price of Norvir by 400% to encourage people to move to Kaletra.

The problem is that some people can't make the move for two reasons. First, they can't afford to. Second, the Kaletra solution is not as effective as Norvir for all people.

> In consumer markets, there are laws at the state level that protect consumers from dramatic price increases. It's called consumer fraud.

Abbott took care of the first problem by exempting government programs from the increase and increasing their support of subsidies to consumers who can't afford the drug.

They didn't effectively take care of the second problem, and that's the rub. Now, there is a significant backlash from consumers and physicians as a result of the increase.

I am a big believer in **taking advantage of market forces. Boeing is doing that now by keeping prices high on their freight-carrying jets because Airbus is stumbling with new product introductions.** There's nothing illegal about that.

But in consumer markets, there are laws at the state level that protect consumers from dramatic price increases. It's called consumer fraud. This is what should prevent stores from jacking up the prices of generators during long-term power outages. The problem is that it is done on a state-by-state basis. That is where the backlash is coming to Abbott.

The executives at Abbott might argue that this will blow over, and the net result will be higher profits and sales for both products. I doubt it will be that simple. State prosecutors have a lot of tenacity when it comes to pursuing fraud by large corporations.

One successful case will lead to another one. If this gets some momentum, I would expect to see pressure to standardize the laws at the federal level so this can't happen in the future.

You might argue that this is "much ado about nothing." I would agree but for one simple fact: **Abbott accepted government support for researching this drug. This makes the argument for pricing to the public good more than a moral one.** It makes it a legal one, and the pricing guys at Abbott will find that it is much ado about something.