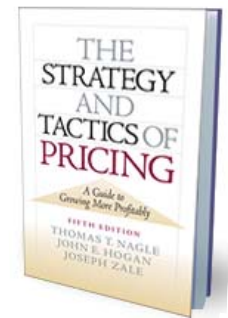


Stop Reacting to Buyers' Price Expectations; Manage Them

by Thomas T. Nagle, Joseph Zale and John Hogan



Expectations drive behavior and nowhere more so than when setting prices. A customer's decision to buy something at the offered price, or not, depends upon more than the tradeoff between benefits and price. It also depends on customers' expectations, and their experience answering this question: how might our behavior influence the prices we have to pay? For example, a retail consumer may believe that a new fall fashion is well worth the price asked for it in September, but still not buy it if she expects that the store following its past behavior will have a 20 percent off sale within the next month. A policy of regular, predictable discounting has trained many retail consumers to wait for the sale price. As a result, sales at regular prices are less than they would otherwise be, increasing the amount of inventory that ultimately will be sold at the lower sale price.

The same dynamic plays out—only more so—when businesses sell products and services to other businesses. Professional buyers have learned to hold their purchases until the last couple weeks of each quarter when sales managers are often willing to discount more deeply to achieve their quarterly goals. Sellers in these situations see the increasing

EXECUTIVE TAKEAWAYS

- Pricing policies empower companies to manage customers' price expectations, and avoid the cycle of discounts and giveaways that hurt profitability.
- Effective policies set expectations during pricing negotiations and improve a company's competitiveness.
- Moving from a disjointed pricing environment to coherent policies requires clear communication from a company's leaders—and a willingness to lose unprofitable customers for longer term gains.

This article is adapted from the authors' new book, *The Strategy and Tactics of Pricing* (Prentice Hall, 2010).

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portion of their sales made when prices are discounted as a sign that customers are becoming more price sensitive in their brand choice. In fact, they are only responding to incentives for how to get a better deal on what they were otherwise willing to buy at a higher price.

Periodic, predictable discounting is just one of many ways that sellers undermine their pricing power by making decisions for short term sales gains that adversely affect buyers' future behavior. When sellers give customers a "special price" if they receive a better offer from a competitor, they create the expectation among buyers that creating a competitive process for their business (for example, a reverse auction) will be rewarded. When sellers allow customers who delay contract renegotiations to continue paying the old price until a new contract is signed, customers find more ways to delay the process. In these and many other situations, the impact of a pricing decision on purchasing behavior can affect profitability long after the initial transaction that created them.

Fortunately, a company can change its customers' expectations by changing its own behavior. Some retailers have changed the expectations that it is better to wait for a sale by offering "30-day price protection," enabling

deal-sensitive shoppers to receive a credit for the difference between the sale price and a price paid within the prior 30 days. Some companies refuse to match a lower competitive price without making an "apples-to-apples" comparison of features and services. Companies preclude unnecessary delays when negotiating new contracts by rigidly enforcing a policy that customers without a contract pay list price, which can be partially rebated only once a new contract is signed. In each of these cases, the goal is to stop rewarding undesirable customer behavior.

Expectations in Price Negotiation

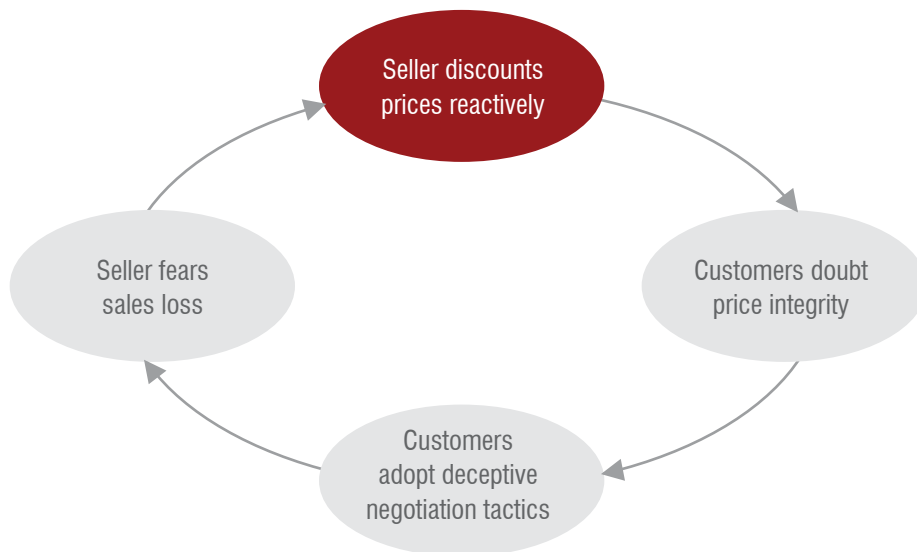
Companies create the most damaging customer expectations when they negotiate prices without policies that tie those prices to customer value and cost to serve. In fact, one might argue that the entire "strategic sourcing" revolution was a reaction to a move by sellers to "empower" their sales organizations to become flexible in pricing. As buyers learned that a seller's prices varied reactively based upon what was "needed" to close each deal, they began to adopt purchasing tactics to commoditize the seller's offer and to hide the value to them of differentiation. In this way, buyers learned to control sellers' expectations and thus the prices they receive, rather than the seller managing the

buyers' expectations about what prices they need to pay. Figure I below illustrates this destructive cycle.

For example, a purchasing department might issue an RFP that focuses only on product specifications even though service levels or supply reliability will be an important choice criterion. After soliciting a range of bids, the purchasing department will give the sales rep a “last

look” at the low prices of other suppliers for the “same” product and solicit a last best offer. The sales rep, fearing a loss to credible competitors, argues for giving the customer a “special price.” Even with that further concession, the purchasing department will still award lower priced suppliers a share of the business to keep them in the game. After selecting its preferred supplier at a competitive price, the purchasing

FIGURE I: DESTRUCTIVE CYCLE OF REACTIVE DISCOUNTING



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department specifies its service expectations as a “contracting issue” and the department awards its preferred supplier all the orders that require services that cheaper suppliers could not deliver as reliably.

Many sellers we’ve met claim that they preclude such manipulation by enforcing a discount approval process: a sales rep can discount up to 5 percent, his regional manager 15 percent, the VP of sales 25 percent. But the moment a sales rep tells the customer that he will have to get approval for a lower price, the seller knows that there is a process through which some buyers are actually getting larger price concessions. The buyer’s challenge is simply to figure out how. Even if the Division President needed to approve a price exception, the lack of objective pricing criteria rewards buyers for their success in manipulating the seller’s expectations. Because senior managers are even more isolated from customers’ needs and alternatives than sales reps are, their expectations are even easier to manipulate.

Pricing by Policy, Not by Exception

The key to improving buyers’ price expectations is thoughtful pricing policies. Purchasers have policies (for

example, a buyer must get at least three bids and purchase no more than 60 percent of consumption from any one supplier) to ensure they do not pay too much. Sellers need policies to make certain they are not paid too little relative to the value they deliver. A pricing policy states explicitly the criteria that, say, a regional sales manager should use when deciding whether or not to exercise his authority to grant a 10 percent discount. It must be applied the same way by all sales managers to all similar requests.

The process for developing good policies involves treating each request for a price exception as a request to create or to change a policy that could be applied repeatedly in the future. The more requests, the more likely it is that a policy, or the more fundamental price structure, is in need of review. In the beginning, if the firm has few clearly defined or consistently followed policies, a lot of potential deals will end up as requests for price exceptions. As new, well-thought-out policies are put in place, customers and sales reps will learn that ad hoc exceptions to policies will not be granted. The only requests for “special pricing” that should be considered are those involving situations not already covered by a policy.

Putting a “no exceptions” stake in the ground is a key to making pricing decisions that are profit enhancing. Most discount proposals, whether to reduce price to win business or to increase price to exploit tight supply, have an immediate reward that is obvious and a cost that is delayed, diffused over more accounts, and is less transparent. In contrast, pricing by policy forces companies to consider the impact on the entire market when making a pricing decision. It should involve asking whether it makes sense to establish a policy that the proposed pricing option could be offered to all customers like this one and still be profitable. Making the decision a policy question has an important effect: it forces decision makers to think through the broader and longer-term implication of the precedents they are setting. Creating the policies is not the responsibility of sales reps or local sales managers since they do not have the perspective on the overall market or the long-term incentives to optimize the balance between immediate and long-term profitability. Policies are the responsibility of management at a market level.

Pricing policies cover more than just discounting. They include the company’s pattern for passing along changes in raw materials costs (such as requiring that all long-term contracts allow for

adjustments versus adjusting only after a fixed-price contract expires) and its pattern for inducing product trials. Pricing policies also deal with how a company will respond to low price offers made to its customers by a competitor. Any pattern creates expectations for how the company will deal with such issues in the future, and thus can change customers’ future buying behavior. Pricing policies also influence how your sales reps sell and which ones succeed. Who is most rewarded at the company: the sales rep who sells at high margins by understanding customers well enough to communicate value, or the rep that drives big volume at a few accounts by understanding his company’s management well enough to make the case internally for price exceptions?

Ideally, policies are transparent, are consistent, and enable companies to address pricing challenges proactively. If your policies are transparent, customers need not engage in threats and misinformation to learn the trade-offs you are willing to make. Consistency communicates that it is impossible to “game the system” by contacting multiple points in the company to find the best deal. Communicating policies proactively is much less contentious than telling a customer reactively that a proposal of theirs has, after some delay for review, been rejected. Over time, a company’s policies can become a source of competitive advantage—creating expectations that drive better behavior on the

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part of customers and competitors, and empowering sales reps to offer creative solutions more quickly and with less effort wasted selling their discounts internally.

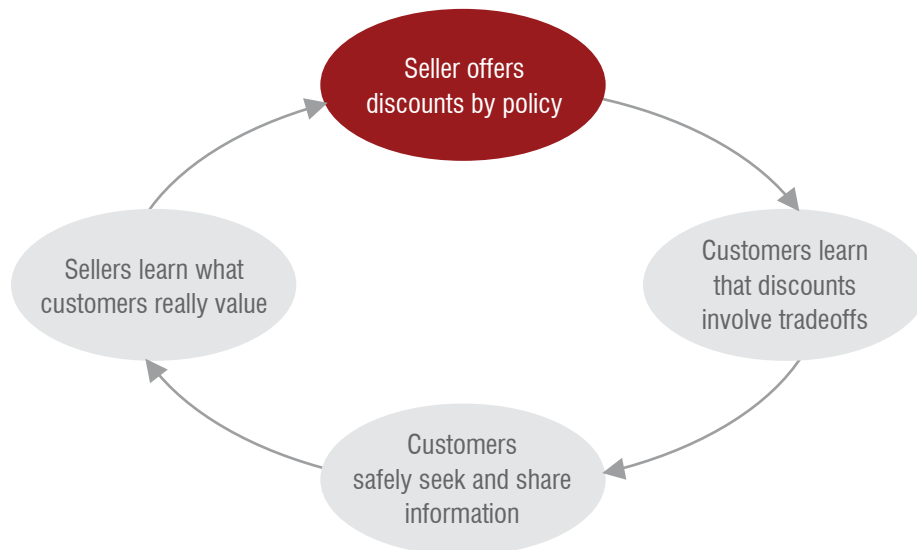
Pricing Policies: A Source of Competitive Advantage

Over time, a company's policies can become a source of competitive advantage—creating expectations that drive better behavior on the part of customers and competitors while empowering sales reps to offer creative solutions

more quickly and with less wasted effort. Consider the example of the purchasing department that separates service and supply requirements from the specifications in an RFP. There are multiple policies that, if applied consistently, could change expectations and improve customer behavior. Figure II below illustrates how policy-based pricing can create a more constructive cycle of expectations and behaviors.

In response to the RFP, the company could either offer both a full-service option or a lowest price option with ser-

FIGURE II: CONSTRUCTIVE CYCLE OF DISCOUNTS BY POLICY



vices stripped out and rules for ordering (such as requiring online purchases) and delivery (must accept shipments 24 hours, seven days) that would make low pricing viable. Customers would no longer be able to use “last look” price comparisons with non-comparable offers as a negotiating technique. That would force the purchasing department to understand what really created value for the firm, perhaps leading them to propose a hybrid between the two offers. They might also try to understand how their behavior drives costs for the seller and explore how other cost-reducing behavior changes might justify a better price.

The seller may have avoided ever having to submit a bid for an incomplete RFP if it had practiced another pricing policy: putting prices on all differentiating services and reporting the buyer’s use of them even when they were unbundled. Each invoice would report how much of each service was used, what it would have cost at the à la carte prices and the credit to the customer’s account because the service was “included” in the bundled price. Then, if asked to compete with a lower price for the product alone, the rep could point out that the company’s product prices were already competitive after subtracting the service costs the buyer incurs.

Policies for Transitioning from Reactive to Policy-based Pricing

In markets where volume comes mostly from repeat purchasers, it is difficult to transition from poor policies to good ones all at once. Customers have already developed expectations that they can get rewards from undesirable behaviors. They will continue those behaviors for a while until their expectations change. It takes time to change expectations within the seller’s own company and to develop good policies. We have seen the move to policy-based pricing fail when management implements a rigid one-price policy with no plan for the transition.

A statistical technique that we call price banding enables managers to estimate how much of the price variation across accounts reflects legitimate tradeoffs and how much this variation needs to be eliminated. The first policies should focus on identifying and managing the outliers: “outlaws” who now enjoy prices much lower than other customers for the same products, service levels, and commitments.

The reason to start with the outlaws is because they are the least profitable accounts, so there is less at risk if they take their business elsewhere. These

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outlaw accounts pull down the prices that other customers pay as well—either as a result of information leaking into the market about their pricing or because their competitive advantage in purchasing enables them to take share from others who buy at a higher price. The customer needs to be contacted by someone above the sales rep (the person’s level dependent upon the size of the customer) to communicate that, while the customer has gotten a much better deal than others in the past, top management is unwilling to continue pricing that is unfair to other customers and unhealthy for the supplier.

With the bad news delivered unequivocally by management, the sales rep is now free to initiate a give-get negotiation in an attempt to save the account. He can contact the customer to learn if there might be some tradeoffs they would consider to mitigate the size of the mandated increase. Various concessions on the part of the customer consistent with those made by other customers could reduce some costs. With the ability to use a second or third source as a bargaining chip now unnecessary, the buyer might even be willing to sign up for an exclusive supply contract to qualify for a discount that would reduce or eliminate the impending increase. If the seller is committed

to pricing by policy, it can offer the outlaws “most-favored nation” contracts insuring them that, although their prices are increasing, no one else is getting a lower price.

Finally, the seller might create a policy authorizing a period of transition to a legitimate pricing level. An outlaw buyer who agreed to either an exclusive contract or minimum “must take” volumes under a long-term contract (say 18 months), could then be allowed to take the necessary price increases in steps: one-third of the increase becoming effective immediately, one-third in six months, and the last third in 12 months. What makes this effective is that the purchasing agent will be able to argue that he precluded an average increase over the contract that would have been twice as large as originally proposed and pushed realization of most of it to the back end. What is important to the seller is that by the end of the contract, the reformed “outlaws” will be purchasing at prices comparable to what other customers pay.

Of course, some of these outlaws will be genuine price buyers who may not accept any increase. Walking away from such customers, and publicly acknowledging it is also a good policy, signaling your resolve externally and internally. It will communicate a newfound commit-

ment to doing business only with good business partners, and put others who may be masquerading as price buyers on notice that there is a potential cost.

The Bottom Line

Good policies cannot magically make pricing profitable, but poor ones can certainly undermine your ability to capture prices justified by the value of what you offer. Good policies lead customers to think about the purchase of your product as a price-value tradeoff rather than as a game of manipulation to win at your expense. As such, they are an essential part of any pricing strategy designed to capture value and maintain mutually beneficial relationships.

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Monitor works with the world's leading corporations, governments and social sector organizations to drive growth in ways that are most important to them. The firm offers a range of services—advisory, capability-building and capital services— designed to unlock the challenges of achieving sustained growth.

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