MFL

The Pricing Times

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Air Canada Eliminates the "Sucker" Syndrome

Air Canada has developed and implemented a new pricing strategy that appears to allow them to simultaneously improve their margins and eliminate the customer dissatisfaction that comes from feeling like they are "suckers" when they pay two to five times more for a ticket than someone sitting next to them in a better assigned seat.

Air Canada transitioned from the traditional complex and hidden pricing approach that virtually all airlines are using today to a simpler six price level system that is transparent to customers. The key to the success of their new system is a clear alignment between the benefits that they offer and the fares that they charge. The highest price aligns with executive class, fully-refundable, assigned seats, use of the executive lounge, and maximum service. The other five fare levels align with reduced benefits. For example, when the ticket is not fully refundable, the fare goes down. When assigned seats are eliminated, the fare goes down, etc.

They developed this pricing approach by using an insightful understanding of their customers' buying process and how their customers perceive price, both before and after a transaction. Air Canada then used this understanding to drive the development of a more powerful and profitable offering and pricing segmentation.

Customers now self-select into segments based on the value (benefits minus tradeoffs minus price) that they desire and will pay for. A surprising number appear to be willing to buy more benefits at a higher price, i.e., a fare higher than the minimum fare. This provides the benefit of satisfied customers who no longer carry the potential negative "sucker syndrome" feelings generated by knowledge of different fares paid by different customers for exactly the same perceived set of benefits.

Pricing Communications—Comic Insights

Is It Too Late For 2005 Price Changes?

Now that it is late summer, it may be too late to develop and begin implementing 2005 pricing strategies and detailed account-by-account tactics. Many businesses wait until the end of their budget cycle to develop their pricing plans for the next year. Unfortunately, timing pricing changes to fit your budget cycle can often create significant problems.

Most businesses start planning for price changes in the following year in the October timeframe. They target to finalize their new pricing strategies by November so they can meet two goals. First, announce price increases on December 1, effective January 1, in order to give their customers 30 days notice. Second, lock in the price elements of their own budget which will then be approved by their Board of Directors at their December meeting.

The results of this timing and communication of a price change – usually an increase – are generally not good. The problem many suppliers have not recognized is how the level, timing, and communication of their price change fits within their customers' procurement and budgeting process. As a result, customers typically strongly resist a desired price change when it is announced at the end of the year.

This resistance can be lessened by recognizing and working with the planning processes that customers use in their own businesses. Most manufacturing companies, operating on a calendar year budget cycle, start their planning for material and service costs changes as part of a standard cost review initiated in August or September. Standards for purchased materials, supplies, and services are typically analyzed, evaluated, and revised no later than the beginning of October. As a result, a December 1 announcement of a price change, which is often higher than the prices assumed in new standards, sets off strong resistance because both purchasing and manufacturing leadership will be hit at the beginning of the year with unfavorable purchasing variances. They then risk losing their bonus because of their inability to meet their annual cost targets.

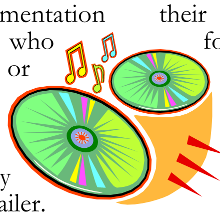
Understanding every customer's budget cycle and process is a critical part of achieving successful price changes. Knowledge of how price changes impact a customer's performance metrics and are included in their planning process can have a dramatic positive impact on the amount of a proposed increase that can be captured. It follows, therefore, that across-the-board price changes to all customers, while seemingly more "fair", will encounter more resistance because of the very different impact on different customers, depending on their budgeting, accounting and bonus systems. A more insightful and customized approach to price change timing and communication generally results in better yield from price increases and happier customers.

Universal's Pricing Missteps

Universal Music Group tried a "bold gamble to revive their music business by slashing the wholesale and suggested retail prices of its compact disks." Their theory was that a 30% retail price cut and a simplification of the pricing mechanism, eliminating deals and perks to retailers, would increase volume by motivating customers to switch back from legal and illegal downloading to buying compact disks. They also believed that these price cuts would please retailers. It did not work!

When Universal cut their prices by 30%, retailers only cut their prices by 5% and volume was only up 3% to 5%. Universal finally recognized a number of pricing missteps, causing them to retreat and restructure their pricing in an attempt to win back retailer loyalty and significant lost profits.

The first misstep was a lack of understanding of retailers' selling and consumers' buying processes. Retailers recognize that their customers (those not lost to Internet downloads) buy more than music. Hence, CD buyers are willing to pay a full price for the benefits they get from a retailer, which could include the visual selection, listening to samples, the physical store experience, holding the physical product in their hands, obtaining expert advice, assured quality of the music, and less perceived hassle and time than downloading. A segmentation approach contrasting people who download music, either legally or illegally, and consumers who go into retail stores could well have pointed out the different benefits that are perceived by buyers and provided by the retailer. The difference in benefits is clearly reflected in the different price that consumers are willing to pay. In addition to this segmentation gap, Universal may not have recognized that retailers need to generate dollars per square foot of floor space, not percents, and therefore a lower price point on most of their inventory would require that they have a higher percentage margin or significant volume gains to cover their dollar-based fixed costs.



Universal also made the mistake of oversimplifying their approach to pricing by the elimination of deals and perks, and by applying their new pricing across the board to all products. The administrative benefit of taking away deals and perks and having a simplified pricing process created more visibility in the marketplace and eliminated a major source of income for independent retailers. In addition, the oversimplification of pricing and its application across the board was a commoditization move for their entire line. Their one price for all offerings – for hot new titles as well as more price sensitive old titles – resulted in significant money left on the table for the new titles and lost volume for old titles.

Another misstep was the lack of understanding of the price timing dimension relative to the economics of the retailer. Universal attempted to implement an across the board price cut at one point in time for all titles for all retailers. They missed the fundamental economic fact of life that retailers have a mix of fast moving and slow moving inventory. Retailers needed to sell off their entire inventory at the old, higher prices before they could lower the price to link with their cost on new inventory. As a result, they were very hesitant to drop prices, particularly on their slowest moving products, until they had the time to sell them through.

A final misstep may have been in the way Universal communicated their new pricing strategy to their retailers. Apparently, they sent an email to all of the retailers announcing the new pricing strategy and their expectation that all retailers would follow it immediately. This approach was viewed by many retailers as arrogant and obviously did not provide an opportunity to get buy-in from the retailers or provide an opportunity for the two-way discussion and explanation of the strategy that might have achieved a more positive response. The result? Retailers felt that, "Universal was forcing a new pricing strategy down our throats."

Universal has since retreated from the key features of their pricing initiative and returned to a more insightful and, hopefully for their sake, profitable approach to pricing. If they had thought in advance about the basic lessons of:

- segmentation
- linking price to actual benefits;
- avoiding commoditizing their offering through their price communication;
- managing the timing of price changes to fit the end customer as well as their distribution channels;
- communicating their pricing strategy to their distribution network in a positive way with appropriate amounts of listening and dialog,

they would more likely have been successful in their initiative and found a way to minimize their volume loss to the downloading channel and maximize both their margins and the margins of their critically important retailers.

To Aggregate or Disaggregate Your Price and Offering—That Is the Question

The wrong price communication approach can actually accelerate the commoditization of your product. In buying decisions where customers have many benefit choices but don't perceive a significant value from every component of the offering, a disaggregated communication of price is a good way to enable customers to pick and choose which components they want and better allows them to match the benefits they get with the price they pay.

However, customers that perceive considerable benefits from most or all components of the offering are often best presented with an aggregated price. Consider how cars are sold; high-end cars most features included and only a few options while cars at the lowest price point have a very long list of available options – each available for a price.

On the other hand, if a buyer of a high end offering sees detailed prices for each element, they are likely to become more price sensitive – e.g., legal bills that show prices for copying and phone calls—tending to commoditize a valuable total offering.

The lesson: high value buying decisions will most likely benefit from aggregated approaches, while lesser value/ competitive buying decisions will work better with disaggregated pricing.

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