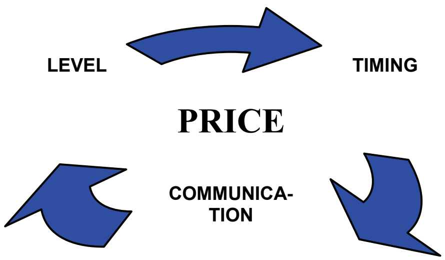
MFL THE PRICING TIMES
February 2006 Edition

2006 – A Good Year To Go Back To The Basics Of Pricing

We are always surprised by how few businesses use the basic principles of good pricing for daily tactical or long-term strategic decisions. This issue of the Pricing Times focuses on a few highly visible examples that demonstrate the power of those basics.

3 ELEMENTS OF PRICE



VALUE EQUATION

PERCEIVED Customer Value = PERCEIVED Benefit Experience - PERCEIVED Tradeoffs - PERCEIVED Switching Costs - PERCEIVED Price

Hotels Turn Price Levels For Internet Access "Upside-down"

The hotel industry has recognized a very important aspect of price sensitivity and perception of benefits by their customers. As a result, the higher the price of a room, the higher the price of high-speed internet access at that hotel. Hotels have recognized that business people who stay at high-priced properties are more likely to pay for internet access as a separate charge because they have both a strong need for timely high-speed access to the internet and ability to put that charge on their expense account. However, business and leisure travelers who use low-priced motels are unlikely to have either a strong time-based need for high-speed internet connection or a ready expense account available for that charge. Therefore, internet pricing at hotel chains varies by price point of the property.

For example, internet pricing at the Marriott chain is "upside-down" from what you might expect. At Flagship Marriott brand properties, internet access has a price of $9.95 per day. However, at the Courtyard and Fairfield Inn brand properties managed by Marriott, internet access is included in the much lower price of the room. As you continue to go to higher price points in hotel rooms, for example, the Ritz Carlton, the price of internet access goes up even further – often to $14.95 per day or even higher.

Lesson learned? Developing real insight into the benefits perceived and desired by your customers and their willingness and ability to pay for those benefits should be the major driver of determining price level strategy.

New Price Timing Strategies For Airlines

Some airlines have recently changed their price-timing strategies. Their old strategies – the closer you are to the flight, the higher the fares – have now changed to improve both their capacity utilization and price based on their customers' real and perceived benefits.

These airlines are using a new price-timing strategy that reduces potential money left on the table by charging a relatively high price six to twelve months in advance of a flight. This change is based on recognition that customers who feel a need to lock up reservations well in advance will not be as price sensitive as those who are willing to take the risk of waiting until closer to their planned travel date. These airlines then begin to lower their prices closer to the travel date to build capacity utilization; e.g. six months to two months before the travel date.

Within a month or two of the travel date, these airlines typically move the prices back up until they reach another high point three or four days prior to travel. In addition, a number of airlines are now offering last minute low fares in order to fill up seats that would otherwise go unsold. Although many of the low-price airlines still have the timing strategy of low price far-in-advance purchases, more sophisticated airlines appear to be using new price timing strategies that create new profit opportunities, but also result in new challenges for travelers.

Lesson learned? Time nearly always represents a real value. Where time is a factor in the offering, e.g. lead times, delivery response time, time of day, day of week, etc., it is often wise to communicate that aspect as additional value and capture that value in price.

Pricing Communications: Is Google Really Free?

Google is one of the best examples we have seen of a business that recognizes, and strategically employs, the importance of the communication element in pricing strategy. Google understands that it can charge a solid price for its services without this price being perceived as a significant or measurable price to their consumers.

The "free" use of Google by millions of people is not free by any stretch. Google users pay by being forced to view ads and by the forced ordering of "preferred vendors" versus other hits when a search is initiated. Those preferred vendors pay Google a fee every time a consumer clicks on their site or buys from them.

It's also logical that those vendors figure their prices in a way that includes the cost of marketing through Google. Hence, there is a price in both the time viewing ads and the price paid for products that consumers buy when they use Google advertisers. However, the communications element of Google's pricing strategy has made the price for their service appear to be negligible, stimulating huge growth in revenues and profits.

Lesson learned? How you describe and communicate price can dramatically shift the value perceived by customers (and competitors) and strongly influence buying decisions.

Level, Timing and Price Communications: Pay First, Call Later

Cell phone networks have developed a new pricing strategy to allow them to attack a "less attractive" segment while generating higher revenue and profit per minute. Cell networks have historically avoided people with poor or no credit ratings. However, they have recently captured new growth by using a pricing strategy that not only allows them to avoid the credit risk that these consumers may present, but also opens up additional niches of customers. Their new pricing strategy changes all three pricing levers: level, timing and communications. They attack this new segment with a plan that is higher in price, charges in advance of use versus after use, and is described as "prepaid" versus "contract". These prepaid pricing plans allow the cell networks to capture customers, regardless of their credit history, who are willing to pay more per minute in order to eliminate the risk of the extraordinarily high price of going over the contract plan minutes purchased.

Prepaid plans work very effectively despite charging a price that is significantly higher per minute for a fixed number of minutes in advance of their use. The consumer simply uses his phone until the prepaid minutes expire - at which time the phone stops working. In this way, the carrier avoids the credit risk and the consumer avoids the risk and cost of excess minutes. The price for this benefit is, relatively speaking, very significant. The average price for post-paid minutes is between 6 & 8 cents per minute, while the average price for pre-paid minutes can range anywhere from 10 cents to 50 cents per minute.

Lesson learned? Developing pricing strategies using all three pricing levers can help open new market segments while getting paid your fair share of the real value you deliver.

It Still Takes Product Performance (Real Benefits) To Get Attractive Prices

The auto industry is filled with great examples of both good and bad business practices. Recent pricing moves initiated by General Motors demonstrate the clear importance of product performance in achieving attractive price and volume levels. GM found that they could only gain significant market share by cutting prices significantly. However, that market share only came at the expense of competitors with similar weak product performance - Ford and Chrysler.

Toyota, on the other hand, was able to sustain price levels without resorting to deep discounts and either held share or, during the time period when General Motors ended their "Employee Pricing" program, gained share in a relatively weak market. The explanation is pretty straightforward. Toyota produces cars that consumers perceive as more reliable, better performing, and a better value despite a higher price for equivalent features. Toyota obviously has developed the strategy and capability to design and produce cars that out-perform those designed and produced by General Motors and, therefore, is able to capture a higher price reflecting its fair share of the value they deliver to consumers. Of equal importance, Toyota has the wisdom and backbone to set prices high enough to capture their fair share.

Lesson learned? The fastest and most assured way to capture increased price is to deliver greater benefits to the customer.

Switching Costs Will Change, But They Still Count!

Maintaining high switching costs in order to sustain specialty price levels has always been important. Replacement cartridges for ink jet printers are a great example. Historically, they have been the major, or complete, source of profit for ink jet printer manufacturers because high switching costs have limited the competitive intensity that drives price down. However, the recent development of chains of franchised print cartridge refilling stations is reducing switching costs and threatening the profit of ink jet manufacturers. To fight the obvious threat to their bottom line, the ink jet manufacturers have been trying to sustain switching costs through continuous and rapid development of their product. Of course, they also continue to file for patents and utilize every legal resource available to prevent refillers from entering their market. However, the continual upgrading of the performance of their inks makes it difficult or risky for consumers to use generic ink in their refilled cartridges. In addition, each time they design a new printer, they attempt to design cartridges that will be difficult to refill because of mechanical and software linkages with the printing system. Finally, they continue to invest in sales and advertising communications that focus on the benefits that their original equipment cartridges offer to consumers. For example, original equipment inks provide ink and outstanding color rendition and extremely long life of print material e.g. photos that people want to be able to keep for many years.

Lesson learned? Depending solely on patents, weak competitors, or good luck to sustain high switching costs is rarely sufficient to sustain the specialty nature and profit potential over the long term. Competitors will find a way to enter the market and put significant pressure on price levels. Continued focus on building or rebuilding switching costs through every available approach is a necessary and critical part of successful pricing strategies.

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MFL's consulting practice focuses on helping our clients build margins and volume by capturing their fair share of the value they deliver to their customers. We have found that pricing, while often managed in isolation, can be a powerful and integrating lever to drive a necessary shift in mindset and capability.

It is not enough to simply create value for customers. That value must be understood, communicated and recognized by the customer in order to capture your fair share of the value you deliver in your price. To accomplish this, an organization should understand and deliver benefits that help their customers be successful in their markets (be market-focused). At the same time, applying a market-focused approach to pricing can capture your fair share of that value while slowing or preventing the commoditization of your offerings from the inevitable pressures of changing customer buying practices and aggressive competitors.

Although it is easy to talk about, creating a market-focused culture in a business is very challenging. Moreover, converting that mindset and understanding into a valuable set of customer offerings and an appropriate approach to pricing can be equally challenging. Our extensive experience at McKinsey & Company and in general management has enabled us to develop approaches that help our clients sustainably improve their profits and growth by successfully meeting these challenges.

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