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Building a better pricing infrastructure

Well-managed companies already recognize the critical role pricing plays in driving performance. A foundation that underpins excellence in pricing is the key to realizing its potential.

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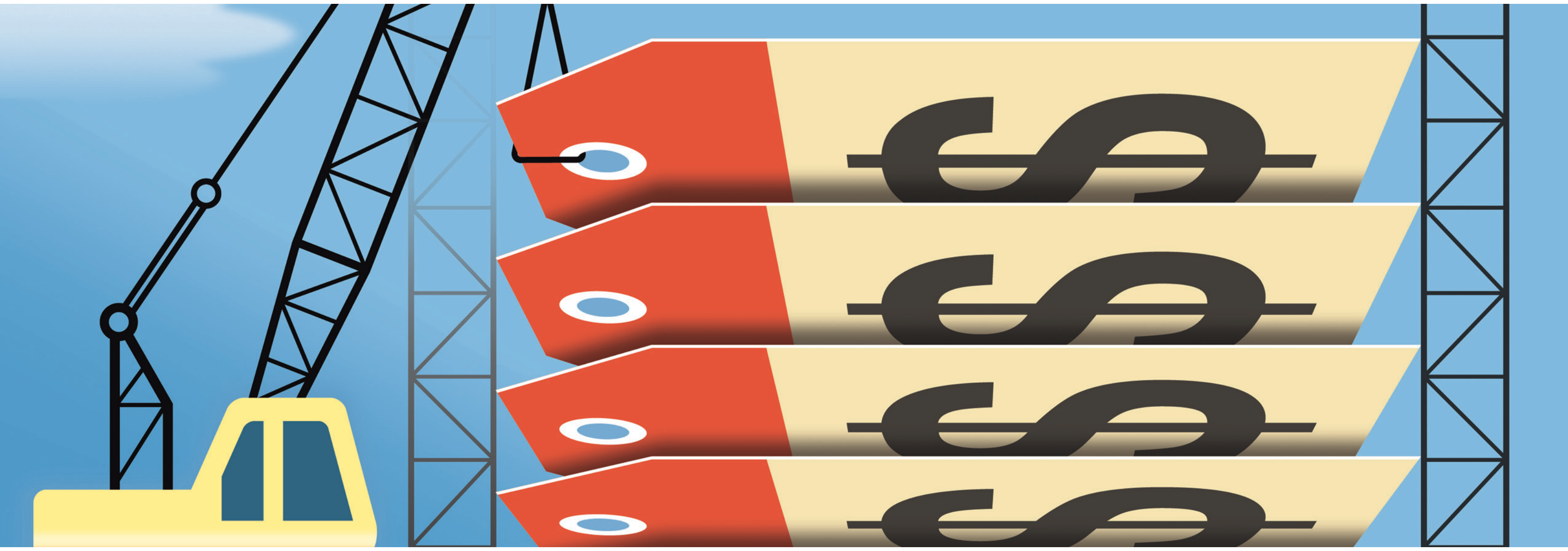

Over the past two decades, most companies have recognized the bottom-line impact to be gained through effective pricing. Yet awareness by itself is not enough. Tapping the full promise of pricing requires an *infrastructure* to drive real and sustained pricing performance. With such a foundation, a company can establish and strengthen pricing activities by creating deliberate decision processes, a specialized pricing organization, mechanisms that appropriately measure and reward pricing excellence, and robust support tools and systems.

A pricing infrastructure can be difficult and costly to create. It requires investing appropriately, empowering the right people, articulating clear targets and goals, and managing risk. Yet the benefits of realizing true pricing excellence are worthwhile: a one-percentage-point improvement in average price of goods and services leads to an 8.7 percent increase in operating profits for the typical Global 1200 company.[1] Since a well-executed pricing-improvement program often yields price increases of two to four percentage points or more, sustaining a long-term price advantage may represent roughly 15 to 25 percent of a typical company's total profits.

CEOs have certainly become aware during the past two decades of the way pricing improvements can drive profit gains. Frameworks to identify pricing opportunities—from pocket-price waterfalls to price bands to value maps—are now widely accepted. Wall Street has begun rewarding businesses that improve pricing and punishing those that fall into price wars. Yet too many companies try to get by with minimal investments in their pricing infrastructure, grabbing quick hits that generate fast and easy bottom-line improvements, then declaring victory and focusing time, energy, and talent elsewhere. The result is that the actual impact of pricing-infrastructure investments diminishes over time, with such efforts falling far short of their full potential.

Successful companies deliberately build a strong pricing infrastructure that underpins and sustains pricing excellence. They start by focusing on the most critical pricing processes, then consider who "owns" and drives the organization's pricing profit center. A constant focus on performance management inspires managers to improve their pricing performance in the context of the overall business strategy, while holding them accountable to meet or exceed expectations. Finally, systems and tools facilitate pricing processes, help people in the pricing organization raise their game, and support performance management. Implementing these elements in this order—processes, organization, performance management, and systems and tools—increases the likelihood that pricing-infrastructure investments will have an enduring impact.

Well-defined pricing processes

At many companies, the processes for making critical pricing decisions have a random, even reactive feel: they lack the structure, thoroughness, and underlying analytics that

[1]The world's largest 1,200 publicly held companies by market capitalization.

such profit-sensitive decisions deserve. Processes whose steps, owners, inputs, and outputs are clearly defined should govern decision making and core pricing activities. These processes lie at the heart of the pricing infrastructure. Companies must first determine which specific pricing decisions are critical to their success and then build robust processes around those decisions.

The most vital pricing decisions—and, therefore, the most critical pricing processes—differ dramatically by company and industry. A commodity chemical company, for example, may focus heavily on industry supply and demand to keep prices aligned with market levels. A consumer electronics manufacturer may concentrate on customer value, using focus groups and next-best-alternative pricing information to set and adjust its list prices. An industrial-parts maker may focus on the rules and policies that govern discounts for different products and volumes.

One important process involves managing special price requests, or exceptions, which often get out of control. (One distribution company, for example, didn't even have the term "standard pricing" in its vocabulary—instead, it used "exception pricing" or "nonexception pricing" to describe all of its deals.) To manage and control runaway exceptions more effectively, companies can create advanced processes to review them: employing active "bid desks" that skeptically evaluate requests for exceptions, tracking their frequency and depth, analyzing deal economics, and providing sellers with real guidance on prevailing price levels.

High-caliber organizational elements

Processes to address vital pricing decisions add value only if these processes function smoothly by conferring clear ownership and accountability. Too many companies try to get by with an ad hoc or management-by-committee approach, with no clear owner; a process emerges only when absolutely necessary. Others believe that full-time pricing personnel are not required and that responsibilities can be spread across staff in areas such as sales, marketing, and product management. But these approaches usually engender an insufficient and inconsistent focus that leaves too many significant pricing opportunities unrealized.

Staffing an organization responsible for a significant portion of a company's earnings requires a deliberate recruiting strategy, compensation commensurate with the importance of this unit, and clarity about the types of skills and attitudes required for each of its roles. The executive in charge should be responsible for coordinating the rollout of pricing methods, counseling sales managers and sales reps on the use of formal pricing methods, controlling the impact of pricing metrics and strategies, and embedding pricing methods and tools in the company's culture. Fundamentally, this executive should be responsible not only for managing day-to-day pricing activities but also for fostering the proactive, continuous-improvement mind-set that separates high-performing pricing organizations from merely good ones.

We also recommend separating the pricing group from any unit responsible for negotiating prices with customers. This division creates a healthy tension between price negotiators and price managers that is difficult to maintain when price management resides within sales groups.

Finally, high-performing organizations regularly evaluate their overall health and vitality—and pricing shouldn't be different. Three practices are recommended. The first is a well-defined career path: employees should see the pricing organization as an excellent stepping-stone to career advancement. The second is 360-degree feedback for key roles, because members of the pricing organization must interact effectively with so many groups. The final practice is monitoring health metrics, such as the rate of employee turnover and job satisfaction, so trouble can be spotted early and addressed.

Performance-management systems

Performance management for pricing regularly measures its impact on a business, using rewards and consequences to reinforce or correct behavior and refine direction. Many companies today have neither accurate measures of pricing performance nor meaningful rewards for executives who make decisions on pricing. That reduces the incentive to stretch for small pricing improvements, which as we noted above can translate into huge improvements in earnings.

Every company should have a set of pricing metrics that measure the financial and operational health of pricing across the business. These metrics may include simple data, such as the average selling price, discount, and margin for key products; operational data, including the number of pricing exceptions and win/loss percentages; and special measures to track the progress and impact of specific pricing initiatives. Best-practice companies use cascading dashboards. While the manager of a single product line may see metrics only for that, the general manager of a business unit sees those same metrics across the operation and can drill down to the level of individual products to understand the root causes of pricing performance.

These metrics should be tied to financial incentives; without that connection, most metrics quickly become irrelevant. Yet it's also important to design incentive plans that strike a balance between increasing revenue, on the one hand, and achieving healthy margins, low discounts, or both, on the other. In addition, nonmonetary incentives can be extremely valuable. One of the simplest and most effective is to rank salespeople publicly by margin or discounting performance, possibly after normalizing for variables such as account size and product mix. This practice appeals to the competitive psyche of sales reps and creates a healthy dynamic among them. Other nonfinancial incentives include recognizing exceptional performance by peers and managers; rewarding counterintuitive behavior, such as walking away from deals as part of an initiative to shed unprofitable business; and tying advancement to specific pricing skills—which sends a strong message that they are essential, not merely nice to have.

One final component of performance management is the use of pricing metrics as the basis for conversations to improve performance. When used diligently and regularly, this kind of coaching becomes a powerful tool. In our experience, high-impact pricing-performance dialogues share three traits: they occur regularly (for instance, weekly or monthly), take place at multiple levels within the pricing organization, and cover a specific set of questions—such as what's happening in it, why, and what needs to be done—before going on to deal with other issues.

Pricing systems and tools

Pricing excellence demands an investment in systems to collect accurate, current pricing data, as well as tools to turn that data into information. Most companies fall short either because they do not understand why they should make such investments or because they overspend on unnecessarily complex systems that don't match their pricing needs. Often, the result is that critical information or analysis isn't available for crucial pricing decisions or that decision makers confused by difficult systems fail to deliver the right information in a timely and convenient fashion.

Companies tend to make poorly informed assumptions about how much data they need and what types of tools and systems will meet their business requirements. After watching many companies struggle to get the most from their investments in systems and tools, we have derived two lessons from best-in-class players: first, understand what information you need and when you need it, and second, move slowly because real business needs for systems and tools are best understood over time. There is no one-size-fits-all answer.

The data needs, reporting capabilities, and frontline decision tools required for pricing excellence vary enormously by business. Generally, pricing systems and tools provide four types of support: to make specific pricing decisions and conduct negotiations, to carry out analyses that identify pricing-improvement opportunities, to monitor ongoing performance, and to track pricing activities.

Decision support tools ensure that people who set prices have the data needed to make informed decisions, whether sitting in their own offices or in front of prospective customers. One electrical-device company with a large portfolio of products, for example, used an analysis tool and found that demand for some older products was waning while their inventory and carrying costs were increasing—all at a significantly faster rate than prices. The company determined that most of the remaining demand was for replacement applications where alternatives were inherently limited, so it increased prices on these low-volume products. The net result was continued minor volume loss but a substantial increase in total earnings.

Metrics, dashboards, and reports should give managers a concise snapshot that helps them monitor pricing performance across their portion of the business and to intervene where necessary. One final challenge is collecting all relevant pricing data in a centralized

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repository. Sales and cost information will often be scattered across multiple IT systems in different functions and departments, but aggregating all this data is critical if the other tools are to function well. Many companies take a data warehouse approach: data from multiple IT systems are routinely loaded into a single large database that's regularly updated. The most important point is that the data should be reliable enough for decision making.

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Pricing can be a significant profit center within a business—if the foundation that underpins pricing has the proper processes, organization, performance management, and systems and tools.

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