What we will look at...

- Conventional Pricing Methods – Pros and Cons
- What is Value?
- What is Value Based Pricing?
- What companies use Value Based Pricing?
- Value Based Pricing – A Journey or a Destination?
Conventional Pricing Methods

**Cost Based**
- Based on our costs

**Competition Based**
- Based on competitors’ prices

**Market Based**
- Based on what we think the market will accept

**“OOTA”**
- Based entirely on a guess
Cost-Based Price Structure

- **€50**: Margin/Mark-up
- **€75**: Variable Costs
- **€80**: Fixed Costs
## Critique of Cost Based Pricing

<table>
<thead>
<tr>
<th>+</th>
<th>-</th>
</tr>
</thead>
<tbody>
<tr>
<td>Easy to calculate</td>
<td>largely ignores the role of consumers and competitors</td>
</tr>
<tr>
<td>Minimal information requirements</td>
<td>Ignores opportunity costs</td>
</tr>
<tr>
<td>Easy to administer</td>
<td>Uses historical accounting costs - not replacement value</td>
</tr>
<tr>
<td>Tends to stabilize markets - insulated from demand variations and competitive factors</td>
<td>Includes sunk costs rather than just incremental costs</td>
</tr>
<tr>
<td>Should insure seller against unpredictable, or unexpected later costs</td>
<td>Contractors may not focus on performance because the cost is always covered by the client</td>
</tr>
<tr>
<td>Fair and transparent</td>
<td>Uses “normal” or “standard” output level to allocate fixed costs</td>
</tr>
</tbody>
</table>
Going Rate Pricing

Going rates

NBCA
Option 1
Option 2
## Critique of Competition-Based Pricing

<table>
<thead>
<tr>
<th>+</th>
<th>-</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitive data are generally available in the public domain.</td>
<td>The available data may be wrong, out of date or irrelevant.</td>
</tr>
<tr>
<td>Relatively easy to position our product</td>
<td>Positioning may not take account of different segmental priorities</td>
</tr>
<tr>
<td>Permits focus on the purchase decision attributes</td>
<td>These may not be the right attributes</td>
</tr>
<tr>
<td>Maintains market stability.</td>
<td>...at the cost of conservative pricing.</td>
</tr>
<tr>
<td>Guarantees we will win some share of the market</td>
<td>Suggests that there are few differences between competitors</td>
</tr>
<tr>
<td>Enables us to collect the price and specification data</td>
<td>Encouraging point by point comparisons on price and specification.</td>
</tr>
<tr>
<td></td>
<td>Does not take into account economic elements of value-in-use.</td>
</tr>
<tr>
<td></td>
<td>Completely ignores psychological or emotional qualities of our offer.</td>
</tr>
</tbody>
</table>
What the market will bear
To understand Value Based Pricing we first have to understand value...
What is Value?
So - What is Value?

In groups, come up with a definition of value.

Start your definition “Value is...”
Answers managers in other companies have given...

- what the customer perceives as adding value to his business and increases our returns and margins
- the things we do over and above competition creating a profit – 1 + 1 = 3
- when you deliver something more than the customer expected

a mystery

to provide your customer with anything he/she appreciates (now there’s an opportunity!!!)

creating the perception in the customer’s mind that he needs our product more or better than competitor’s.
Value? Let’s look at Water...

€0.002/ litre

€0.05/ litre

€1.06/ litre

€2.13/ litre

€11.00/ litre

€11.00/ litre

€86.00/ litre

Priceless!

So what is the price of water?...
The Value Triad©

**VALUE TO THE CUSTOMER**

**REVENUE GAINS (RG)**
- Margin improvement
- Higher price
- Better productivity
- Higher market share

**COST REDUCTION (CR)**
- Labour Cost reductions
- Capital cost reductions
- Cheaper materials
- Part Reductions

**EMOTIONAL CONTRIBUTION (EC)**
- Risk reduction
- Comfort
- Confidence
- Peace of mind

What is a Value Driver?

A value driver is any factor which, when acted upon within a business, leads to an enhancement of competitive advantage.
## Value Drivers

Customers want to know how we can help them...

<table>
<thead>
<tr>
<th>Examples of Value Drivers</th>
<th>Nature of driver</th>
</tr>
</thead>
<tbody>
<tr>
<td>Get to market faster</td>
<td>Economic, Emotional</td>
</tr>
<tr>
<td>Eliminate “hassle”</td>
<td>Emotional, Economic</td>
</tr>
<tr>
<td>Eliminate costs</td>
<td>Economic, Emotional</td>
</tr>
<tr>
<td>Reduce their anxiety</td>
<td>Emotional, Economic</td>
</tr>
<tr>
<td>Enhance operational efficiency</td>
<td>Economic, Emotional</td>
</tr>
<tr>
<td>Remove conflict</td>
<td>Emotional, Economic</td>
</tr>
<tr>
<td>Improve customer retention</td>
<td>Economic, Emotional</td>
</tr>
<tr>
<td>Achieve greater peace of mind</td>
<td>Emotional, Economic</td>
</tr>
</tbody>
</table>

...and they will select us if we can demonstrate convincingly how we can do these things for them
What is Value Based Pricing?
Why bother?
Comparison of Profit Levers

In a study of over 2000 companies price had the most significant impact on operating profits.

<table>
<thead>
<tr>
<th>Levers</th>
<th>1% improvement in</th>
<th>operating profit improvement of</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>11.1%</td>
<td></td>
</tr>
<tr>
<td>Variable Costs</td>
<td>7.8%</td>
<td></td>
</tr>
<tr>
<td>Volume</td>
<td>3.3%</td>
<td></td>
</tr>
<tr>
<td>Fixed Costs</td>
<td>2.3%</td>
<td></td>
</tr>
</tbody>
</table>
If a Martian asked me “What is Value Based Pricing?

This is what I would tell him...

“Value Based Pricing is a pricing method where we would work out the total benefit to the customer of our product or service...and then base our price on the benefit the customer receives.”
Value Based Pricing is based entirely on customer value – the benefits and advantages we can bring to the customer that he really cares about, and that no other supplier can match.

So – we must understand the customer deeply – more deeply than our competitors.

And arguably even more deeply than the customer himself!
Some industries that are now using VBP…

Automotive suppliers
Automotive manufacturers
Energy Consultants
Logistics companies
Biotechnology manufacture
Legal services
Engineering
Mobile telecommunications
Chemicals
Medical devices and supplies
Telecoms network providers
Power generation
Travel consultants
Legal firms
Value Based Price = Reference Price + Net Revenue Gains + Net Cost Reductions

Reference Price
Price of product, service or method your customer would use if your product was not available (Next Best Competitive Alternative)

Revenue Increases (net)
Any gains in sales or productivity arising directly from the use of your product or service compared to the reference

Cost Savings (net)
Reductions in costs arising directly from the use of your product or service compared to the reference
We want to capture our *fair share* of this!

**Structuring the VBP using the Value Triad**

- **Reference Price**
- **Revenue Gain**
- **Cost Reduction**
- **Emotional Contribution**

**Value Based Price**

**Added Value**
## Simple Example

<table>
<thead>
<tr>
<th></th>
<th>Competitor Machine</th>
<th>Our Machine</th>
<th>Our Added Value</th>
<th>Maximum VB Price*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Price</strong></td>
<td>€100,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td>€250,000</td>
<td>€300,000</td>
<td>€50,000</td>
<td></td>
</tr>
<tr>
<td><strong>Costs:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel</td>
<td>€75,000</td>
<td>€68,000</td>
<td>€7,000</td>
<td>€88,000</td>
</tr>
<tr>
<td>Spare Parts</td>
<td>€35,000</td>
<td>€30,000</td>
<td>€5,000</td>
<td></td>
</tr>
<tr>
<td>Maintenance Labour</td>
<td>€60,000</td>
<td>€34,000</td>
<td>€26,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total Added Value</strong></td>
<td></td>
<td></td>
<td>€88,000</td>
<td></td>
</tr>
<tr>
<td><strong>Maximum VB Price</strong></td>
<td></td>
<td></td>
<td>€188,000</td>
<td></td>
</tr>
</tbody>
</table>
In this case the **scenario** is a 12-month Business Development option for the operator.

- Novel technology permitted doubling or trebling of unit coverage (1500 per 10 weeks to 3000 or even 4500).
- Rental price per unit to operator’s customer - £175 per annum (£3.40 per week).
- Revenue gain £260,000 (doubling scenario)
- VBP = (£260K + £14K + £30K)/1500
- Max Unit VBP on this schedule ≈ £200, negotiable on corridor.
- EC of £30k accepted by major operator because of reduced hassle, more flexibility and “natural plants”.
Negotiation Corridor

- Understand as fully as possible the customer/client context
- Collect evidence to support revenue and productivity improvements
- Collect evidence to support cost reduction claims
- Think through which intangible benefits are relevant
- Use Value Triad© elements to support important assertions
## Comparing the Methods

<table>
<thead>
<tr>
<th></th>
<th><strong>Competition Based</strong></th>
<th><strong>Cost Based</strong></th>
<th><strong>Value Based</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Focus</strong></td>
<td>Competitors’ price levels</td>
<td>Internal costs</td>
<td>Win-Win</td>
</tr>
<tr>
<td><strong>Encourages</strong></td>
<td>Pursuit of market share – not profit</td>
<td>Formula based approach</td>
<td>Cooperation and partnership and deep customer knowledge</td>
</tr>
<tr>
<td><strong>Customer relationships</strong></td>
<td>Ignored</td>
<td>Ignored</td>
<td>Central to all transactions</td>
</tr>
<tr>
<td><strong>Reward for innovation</strong></td>
<td>None</td>
<td>None or even negative</td>
<td>High and sustainable returns</td>
</tr>
<tr>
<td><strong>Selling efforts</strong></td>
<td>Minimal</td>
<td>Minimal</td>
<td>Consultancy and solutions based</td>
</tr>
<tr>
<td><strong>Inducement to buy</strong></td>
<td>Discounting</td>
<td>Discounting</td>
<td>Demonstrable economic advantages</td>
</tr>
<tr>
<td><strong>Value capture</strong></td>
<td>None</td>
<td>Minimal</td>
<td>Complete, or as well as your salespeople can negotiate</td>
</tr>
</tbody>
</table>
Value Based Pricing
The Journey or the Destination?
Generic 4-Stage Model of Pricing Maturity

Stage 1
Administration

Stage 2
Control

Stage 3
Value

Stage 4
Optimisation

Value Maturity Chasm

It seems we’re on a journey – a trip through space and time...
(Abba ca 1977)
<table>
<thead>
<tr>
<th>Key Factor</th>
<th>Issues for Attention</th>
</tr>
</thead>
</table>
| **Change Drivers**| • Recent takeovers made the company truly global  
• Need to drive up margin  
• “Customer Intimacy” the key corporate strategy  
• Segmentation project highlighted need for change  
• Value orientation seen as next step on the journey |
| **Current Methods**| • Issued price list basis for negotiation  
• Cost plus and discounting  
• Sales team technical specialists and order takers  
• Limited understanding of customer value |
| **Customer Value** | • Products and services perceived to be good value but not cheap  
• Value given away by discounting as the primary business winning tool  
• Pricing Project underway |
## Global Lubricants …*continued*

<table>
<thead>
<tr>
<th>Key Factor</th>
<th>Issues for Attention</th>
</tr>
</thead>
</table>
| **Changes Required** | • Senior management, product management and marketing all bought in and supportive  
• Salespeople generally open and “persuadable!”  
• Sales highly technical and product focussed - greater customer focus required  
• Positioned as a corporate initiative  
• Case studies being built demonstrating value impacts internally and externally |
| **Apprehension**  | • Level of sales management buy-in varies country to country  
• Some apprehension that it is just a means of raising prices  
• Extensive and expensive VBS training recently completed and must deliver demonstrable margin improvements |
| **Implementation** | • From a European start-out, now global  
• Real strategic support, and a structured communication programme  
• Cultural change requirement recognised and supported  
• Customer segmentation helping to target value customers |
Global Lubricants

Tips...

• Communication is key
• The process is strongly supported by senior management
• Value forms the core of sales and pricing discussions
• There is a simple PI - margin improvement

Traps...

• Don’t rush the process
• Remaining focussed on value and not returning to the “discount default” can be tough
• Some sales people will “get” value quickly, others will struggle - so tailor your training and support
And don’t forget to **Reward** everyone who has contributed to the success of the project!
Conventional pricing methods like cost-based and competition based approaches still work, and work adequately, for many companies;

These methods are less satisfactory when significantly greater differential value is created for the customer;

Value based pricing methods capture more completely the value created and benefit both vendor and customer economically and emotionally;

For this reason many industries are exploring value based pricing approaches – or have fully adopted these methods;

Implementing Value Based Pricing in your organisation should be considered a strategic initiative - and should be given enough time to work.
Any questions?
Thank you for your attention!
Harry Macdivitt can be contacted at:

info@cpd-associates.co.uk

Mob: 0044 781 298 1651