Bulletin

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One-club golfers

PREVENTING COMPULSIVE PRICE DISCOUNTING

Pressure to expand, especially when the market looks weak, often leads companies to cut prices indiscriminately. Placing too much weight on the pricing weapon is a dangerous practice, but many businesses are organised in such a way as to maximise the temptation to succumb to compulsive discounting. Strategic management of pricing decisions is needed to make sure the full range of clubs is used for this part of the corporate game.

To survive in competitive markets, companies must constantly strive to increase efficiency, in order to decrease the cost of what they offer and/or enhance its quality. Over the past 15 years, increased competition in the global economy has led to steady declines in the price of many manufactured goods, even as their capability has been enhanced. In this downward price spiral, many manufacturers (e.g., of components) have been price-takers, unable to do more than argue about the degree of "price-down" that was appropriate in a particular year. Others have however been price-leaders, taking a pro-active approach to the mix of price and quality they offer the market. Such strategies require commitment, and often

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substantial investment, over a number of years. Still other companies, however, have become compulsive discounters, over-using the one golf club to the detriment of the greater game. Such companies are reactive rather than pro-active, too often shifting their strategies at the first sign of danger.

Frontier's strategy work with companies suggests that the reactive price addicts typically have two corporate characteristics:

(i) pricing is rarely "owned" by a single department, with responsibility for creating a consistent proposition; and,

(ii) knowledge of how customers trade-off different elements of the proposition is poor, so that managers tend to attribute too much influence to price.

WHO'S THE OWNER?

Most customers care about "value for money". This attribute, however, is not easy to measure and compare, since it is a combination of price, quality, service and other, even less tangible, elements. Of all these, however, price is usually:

- the easiest to measure, so that organisations tend to spend much more time benchmarking prices than comparing (say) service quality;
- the easiest to change, so that in most organisations this can be done in days, if not hours, while service quality may take months or years to alter.

Measurability and flexibility tend to inflate the role of price in short-term decisions. When competitors offer a new product, the knee-jerk reaction is to cut prices. When investors become concerned about a fall in market share, management will automatically reach for the price lever.

If the lever is controlled by someone with holistic responsibility for the long-term proposition, then the chances are the right decision will be taken. But in a surprisingly large number of organisations, there is no single owner of pricing. Lots of departments - commercial, marketing, sales and finance – have interests that may conflict with the interests of the business as a whole.

If the marketing department wants to give a strong message, low price is often the easiest way to do so. If the sales force wants to push a particular product, they will ask for "price support". If a divisional director wants to trial a new product, this is usually done at a low margin. Everyone can create a good "exceptional" case for discounting, provided everyone else refrains.

Economists know this type of co-ordination problem as the "problem of the commons". This occurs when property rights are not fully assigned and so, as a result, an asset or skill is over-exploited to the detriment of all users. (It is the problem of the commons that explains the rapid demise of the buffalo on the American plains, the over-fishing of international seas and the collection of space junk currently orbiting the earth.) For companies trying to build a long-term value-for-money proposition, a version of the problem of the commons will flow from a lack of strategic ownership of pricing. Different managers will chip away at the price position in pursuit of their individual objectives.

The second characteristic of compulsive discounters is that they place too much weight on price in the value-for-money mix, systematically over-estimating the long-run price elasticity. They do so for – broadly – four reasons.

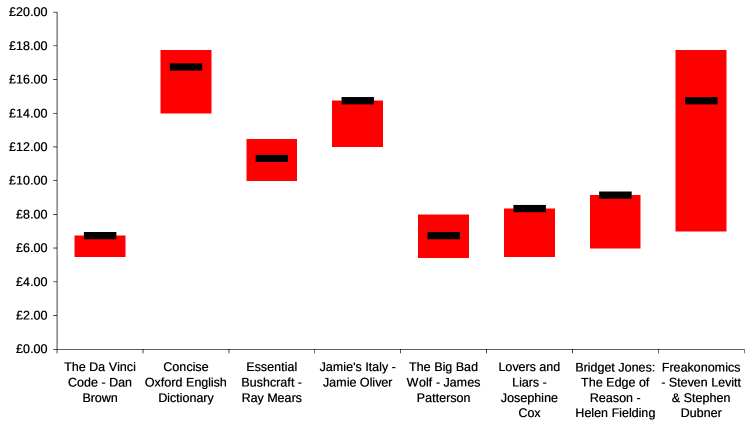
- Some rely heavily on simple customer surveys that ask customers which attribute they care about most. These may show price at the top of the list, but provide no information on trade-offs that customers are willing to make.
- Some fail to weigh the gains from new customers properly against the loss of margin on existing ones. The bigger the existing customer base, the greater the value leakage from a price cut.
- Some fail to spot the difference between extra sales and time-shifting. If customers simply bring purchases forward, making them at discounted prices, there may be value leakage over time. This is common in markets for big-ticket items, such as electronics or furniture, and, unless the two effects are distinguished, can lead to significant over-estimation of price elasticity.

ALWAYS THE CHEAPEST?

When products are standardised and searching is easy, price can be particularly important. So consumers should be most price-sensitive online. A Frontier survey, conducted in 2006, compared the prices at Amazon – by far the most successful online retailer – with those at other leading web retailers.

Looking across 40 products, in 5 categories, two points emerged. The first is that online prices do not always converge to the lowest level. The second is that Amazon is rarely the lowest-priced. In 40 comparisons it was: cheapest only three times; within 10% of the leading price only 11 times; and over 20% dearer than the cheapest price 21 times.

The results for one category, books, illustrate the point.



Customer surveys reveal that online customers often rank absolute price behind security, convenience, site friendliness, range and reliability. You need to be low cost, but not necessarily the lowest cost. Non-price elements of the proposition can make the difference, even online.

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- Finally, some discounters fail to think through the long-term implications. Customers like paying less for the same proposition today, but if discounts have to be paid for by reducing quality tomorrow, they may walk away.

This last problem is often the most serious and the most difficult to spot. To retain margin in periods of excessive discounting, the focus switches to cost. And the cost lines which are vulnerable are those with distant or intangible pay-offs, such as service levels, new product development and, ultimately, brand. Companies that get hooked on tactical pricing may all too often sacrifice other elements, gaining a reputation for "cheapness" instead of value for money.

WHAT'S THE ALTERNATIVE?

Of course, not all companies have the option to be price-leaders. But with a carefully executed strategy, price discounting can be limited, even in markets where price sensitivity is assumed to be high. The Amazon case study (see box) provides a good example. Companies can guard against compulsive discounting in a number of ways.

- **Investing in customer insights**. Understand the role of price, within the overall proposition, for different groups of customer making different types of purchase. Don't assume that price is the only thing customers care about.
- **Assigning ownership.** Place pricing squarely within the proposition design process and encourage decision-makers to use trade-off analysis when discussing changes to any part of the proposition.
- **Using root-cause analysis to understand changing market outcomes.** If sales change, encourage managers to look at all parts of the proposition relative to rivals. They should look at price (the easy bit) last.
- **Creating a champion for high prices.** Even if only one person is tasked with arguing the case for high prices, the decision-making process will be improved.
- **Learning from each episode**. When discounting does have to be deployed, ask managers to predict the short- and long-term consequences, and measure results against their predictions.

These steps can help to put discipline back into pricing, locking it into the proposition design process. In the long run, strategy almost always beats tactics.

CONTACT	**Simon Gaysford** simon.gaysford@frontier-economics.com
	Phil Maggs philip.maggs@frontier-economics.com
	Frontier Economics Ltd
	FRONTIER ECONOMICS EUROPE BRUSSELS | COLOGNE | LONDON
	www.frontier-economics.com