Confessions of the Pricing Man

Hermann Simon, 2016, 221 pgs

Chapter 1 tells us about how Hermann Simon was initiated into the world of pricing. Chapters 2-4 offer a bird's eye view of pricing including how pricing is central to the economy, the psychology of pricing, and how pricing and strategy are interlinked. Chapters 5-7 cover the inner mechanics of pricing. Chapters 8-9 cover pricing innovations as well as pricing applications in real life scenarios including crises. Chapter 10 details how a CEO should approach the topic of pricing.

Chapter 1 - My First Painful Encounters with Prices

autobiographical in nature

1. Never run a business in which you have no influence on the price you charge.

Chapter 2 - Everything Revolves around Price

2. Price has many dimensions

- Base price
- Discounts / rebates / special offers
- Differentiated prices by size / packaging variant
- Differentiated prices by time or customer segment (seniors, kids)
- Prices for complementary products (razors + blades) or bundles
- Prices for special offers or services etc

3. Pricing has become more 'transparent' thanks to the internet, but also more complicated to understand e.g., do you know what a minute of conversation really costs on your mobile phone plan?

4. The most important aspect of pricing is the <u>value to customer</u> from paying for the good or service. The price a customer is willing to pay is always a reflection of the <u>perceived value</u> of the product or service in the customer's eyes. If they 'perceive' a higher value, the willingness to pay increases. Note that it doesnt have to be real, only perceived.

4.1 Pricing is how buyer and seller divide up value.

5. When the company is trying to figure out the price it can achieve, only the perceived value of its offering to the customer matters. Therefore price decisions involve 3 broad tasks

5.1 Create value - via selection of materials, performance and design. Product innovation matters here.

5.2 Communicate value - this is how you influence customer's value perception. This includes how you describe product, selling proposition etc. Value communication also includes packaging, product performance etc.

5.3 Retain value - what happens post-purchase is decisive in shaping a lasting positive perception. Expectations about how long value lasts will have a huge influence on customer's willingness to pay higher e.g., Miele, Luxury Goods etc.

6. The process of price-setting must begin at the conception of the product idea, not just after a product is ready to launch.
7. The quality you bought endures long after you have forgotten the price. It is ok if you get ripped off but the product delivers. But it is not ok the other way around. Research shows that price paid is forgotten but quality stays with us.
8. The perceived value of a product in the customer's mind is linked to outcomes resulting from
8.1 Second-order effects: for an air-con manufacturer selling to truck manufacturers, it was lower accident rates amongst fleet drivers. For TOI advertisers, it may be confidence-building amongst trade?
8.2 Intangible benefits: for BahnCard 50 buyers, it was convenience and peace of mind. For TOI advertisers, it may be reassurance for CMO?
9. BahnCard 50, London Olympics Pay Your Age as examples of smart pricing
10. BahnCard 50, Amazon Prime are examples of 2-dimensional pricing schemes. Pay to become a member or certain privileges, and pay then for each use, simultaneously availing some benefit due to prior payment.

Chapter 3 - The Strange Psychology of Pricing
11. There is a prestige effect of price: for certain luxury goods the higher the price, the greater the willingness to pay. This is called Veblen effect (after economist Thorstein Veblen who wrote about how high prices signal social status and prestige). For premium + luxury goods, one needs to know whether such prestige effects exist, and whether the demand curve slopes upward. This brings us to a key lesson: you need to know what your demand curve looks like; the more precisely, the better.
12. Price is likely to serve as an indicator of quality when buyers are uncertain about a product's underlying quality (quality effects). This happens when they are confronted with a product that is entirely new to them or one that they rarely buy. A thumb rule is that consumers typically make such price-based judgements when the absolute price is not high, when they have little transparency on prices for alternatives or when they are under time pressure.
13. If prestige or quality effects are present in a market, these defuse price as a competitive weapon. What should a company do in such a context? The best method is to position the product in a price range that corresponds to its true quality, and accept lower sales initially.
14. Price anchor effects - When a buyer has neither the time nor the ability to do an expert assessment, and when the product is of much lesser value, there is a tendency to look for reference points or anchors. An anchor could be the highest price in a range or an initially stated price that 'anchors' the price expectation in the buyers mind.
14.1 Another interesting effect of price anchors is the 'magic of the middle'. When buyers know neither the price range of a product, nor have any special requirements (e.g., high quality, low price), they gravitate towards a price in the middle of the range. The less a buyer

knows about the quality of the products and prices in an assortment, the stronger the pull of the 'magic of the middle' is. By selecting a product from the middle of the price range, buyers simultaneously reduce the risk that they buy something of poor quality and the risk that they overspend.
14.2 Sellers should be careful setting price anchors at very high or very low levels. A very high price may scare off buyers not looking to pay that much, and a very low price may scare off buyers who become suspicious of the quality.
14.3 Price anchor effects make it worthwhile to carry a product in an assortment even though no customer ever buys it.
15. Introduction of additional alternatives can significantly increase sales and shift demand towards higher priced products. Simon gives an example from banking where initially you have two options - a checking account only at $100, and the second, a checking account + credit card at $150, with ~60% of consumers plumping for the latter. Then the bank introduces a third option, credit card only at the same price as the checking account + credit card. About ~80% of consumers pick this option, resulting in additional revenue by introducing just one option. Thus small changes in the assortment or price structure can have a dramatic impact on revenue and profit, without any increases in costs.
16. Creating a perception of scarcity, that a product is available only in limited supply can create an even stronger urge to buy.
17. Price thresholds and pricing on 9s - A price threshold is a price point which triggers pronounced change in sales whenever it is crossed e.g., Rs 10 in india, 0.99 or 9.99 in US and Europe. There is a widespread belief that price thresholds exist, though there isn't any convincing scientific evidence in support. It seems more that it is widely believed to hold because everyone is seen to be doing it. Such a mistaken belief can lead to reducing volume of product and suffering consumer upbraiding (Toblerone, Maggi) or loss of profits due to underpricing.
18. Prospect theory, developed by Daniel Kahneman & Amos Tversky, is a key pillar of behavioural economics, and is of considerable significance in understanding pricing as well as deploying pricing. Prospect theory differentiates between positive marginal utility from gains, and negative marginal utility from losses. It says that the pain we feel from a loss is greater than the happiness we feel from a gain. Thus winning $1m and losing it confers lower net utility than if we had never won or lost at all. Prospect theory shows that it is not only the net utility that matters to an individual, but how that net utility comes about.
18.1 Prospect theory explains behaviours such as cash backs, and why we don't like to pay a second time for a lost movie ticket, but will pay for a ticket if we had lost money equivalent to the cost of movie ticket (there are different accounting folders in our minds for movie tickets and cash. We will not pay 2x the cost of a movie ticket ideally).
18.2 Prospect theory also provides concrete guidance to set up price structures, such as why insurance premiums are annual and not monthly (the smaller amount should have made it

more palatable ideally) because each payout is negative utility. Paying monthly hurts 12 times a year; the annual payout though larger, just hurts once a year.
19. Brain research provides useful insights into how prices should be displayed and communicated. In decreasing order of pain - $16.70, 16.70, 17, seventeen. Showing prices as 17 in menus have become common in restaurants.

Chapter 4 - Price Positioning: High or Low
20. Whether a company selects a high-price or low-price positioning is one of its fundamental strategic decisions, typically taken by its founders. Once taken, it is not easy to change course, either from high to low, or low to high. The latter is virtually impossible and unheard of.
21. Simon details examples of low-priced successful brands that make high profits (relative to the industry they are in). These companies are Aldi, Ikea, H&M, Zara, Ryanair and Dell (in its prime). These prove that one can achieve high profits with low prices. He says there are more such companies, but not too many more. Far more companies have failed with the low-price strategy than have consistently achieved high profits.
22. Simon details out success factors for a low-price strategy - these are
22.1 They began with this strategy from day one - low-price was the cornerstone of a distinct business model, with other key aspects underpinning the low price (H&M, Zara - fast fashion concept; Ikea - mega store outside city with DIY, flat packing etc)
22.2 They are very efficient when it comes to cost management - there is a culture of frugality in these companies, and they are very strong in procurement
22.3 The products are low-price but not low-quality. This is an important factor, else low-price is no guaranteer of sales volume.
22.4 They have a strong understanding of the core product. They do nothing that is not required by the consumer. Often the products are stripped-down versions of their competitors (low frills is the term used), but that is because they have a strong sense of what the consumer finds value in. They know exactly what they can leave out of the product without causing the customer to refuse the product or move to a competitor.
22.5 They stick to an everyday low price strategy. The brand has strong connotations with value or low price.
23. Most markets have room for only 1-2 low price-high profit players. Typically the low price-high profit scenario happens when a company is blessed with a clear, significant and sustainable cost advantage over its competitors. The skills to pull that off must be anchored in the company and its culture from the beginning. It is not possible for a company to decide suddenly on one day that it will become a low cost-high profit player.
23.1 The key is to find an acceptable (not minimal) level of value to the consumer, delivered with the highest cost efficiency. This kind of a company also has a very thrifty, spartan work culture; not everyone can work there.

24. Simon explores the emergence of an ultra-low price segment, specifically products created for emerging markets such as India, Vietnam and even Romania. Examples include Tata Nano in India, Renault's Dacia Logan in Romania, Honda Wave in Vietnam etc. Ultra-low prices are no longer limited to consumer goods alone. Thanks to China's growth, as well as growth in mobile phones supply chain, we are seeing the availability of cheap industrial and electronic goods.
24.1 An effective defense strategy for the premium and midrange segments is to become competitive in the price segments further downmarket. It is unlikely that a company can develop low-price products sitting in developed markets. The only way would be for companies to relocate their value chain to a developing market (Alternately hire people from a different industry which uses different cheaper value chain e.g., mobile phone supply chain comprises cheap, tiny components that can be used in many other sectors).
24.2 When deciding whether to pursue an ultra-low price strategy in an emerging country, companies should not only look at the attractiveness of the product category in the emerging market, but also what consequence - good or bad - such a strategy could have on their higher price positions in developed markets.
25. High prices - high margin - high profits is actually a very difficult positioning to pull off. If it were simple, everybody else would try it. Customers will pay high prices for a product or service when they receive high value in return. High value, in turn, often requires high costs in order to produce and sustain those standards. Even if the company is able to realise those margins, a company needs to sell enough units (not easy at those high prices) in order to get to high profits.
25.1 Simon details examples of high price - high profit companies such as Porsche, Miele, Apple, Gillette, Enercon (3rd largest mfr of wind turbines globally). Enercon is an interesting example - its prices are 20% higher, but is able to sustain it because its gearless turbines break down less. It has a very interesting pricing model called EPC - Enercon Partner Concept, where customers can sign up for maintenance, security services and repairs at a price linked to the yield of the turbine. More than 90% of customers sign an EPC contract. Enercon's success is built on its focus on research and innovation - it holds over 40% of all wind power patents.
26. Companies such as Enercon or similar players which have a technology or innovation advantage can offer an unconditional guarantee to its customers that it will reimburse their costs with a penalty should the product fail. This unconditional guarantee can help sustain high levels of pricing. The example Simon suggests is of "Bugs" Burger Bug Killers, whose price is 10 times as high as competitor's prices and offers an absolute guarantee, and phrases it confidently.
27. Companies that create a new product offering superior cost-benefit saving to the consumer may wish to launch the product with a new price metric. Simon cites LED bulbs where manufacturers have not been able to extract the enhanced value that LED technology confers (these bulbs are 10x longer at a fraction of the energy) from the consumers. Instead

he says had they offered light per hour instead of light bulbs, they may have convinced customers why they should pay higher prices. Michelin adopted this strategy for its tires for trucks and industrial vehicles by selling tire performance and charging a price per km.

28. The success factors behind a premium price strategy are, according to Simon

28.1 Superior value to consumer from using the product, translated into an appropriate price-value relationship

28.2 The superior value and the resulting price premium is built and sustained by leadership in innovation and research.

28.3 Premium pricers typically have strong brands - one function of brands here is to transform a technology advantage, often temporary, into a long-lasting image advantage. Hence premium pricers invest heavily in advertising as well.

28.4 Premium pricers are hesitant to offer special offers and promotions. If these become too frequent, they endanger the premium pricing position.

29. Simon explores the success factors for a luxury pricing strategy. These include

29.1 They cannot have any weakness across the performance spectrum. From suave staff to high-quality products to strong communication, they have to do it all well. Even one bad link can make it impossible for consumers to accept the high prices.

29.2 Bundling of highly desirable and less desirable products to dealers is very common. De Beers does this with its diamonds

29.3 Effective policing of dealers to make sure the premium products are not discounted is a must do. Else customers who pay $30,000 for a luxury watch will not want to see it available at $10,000 at a discounted site. This also means that luxury goods companies cannot indulge in price promotions or special offers. Customers who pay a high price for a luxury good expect that to hold its value. And enduring value cannot be built via too frequent promotions and offers.

29.4 Even when business is doing well, luxury goods companies must resist the temptation for big volumes. The high price-low volume approach is an integral part of the premium pricing strategy. Porsche does ~225,000 cars annually. Ferrari does ~9,000, and Patek Philippe ~50,000. They set volume limits and stick to it. This ensures they do not fall prey to 'massification' (the degradation of a once exclusive brand to mass-premium status) which has impacted Lacoste, Opel etc.

30. Which is the most promising price strategy to pursue? All strategies have their challenges. Neither of these three are really easy. Else everyone would have been pursued that. The best way to answer this question is however to look at empirical data. A study by Michael Raynor and Mumtaz Ahmed revealed that the top ~1% or so best-performing companies over a 44-year span (which they called 'Miracle Workers') compete on differentiators other than price and typically rely much more on gross margins than on lower costs for their profitability advantage. For the next 1% ('Long Runners'), it was found that they depend as likely on a cost advantage as a gross margin advantage. Raynor and Ahmed derived two success rules

from their study - “Better before cheaper” and “Revenue before cost”. They concluded that “very rarely is cost leadership a driver of superior profitability”.
30.1 The above survey revealed that the share of companies successful with a premium price strategy is greater than the share of companies who have achieved sustained success with low-price strategies. This is also intuitive as in most industries there can only be room for one or at best two low-cost high-volume players. In contrast markets can support more premium-price companies with their differentiated offerings. Luxury players will really be the smallest of the three, and will be present only in certain categories. Sizewise, those low-cost players who succeed will be the biggest in revenue, then premium-price players and finally luxury firms.

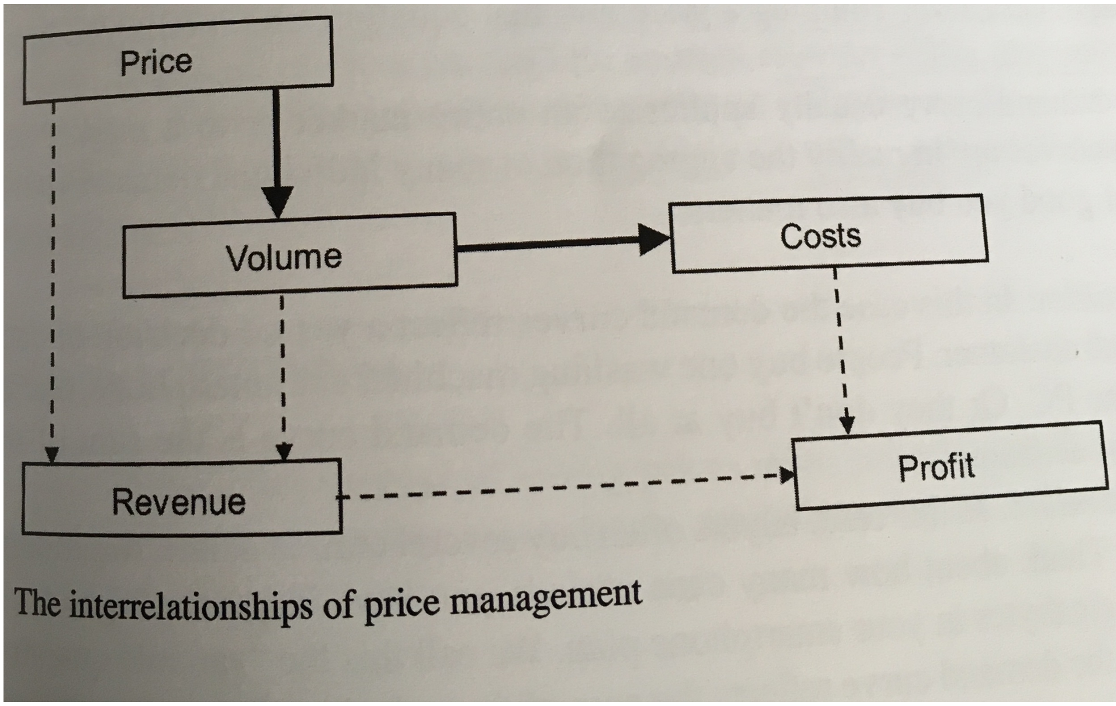
Chapter 5 - Prices and Profits
This chapter elaborates and brings out how critical pricing decisions are to generating profits, and how they are amongst the most important of the marketing instruments with a company.
31. Every percentage change in prices can have a dramatic impact on profitability. A company with a margin of <1-2% may sacrifice all its profits if it tries to cut its way to growth.
32. In most large companies, market share is given disproportionate importance, and prioritization over profits. Most companies refuse to walk away from unprofitable accounts. Simon says, the dominant concern in such companies is to have enough work for their employees.
32.1 In most companies profit goals are under-emphasized relative to goals such as market share, revenue or volume. This prioritization leads to bizarre pricing strategies.
33. Simon dwells on Japan where there is a national obsession with market share, and hence an absolute unwillingness to walk away from unprofitable accounts or raise prices. He wonders if this emanates from its militaristic tradition of unwillingness to retreat and counter attack, as its topography doesn't allow such a manoeuvre. In Japan, he elaborates, loss of market share is akin to loss of face.
34. The book depicts a chart of corporate profitability by country. Smaller countries are seen to have higher profitability than larger countries. Simon posits that this may be due to both higher competitiveness as well as importance attached to market share in larger countries.
35. There is nothing wrong with having sales, volume and market share targets. But these three secondary goals give you no useful guidance for price-setting. Price-setting requires a thorough understanding of two things: how your customers perceive your value, and the profit level you need to sustain or improve that value.
36. Price increase of 1-2% can be effected by reducing the discount that you give your customers. A smart way to do this is by reworking the incentive scheme to prioritize profitabilty. Simon cites the example of a $14b industrial goods major who introduced an

anti-discount incentive. The lower the discount that sales people offered, the higher their commissions were. The reduced discounts were a de facto price increase.
37. Every business has only three profit drivers: price, volume and cost (price x volume = revenue, and revenue - cost = profit). Each of these three affect profit (absolute dollars, not margin) to different degrees. Anecdotal evidence suggests that managers allocate 70% of their time to cost issues, 20% to volume and only 10% to price. This prioritization runs in opposite order to the effects these drivers have on profits. Prices get the least attention but have the highest impact.
37.1 Simon illustrates the above through a simplistic example of a fictional company (pgs 88-89). It is shown that an increase in prices has far greater impact than a similiar percentage increase in volumes, or a similiar percentage decrease in fixed or variable costs.
37.2 His second illustration shows that when you cut prices by a certain percentage, then the increase in volume has to be disproportionately larger to keep profits at the same level. In his fictional example, a co cuts prices by 20%, but has to double volume to maintain the same level of profitability. Most people when asked how much volume needs to increase to offset a 20% price cut, answer 20% increase. This is grossly off the mark.
37.3 Volume discounts and free shipping, which are prevalent in the online retail space, are some of the biggest leeches on a company's profitability, for the above reason. Simon illustrates this with another example of a fictional co (pgs 89-90). Dramatic discount schemes, of the likes of GM's 2005 Spring scheme, actually borrow customers from the future, i.e., customers prepone their purchases to take advantage of the discounts.
37.4 Pgs 88-90 are amongst the most illuminating and insightful pages in the book.
38. Simon introduces the concepts of contribution margin (price - variable cost) and break-even volume (fixed cost / contribution margin) to illustrate how you can judge price cuts. Look at how the break-even volume increases. Ask yourself where will the increased volume come from. Who wants your product? The competitors? If so, is the increased market share realistic? Your future consumers? The break-even analysis is a simple but powerful way to see how price changes affect the likelihood of turning a profit.
39. Price elasticity is a powerful tool to understand the impact of price on volume. It is essentially the ratio of percentage change in sales volume to the percentage change in price. It is usually a negative number, because price and volumes move in different directions, but it is customary to leave out the negative sign and look at the magnitude of price elasticity.
39.1 A price elasticity of 2 means, for a 10% increase in price, the volumes drop by 20%, or that a 10% decrease in price leads to a volume uptick of 20% (*Sajith - can't price elasticities be asymmetric? Price increase elasticity is 2 but price decrease elasticity is 3?*)
39.2 Other marketing instruments have elasticities as well - such as advertising, or trade promotion, or sales force investment. On average, price elasticity falls between 1.3 and 3, with a median of 2 (all this depends on the type of product and region). Advertising elasticity is in the region of 0.05 to 0.1 and sales force elasticity around 0.2 to 0.35. Thus price elasticity is 10-20x ad elasticity and 7-8x sales force elasticity. Hence, you would need to

increase ad budget by 10-20%, or increase sales force investment by 7-8% to achieve the same effect you get by changing prices by just 1%.
39.3 A price offer, combined with increased advertising and enhanced sales force can amplify the individual effects considerably. The combined elasticity could then be as high as 10. Of course, as with the GM scheme, you need to understand the sources of demand - have you created new consumers? Or attracted your competitor's loyalists? Or borrowed against your future sales by selling at lower prices instead of higher prices in future?
39.4 Price has two big advantages over marketing instruments. Firstly, it can be employed without any upfront investment unlike advertising and sales force investments. The latter require upfront investments, and have a delayed payback. Secondly, price changes can also be implemented far more quickly than advertising or sales.
39.5 Pricing's high-speed high-impact power has other downsides. Competitors can respond quickly to neutralise your advantage. This explains why companies rarely win price wars. And unless you have an unbeatable cost advantage that prevents your competitors from matching your price cut, it is impossible to establish a sustainable competitive advantage through price cuts.
40. How do you optimise your price decisions in the light of the above variables and complexity? This is the goal of this book - to convince and get you to go all in on pricing, but in a way that lowers risk and makes the rewards attractive and sustainable.

Chapter 6 - Prices and Decisions
This chapter looks at pricing decisions and how a co should approach them.
41. Simon looks at pricing decisions through the lens of the 5Ws and H.
41.1 Who sets prices? The more homogeneous your product, and the more the number of buyers and sellers, the more likely you'll be a price taker. Away from commodities, most sellers have some leeway in setting prices. This leeway is substantial if your product is unique. However as Evian shows us, even a commodity (water in this case) can be branded, smartly packages and transformed into a differentiated good sold at premium prices.
41.2 Who decides prices? It is people who make pricing decisions. And they are prone to habits, perceptions and biases. In some companies where ticket sizes are large, the top executives get involved in pricing. In industries where there are lots of pricing decisions (airlines, hotels etc), they have a team (Yield Management) who focus on pricing. Otherwise pricing has no natural home. Its location varies from company to company. In certain industries, even sales guys have leeway to set pricing (within a predetermined range though).
41.3 What do they decide on? No company has just one price even if it has only one product. There are discounts, offers, special charges (for services such as shipping etc), base price + variable price combos etc. Typically a company has hundred and thousands of prices across all its SKUs and components, with conditions and incentives.
41.4 How do people make pricing decisions? As David Ogilvy said “Pricing is guesswork”. This still applies to large parts of the economy. However increasingly, certain companies and

industries are beginning to use sophisticated pricing techniques. However we should distinguish between sophistication and professionalism. Airlines use the most sophisticated pricing systems, but still get into price wars.
42. Simon illustrates below how pricing decisions impact volume, which thereby impact costs, and then all three combine to determine profits.



The interrelationships of price management

This is of course an overtly simplistic chain. There are additional factors such as competition, time and reseller / distributor's actions that impact profitability, and including them will lead to an even more complex chain. However all paths to profit start with price.
43. Reactions to pricing decisions by consumers are either discrete choice (Yes / No) or variable quantity (buying more or less of an item) decisions. This depends on the industry. This also implies that the seller's salespeople will have different degrees of freedom depending on the industry they are in. (See 41.2 last line)
44. To make a well-rounded price decision, managers need to take their company's own goals, costs, behaviour of its customers, and those of its competitors into account. This requires some degree of effort and evaluating many trade-offs. Thus as a thumb rule, managers typically rely on two approaches a) Cost-plus b) Competitor-benchmarked.
44.1 The advantage of cost-plus pricing is that is based on hard data, and it guarantees the seller a positive contribution on each unit sold. The disadvantage is that unless it coincides with your customer's willingness to pay, you would have overpriced or underpriced your product. The other important factor to note is that there is no reference to competitor's prices here.

44.2 The advantage of pricing with reference to competition is that you are competitive. The disadvantage is that you are putting your competitor in charge of your pricing, when your cost structures may be different.

45. Through his analyses, Simon draws out relevant insights on pricing

45.1 The revenue-maximizing price is not the same as the profit-maximizing price

45.2 A co many have similar revenues or similar profits at different price levels. This refutes the widely-held belief that it is better to misprice / err on the higher side than the lower side. In practice though, it is easier to move from higher to lower price than vice versa.

45.3 The optimal price (highest price) lies exactly between the maximum price (zero sales) and variable unit cost. (*Sajith - Simon asks us to assume 'a' variable unit cost. In reality this will change basis manufactured quantity, no?*)

45.4 The above decision rule also helps us determine that if your variable unit cost rises by $x, then you only pass half of that to the consumer. Similarly with cost savings; only pass half of that. The rule of thumb is to share the impact of the changes - whether positive or negative - evenly with your customers. Common sense too corroborates this principle. If your product delivers 20% more value than your competitor's products you should not collect all that value from your consumer and leave him empty-handed. Better to split it evenly with him.

45.5 Cross-price elasticity is the percentage change of our volume divided by the percentage change in the competitor's price. Absolute value of cross-price elasticity tends to be lower than price elasticity. The less differentiated the products are, the closer these two elasticities will be to each other.

45.6 We can expect a competitor to respond in some way to our price changes. The worst situation is when he too cuts prices to match yours, resulting in a status quo, and loss of profits for all (referred to as Cournot Hypothesis). The ideal is when you are both able to lift prices (referred to as Chamberlin Hypothesis), without making it look like you are colluding; which results in penalties.

45.7 The best way to drive price increases across the industry without investigation is through price leadership or signaling. In price leadership, you allow the most dominant player to take up prices, and then follow him. Historically GM in the U.S. car market, and Aldi in the German retail market have played price leadership roles. George Stigler, Economics Nobel Laureate, claims that price leadership is the best solution for companies in a highly competitive oligopoly. In signaling, you communicate ('signal') to all in the marketplace, including customers and investors, that you are looking to up the prices. The signaling should not reveal anything which implies or aims at an agreement or contract, such as "if x raises their prices, we will follow". However signaling can be used to announce a possible retaliation that "if competitors take aggressive actions on increasing market share, we will not sit tight" etc. Keep in mind that you have to always follow through on your signals; else you will lose credibility and the signals will lose value.

46. How should we determine demand curves and price elasticities? The simplest way is to ask people. Ask the sales guys such hypothetical questions as “what would be the impact on sales volume if you increased or reduced prices by 10%. Gather their estimates across a range of price changes. This will show how price elasticity changes depending on the magnitude of price change.
46.1 This approach works better when you follow your quantitative questions with two qualitative ones: Why? And what happens next if we do this? The question 'why?' forces him to explain the estimate. The 'what happens next' forces him to think through competitor's response to your price change. These two queries take estimates beyond the realm of mere guesswork. This exercise becomes more meaningful when you ask these questions not only around changes across multiple price points but also across a range of people in the organization. This expert judgement approach is particularly useful for new products, as 'insiders' will be able to make better assessments than customers, who have yet to test the product.
46.2 The 'why' that you ask will prompt discussions about the value of the product to customers, and offer some guidance as to what value messaging you will need to do communicate as well as reinforce the benefit.
46.3 Pros of this approach - quick and cheap. Cons - all internal as it has no customer voice. Even the best experts can be off when they try to anticipate how customers respond to price changes.
47. You can also ask customers directly about how they will respond to price changes, or what their acceptable price range is. The disadvantage of this direct method is that it makes people far more sensitive to prices than in real life, thereby overriding the advantage of the simplicity of the approach. Given the low validity of this approach, it is better to complement it with other more indirect appoaches.
48. In the indirect approach, you do not ask the consumer about price in isolation but about price and value at the same time. Under this approach, titled Conjoint Analysis, the respondent is asked to select between options of different price-value bundles and even indicated how much he will select an option over the other. Through the use of computers we can make it more sophisticated and interactive (such as making each successive trade-off tougher). This gives us data necessary to estimate sales volumes at different price configurations and plot a demand curve, and thereby make a robust, reliable price decision.
49. At the end of the day, survey methods, direct or indirect, however sophisticated, are still simulations with a certain margin of error. This is where field experiments come in. A company changes real prices in a store or online and tracks how customers respond to these changes. Thanks to advances in modern tech, and the rise of online shopping, field experiments are becoming more and more easier to conduct, and popular than before.
49.1 Over the years, Simon has found that a combination of these methods has produced most reliable results. Use one method to cross-check others. If all point in a similar

direction, then you can be reasonably sure that you have correctly estimated how customers will respond to your prices.

Chapter 7 - Price Differentiation: The High Art

50. One uniform price, even when set optimally, only exhausts part of the profit potential in the market. The illustration below conveys this. The graph on the right shows the entire profit potential bounded by triangle A-B-C. It is much larger than the profit realised from the uniform price, the rectangle defined in the left graph.

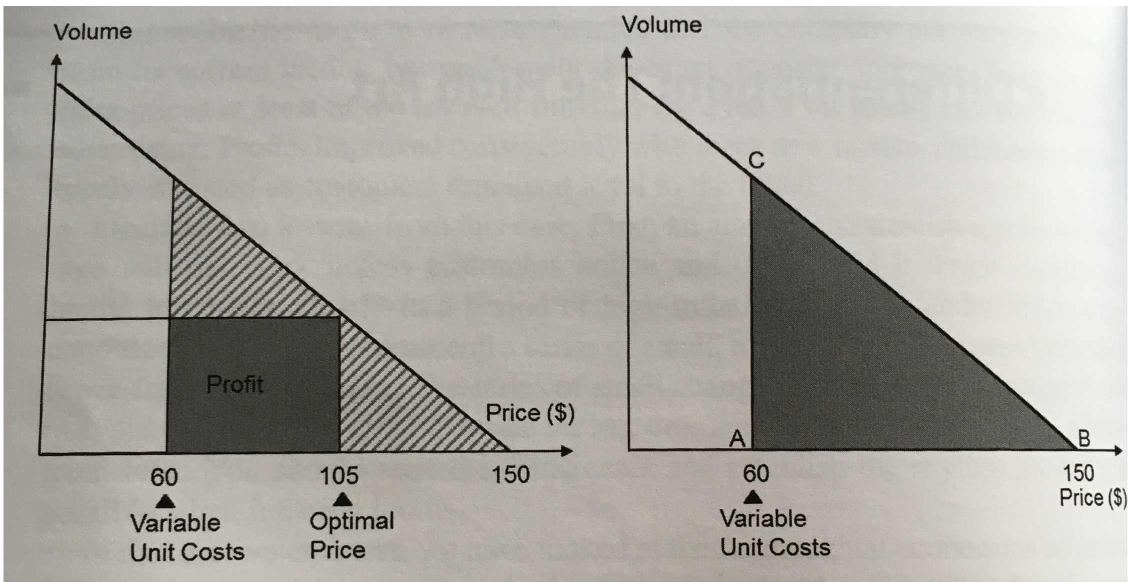


Fig. 7.1 Profit at a uniform price and profit potential from price differentiation

51. With a linear demand curve, and linear cost function, the area covered by the triangle is twice the area covered by the rectangle. With a non-linear demand curve, the relationship is less straightforward, but still around twice the profit potential from the rectangle. Thus a uniform price only taps about half the profit potential.
51.1 How do we get from the profit rectangle to the profit triangle, i.e., tap the two triangles or areas of profit potential that elude us when we charge a uniform price? This is amongst the most interesting, difficult and potentially lucrative questions in the field of pricing.
51.2 In normal circumstances, it is almost impossible to realize the entire profit potential, as it would require us to get every customer to pay his or her individual maximum price, while segregating each to ensure no one pays less. This is what is called price discrimination or differentiation. This is not easy, though there are some situations such as an auction where there is greater chance of this happening.
51.3 Price differentiation is far more common than we think. See the price of coke when you buy from a shop versus buying it from the hotel minibar.

51.4 Price differentiation makes sense only when we can fence the person willing to pay the higher price from consuming the product at a lower price. In the absence of a fence, the realisation will drop, dragging down profitability. You end up then making far less profits than with the uniform price. Without an effective fence, price differentiation is a dangerous endeavour.

51.5 Another case of price differentiation is when a business charges different prices for succeeding units of consumption, as in different prices for 1st, 2nd and 3rd beers to reflect the declining marginal utility of the consumer. In such cases you can realize far higher profits than if you had a uniform price. But this is operationally not easy to implement, and requires detailed knowledge of the consumer and his willingness to pay.

52. When a seller packages several products together and charges a total price less than the sum of the individual product prices, it is called price bundling. Bundling is a very effective way to differentiate prices and cover more area under the profit potential, as Simon proceeds to illustrate with an example. The core reason is that the bundle does a better job at exploiting the consumer's maximum prices than the individual prices do. The profit situation gets even better when the seller practices mixed bundling, when buyers can buy either the bundle or the individual products separately.

52.1 Bundling is not suitable for all contexts. There are situations in which unbundling - the elimination of bundles by breaking them up into their constituent parts - can be more profitable. Some examples of the situation are when you can open up new markets by selling components on a stand-alone basis, or when the bundle price has evolved over time to be very high, or there is more and more standardization and compatibility, such that the consumer can compile a bundle on his own. Over the long term, as the industry matures, the balance tips in favour of unbundling.

53. Volume discounts are another form of price discrimination. Simon urges the seller to offer only incremental discounts, i.e., where the discount rate applies only to the incremental volume, not the full volume. The profitability under the incremental route is far higher.

54. Simon provides examples of how sellers can discriminate or differentiate between buyers and charge different prices. Many of these routes are becoming difficult to implement due to the internet, which enables price transparency to a considerable degree. Still companies can take advantage of these routes. They include a) differentiating by location including distance surcharge b) differentiating by time; essentially dynamic pricing to reflect weekend load, peak hours load etc

55. It is not wise to have a system of last minute prices, either for perishable goods, or even for plane seats, as customers tend to game the system by shopping only during the time the price discounts are on. This is why airlines now let the seats go empty than charge a low price, even when the low price is actually pure profit.

56. Special variants of time-based differentiation are early bird discounts, advance sales prices etc. These are very common in the travel industry, where there are established patterns such as leisure travellers booking early etc, thereby resulting in an effective fence.

57. Typical price strategies for new products are penetration pricing (low prices initially to get consumers to try out the products) or skimming (high prices initially to get the most enthusiastic consumers or fans to pay). Penetration prices are more common for experience goods, which require the consumer to gain some experience with them in order to understand their true value. Penetration prices thus help lure in consumers, and motivates them to give the product a try. We also see penetration prices in categories where there are economies of scale. Skimming on the other hand is widely seen with electronic goods and novelty products. iPhone is a great example of a successful skimming price strategy.
58. Fencing is the most important component of price differentiation, for without it, all those willing to pay higher prices would pay the lowest possible price. Fencing is effective when the value differences between the two price categories are sufficiently large, and the seller can control access. In order to erect an effective fence, pure price differentiation - charging different prices for the exact same product - is not sufficient. Product versioning, use of different distribution channels, targeted messages to individual customers, access control etc are required. Effective price differentiation needs to comprise several marketing instruments, which makes it more than simple pricing. Price differentiation thus also means higher costs.

Chapter 8 - Innovations in Pricing
59. In this chapter, Simon details several pricing innovations that have been introduced over the years. These include
59.1 Pay-per-use: Rather than sell the product itself, the manufacturer reorients the business model to sell what the customer is buying the product for, e.g., Rolls-Royce sells thrust, not engines to airlines, charging them by the hour for engine performance, Michelin sells miles not tyres to trucking companies; EnviroFalk charges per litres of water treated not water treatment units etc. The advantage here is that you are able to charge a much higher price overall for the product sold as a service than a good e.g., Michelin had a tyre that lasted 25% longer but was not able to charge a price 25% more because of the presence of anchor prices for tyres established over a long period. Buyers are also happier as there is no or reduced upfront payments, and they are able to get the benefit without owning the product.
59.2 Changing the price metric: Here you are changing the measurement basis for the price, e.g., charging per weight of the flyer, and not per seat as Samoa Airlines does.
59.3 Introducing a new price parameter for a previously free or bundled service, such as airlines do with all their surcharges for checked-in bags or leg space, or Tank & Rast did with their Sanifair toilets in Germany.
59.4 Two-dimensional pricing such as Amazon Prime or the BahnCard model. In all multidimensional pricing schemes, there is some kind of price discrimination. The company makes the same price offer to all customers, but each customer pays a different amount according to his or her actual usage.

59.5 Freemium: as seen with a lot of online media companies, online gaming companies and online software companies such as Quip, Evernote etc. Freemium requires appropriate fencing between the basic and premium offer, via product features or limits on usage intensity in order to convert buyers to premium offer. According to Simon, basis Simon-Kucher & Partners' experience, a systematic optimization of price and and product using a freemium model typically increases revenues by 20%.
59.6 Flat rates: Here a customer pays a fixed price per month or year, and can use the product or service as much as he or she wants in that period. A co that offers flat rates runs the risk of realising lower revenues from their heavy users, and potentially higher costs from having to service them. One interesting variation in flat rate pricing is seen in Japanese buffetts, which offer a 'all you can eat' but in one hour option for 1,500 yen (~$15) i.e., flat rate with some limits so that the risk from the offer is limited. Ideally if consumption is not curtailed by some natural or artificial limits, companies should be very careful with flat rates. If the number of heavy users is large, flat rates put profits at considerable risk. Consumers love flat rates, even when it is not their most economical choice, because it limits his out-of-pocket risk to a fixed amount.
59.7 Happy Hours, seen in bars, is another price innovation, though Simon doesn't reference it specifically.
59.8 Prepaid systems, such as seen with most Metro / travel cards, and even with Starbucks (which made a profit of $33m from inactive or 'dead' cards in 2013)
59.9 Pay what you want model seen with websites such as wikipedia, brainpickings. This is also referred to as 'panhandling' (slightly derisive connotation) and is becoming an accepted way to pay / appreciate a 'free' website.
59.10 A la carte pricing, seen with iTunes or HBR where you can pay for a single song or article. There is a risk with this model, as you stand the risk of realising lower revenues from your customers, who would otherwise have paid for the full album or annual subscription.
59.11 Auctions, once popular with eBay, now less so. Google uses this to determine pricing of adwords.

Chapter 9 - Pricing in Crises and Price Wars

60. In the context of this chapter, crisis refers to a fall in demand. This is marked by inventory pileup, capacity underutilization, price pressure as well as selling pressure. In such a context, the temptation is to cut price and keep volumes constant, so as to protect jobs etc. However as we have seen from previous chapters, cutting prices lead to drop in profits, as the volume uptick needed to preserve profits tends to be very high. A better approach, and one that preserves profitability, would be to keep prices constant and drop volumes, even at the risk of shutting down production lines (or reducing work hours) and letting go people. To summarize, from a profit standpoint, it is better to cut volumes than price. If there is no way but to cut prices, then one should structure the price cut in such a way it minimizes negative margin effects and maximizes positive volume effects, such as by giving goods free

instead of lower prices, e.g., a sixth item free on every five purchased as opposed to cutting prices by a sixth. Ideally the price cut needs to be backed by special price-oriented advertising, additional placements etc.

61. It is also possible to make selective price increases during a crisis, especially when you have a large assortment of products, or when you have a must-have set of products or ones which are relatively price inelastic e.g., spare parts.

62. Overcapacity is the biggest challenge that pricing faces today. Companies that are seeking to reduce their capacities have to be very careful in how they manage the reduction, lest competitors take advantage of the situation. One way is to signal continuously your intention through interviews or public statements, including your willingness to defend your market share or retaliate if competitors take advantage of the reduction in supplies; and naturally follow through on all that it has announced. Of course, in the unfortunate situation that competitors pounce, you do have to retaliate.

63. The smart industries avoid price wars and are profitable; the not so smart industries get stuck in price wars and incur losses. Choose your industry well, and pray for a smart competitor.

Chapter 10 - What the CEO Needs to Do

64. In this chapter, Simons shares advice that he would give a CEO who seeks his counsel.

64.1 The goal he has to work towards is long-term profit orientation. He has to keep in mind that price is the most effective profit driver, and thus infuse the company with a strict profit-oriented mindset. How?

64.2 Repeat the profit mantra frequently, backing it with consistent actions. The most important of this is basing the incentive systems of the country managers strictly on profit, not on revenue, volume or market share targets. See #36 or pg 86 of the book for a scheme which does this. This is also covered in pg 167 of the book.

64.3 Creating a price metric for the top managers to use, such as relative prices. This is a a system created by Toyota where they express their own models' prices relative to the average price of the relevant competitor models, and offer specific instructions on how local managers should change these relative prices.

64.4 Another action is not to start price wars, or respond to every aggressive moves of a competitor.

64.5 In countries or regions where it has market leadership, it should pursue price leadership via a consistent campaign that emphasizes price and value

64.6 He should remember, the most important aspect of price is and will be value to customers. Thus good pricing has 3 prerequisites: create value, quantify that value and communicate the value to customers.

64.7 The more importance the CEO attaches to pricing, the more importance the organization will attach to pricing, and orient their behaviour around his.