Building Prices on Value

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Many pricing problems are not really pricing problems at all. Building a price is largely a mechanical, mathematical procedure, seasoned with mature business judgement. Effective price setting depends on our ability to reach a proper understanding of what value actually means in a given commercial context. Even in the same market segment, different customers will have quite different perceptions of the value we offer. Some will reject our propositions; some will reluctantly accept them; others still will embrace our offer fully and seek to work with us to develop it. In pricing work, we need to recognise the large variation in the acceptance of our value proposition and consequently the options we can have in developing pricing strategies. Even more importantly, we need to recognise that we may require to adjust the proposition for different customers in the same segment, or craft completely different ones for different segments. Once this is clear pricing decisions become easier.

The Aim of This Session

This session examines rigorously the concept of Value. Optimising Customer Value underpins all marketing decisions. By means of the Value Triad, we demonstrate how to create a Value Based Price which captures, and enables us to share, as much as possible of the value created for the customer.

Intended Outcomes

Having read this session, readers should:

- Understand the concept of *Customer Value*
- Understand and be able to apply The *Value Triad*© in analysing and prioritising a customer's specific needs in the context of his life or business.
- Be able to identify critical customer *Value Drivers* and be able to quantify these
- Be able to assemble the key elements of a *Customer Value Proposition*
- Understand that the process of implementing Value Based Pricing in his organisation is a change management process, not merely cosmetic manipulation of numbers on a price list or spreadsheet.

Introduction

Most businesses today are confronted with breath-taking technological change, intensive competition from existing competitors and new entrants, and ever decreasing lifecycles. These conditions have resulted, in many industries, in premature commoditisation. In order to preserve their market share, companies often reduce their prices either voluntarily or as a result of insistent buyer pressure. The result is declining revenue, margin erosion and business failure. Nevertheless some companies manage to thrive. These companies identify and use customer value as a strategic tool.

What often present as pricing problems in reality are failures to come to grips with the underlying value issues. A deep understanding of customer value helps us to make much better decisions, not just in pricing but in all areas of the business. In one sense, every price paid willingly by a customer is a value based price. If there were no value to that buyer there would be no sale! We can achieve much better prices by creating products and services which deliver much better value. Or by making customers aware of the real value we deliver to them. This is true, whether we are pricing on cost or competition or deploying value-based pricing.

What is Value – and Why Does it Matter?

Value is tricky to define and conceptualise. This uncertainty and ambiguity often creates difficulties both inside organisations and in communications with customers. Failure to identify the value created, and to present this compellingly to customers, reinforces commodity perceptions and fuels demands for further and deeper discounts. This requires new and different thinking in which the focus of attention is moved away from product technology and specification to how products and services impact on customers at economic and emotional levels. When businesses make this transition, margins increase and market shares are protected.

Have you or your sales people heard any of these?

"All products in this market are exactly the same – including yours…"
"This is a commodity market now…"
"You'll have to drop your prices if you want to keep our business…"
"There is no way you'll get a penny more per litre than your competitors…"

Every one of these assertions was made during a sales interview. Every assertion was made directly to sales people who promptly passed the problem "upstairs" to product managers or other business managers. In every case the supplier's market share exceeded 50%. In every case managers were almost completely at a loss to know how to deal with the situation. (Macdivitt, 2013)

Continuing economic uncertainty has engendered the conviction that the only solution to a pricing problem is to yield to customers' increasingly unrealistic demands, drop price and hope for the best. This is wrong. Dangerously wrong. Because managers and sales people do not know how to respond and, critically, lack confidence in the acceptability of their pricing, they feel that the only solutions are either to walk away or to discount - usually deeply. Discounting has become a default response to price objections. Customers know this! Deep discounts make things worse, not better, and set up the discounter for more of the same. Walking away creates an opportunity loss.

There are alternatives. The above companies were not, and are still not, commodity suppliers. Each is still a leader in its segment with a market share between 3 and 5 times what one would expect in a genuinely commoditised situation. But their salespeople had been brainwashed by their customers into believing that their prices were too high, that their products were commodities and not worth the prices being charged and that they would lose out if they didn't drop their prices right now! Because these companies learned how to identify and use value, their customers are still buying, often at higher prices than before. The buyer's assumptions were completely specious – opening fusillades in a war of value attrition!

Most businesses today are seeking to protect the revenue, profits or share that they already have achieved. Developing a value argument for them is a strategy to reverse margin erosion. To achieve this, they must persuade their customers of their differential value. These companies employ value as a means of fighting back against the torrent of demands for discounting. This is why Value is important.

The concept of value is of importance in all aspects of business - not just marketing. Peter Drucker, a well-known management guru once commented..

"These are the satisfactions the customer looks for, values, and needs."

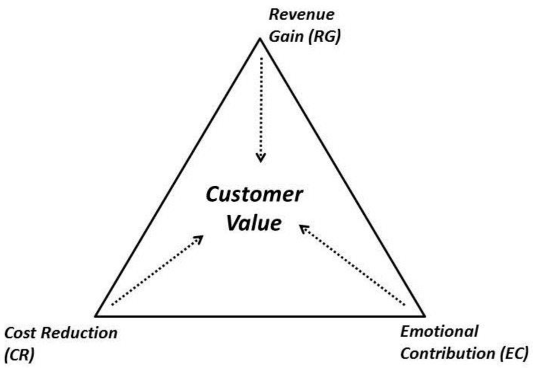
Creation of customer value, through innovation driven by deep customer insight, is the whole reason for existence of a business. In pricing it applies both in business to consumer and business to business contexts. Think about how to apply the Value Triad© in *your* organisation.

The Value Triad©

The Value Triad© (Macdivitt and Wilkinson, 2012) is a practical tool which helps managers capture optimally the depth and breadth of meaning embedded in “value”. By building a real focus on customer value into product development and service delivery processes, companies create a solid basis for creating differentiation - doing something different in a manner that really matters to the customer. By clearly focusing on customers’ needs and pain points, novel ways of serving can be revealed.

The Value Triad© helps us to identify the factors critical to the customer’s purchase decision, and how these can be met effectively. Value Triad© thinking helps users build powerful value propositions and construct prices based firmly on how products impact customers’ businesses economically and decision-makers emotionally. A price developed in this way need not necessarily be a *Value Based Price* but its construction is based soundly on Value. Its effective negotiation depends completely on a deep and practical understanding of value to the customer and how this is perceived by the customer. Value Triad© analysis lies at the centre of sales, marketing, product management and pricing. It is a unifying concept and can bring all of these important functions together.

FIGURE 1 The Value Triad©



The three elements of the Value Triad© are Revenue Gain (RG), Cost Reduction (CR) and Emotional Contribution (EC). Revenue Gain and Cost Reduction focus on the functional, tangible, objective and inherently measurable elements of value. Emotional Contribution, as its name implies, focuses on how less tangible, more subjective and somewhat less readily measurable factors contribute to the purchase decision.

Revenue Gains refer to the increases in customer revenue resulting from the application of products and services. Cost Reduction relates to how products and services reduce customers’ costs. The key issue is that output value to the customer is not compromised. Finally Emotional Contribution is in general linked closely to the “feel good factor” – e.g. reduction of “hassle”, peace of mind, increased confidence, greater safety, aesthetic appeal, trust, self-esteem, reduction or elimination of psychological risk, etc.

While executives’ opinions around tangible factors are generally closely aligned, the same executives may have widely differing opinions about what affects them, personally, from an emotional perspective. Consequently, emotional impact is not absolute in the same way as are CR or RG. Different metrics apply to different people and have different weightings. Even for an individual the same metrics will have quite different weightings at different times depending on mood, personal confidence, anxiety and other psychological states. Thus EC intangibles can be difficult to quantify. But they are not impossible to quantify (Hubbard, 2007). In some circumstances, and using special marketing research techniques, Emotional Contribution can be estimated (Lipovetsky et al, 2012). It is important that we at least try to make this assessment because emotional considerations can have a profound (albeit covert) impact on the overall attractiveness, or even acceptability, of a proposal. An important aspect of EC is psychological risk. Even when all the value elements are lined up in a row, risk factors may scupper the deal. *Significant Objects* (Glenn, 2012) is a fascinating book containing stories about mundane, everyday objects. These well-crafted stories enhance the economic worth of these articles enormously. A huge part of building both value propositions and creating collateral is to build such stories for our own products and services!

Value Drivers

Value drivers (Anderson & Narus, 1998, Macdivitt, 2012) are those factors which ultimately lead a buyer to identify a preference and make a purchase decision. In a given context there may be several such drivers each with different "weightings" in the choice process.

Tangible Drivers	Value Drivers that are readily measurable or quantifiable. In Value Triad thinking, these include Revenue Gain and Cost Reduction elements.
Intangible Drivers	Value Drivers that are less easily measurable. In Value Triad thinking, these include Emotional Contribution elements.

Table 1 Tangible and Intangible Drivers

In Table 1 we define tangible and intangible value drivers. The best way to make this happen is to "map" the clever parts of the product offer to the important parts of their customers' needs. This task goes well beyond the sales team and should engage the attention of marketing, product management, product development, and design people at the very least. In short, value should run through the whole value chain, like a golden thread. By Value Chain I mean all the value creation activities undertaken in a business to create sustainable customer value. Value Chain Analysis is a hugely important topic in business and is one with which marketing professionals must become deeply familiar (Porter,1998)

Let's drill down into each of the elements of the Triad. What follows is not a comprehensive list and you will be able to identify others relevant to your industry or business. Indeed we encourage you to do this. There are potentially hundreds of Revenue Gain (RG),Cost Reduction (CR) and Emotional Contribution (EC) items. For any given situation we need to be sure that the items we identify have real traction with the customer given his situation. Ultimately what most customers are looking to achieve as the result of purchasing products or services is a combination of these. In general, customers are not hugely interested in technical specifications or even technology (OK, so there are some!) The task of sales and marketing is to identify the ones that matter to a given stakeholder and to use these to create a compelling value proposition to stimulate their interest. We list a few typical examples below.

Revenue Gain

- customers' ability to negotiate higher prices with his customers
- greater competitiveness leading to greater market share
- enhanced output or productivity from operations
- reduced time to market

- shorter time to money
- shorter delivery time to customers
- better yields from manufacturing processes
- reduced or eliminated downtime

Cost Reduction

- reliability in use, avoiding costly downtime and repeated start-ups;
- ease-of-use, enabled by user friendly, intuitive product design;
- our product lasts longer and is more robust than other equipment the customer may have used previously;
- the equipment is easier and quicker to service or repair, spare parts are more readily available and can be installed by the customer's own personnel;
- storage costs are reduced or eliminated because we are able to provide the customer with frequent deliveries, just in time;
- training costs are reduced or eliminated because of an intuitive machine-user interface, user-friendly manuals and a helpful website.

Emotional Contribution

- Peace of mind - instilling into the mind of the customer that our solution to this problem will work reliably and without inconvenience
- Comfort - as a consequence of ergonomic design, our product is easy to use, minimises fatigue and can be used by operators for extended periods
- Aesthetics - the visual attractiveness of the product which might be the result of a combination of non-tangible factors such as colour, shape, "footprint", and so on
- Hassle - managers are very busy people and often lead stressful business lives. Anything that we can do to minimise the stress is bound to be beneficial.
- Risk - we can measure economic and physical risk in mathematical terms using tools such as Monte Carlo simulation. Monte Carlo simulation is a statistical tool which allows you to model all the possible outcomes of a business decision and assess the impact of risk. In particular it permits you to make better decisions under uncertainty (http://www.palisade.com/risk/monte_carlo_simulation.asp accessed 130302). In the context of EC, we are referring primarily to psychological risk.
- Relationships - how easy we are to deal with as a supplier, how responsive and supportive are our people, especially in customer facing roles, transparency of our billing practices and reasonableness of our commercial terms and conditions all contribute to fruitful business relationships. Some of these factors are quantifiable. Others are not. But relationships between vendor and customer might outweigh the economic aspects of our offer.
- Trust – of all the elements of EC, perhaps trust is the most important. Have we, and all the other members of our team, built a trust based relationship with the client. The more a customer trusts us, the more information they will share, the more they will accept the things we say and the assertions we make. This, truly, is the most valuable of all the EC elements.

Value Analysis

I advocate a four step process to identify the real value of your offer. Each step in this process is illustrated using a typical B2B scenario.

Value Analysis Process

Step 1 Design the Value Triad© for your customer organisation
Step 2 Summarise the role and importance of each stakeholder in the buying process
Step 3 Undertake a So What? Analysis for each important stakeholder
Step 4 Assess the economic contribution of each driver on the business and the emotional impact on each stakeholder.

Illustrative Scenario

A company sells lighting systems and assemblies to automobile manufacturers. The products are very clever. They can help drivers see round corners and when integrated with satellite systems are even able to give the driver forewarning of significant changes in road curvature and topography. New generation systems combine Xenon, LED and Adaptive Front Lighting technologies and are equipped with sensors that detect ambient light levels. They switch on automatically to the correct light intensity for the conditions and switch off again when not required. They are made with robust materials and employ efficient designs that mean that the average time before failure is longer than competitive products by a matter of months. Until now, the company has been selling these on a cost basis and managers are convinced that there is more value to the products than they seem able to capture. The company sells directly to Ford, BMW, Peugeot and Volkswagen) to install in new vehicles. The company also sells into the aftermarket to parts suppliers and vehicle service businesses. For the sake of this illustration, let's focus on the car manufacturers.

Step 1 Use the Value Triad© to identify "high level" customer value

Think through all the possible value items to the customer. Work through each of the Triad elements in turn, doing your best to leave nothing out.

Value Triad Element	Value Statements
Revenue Gain	Novel technology makes car more attractive to channels and end-users thus increasing market share and unit price; An advanced lighting package enables the OEM to offer a premium priced option for wealthier customers.
Cost Reduction	Last longer than competitors so do not need to replace so frequently; Easy to fit and replace so doesn't not require a lot of expensive workshop time; Helps avoid night time collisions and all the costs and inconvenience this causes.
Emotional Contribution	Better night vision improves safety; Prestige.

Step 2 Summarise the role and requirements of each stakeholder and their influence in the buying process

Who is interested in this list of product attributes? Clearly the end-customer/driver is one. So also is the product designer who is looking to incorporate leading edge specifications into his product. Other executives may also be interested. A third group might be the dealer who sells and services the new vehicle after sales.

Stakeholder	Role	Requirements	Influence (%)
Product Designer	To ensure that the vehicle specification is met thorough efficient design employing the best materials and technology components.	Full and detailed knowledge of the differential advantages of "our" offer compared to alternative materials and components	25%
Dealer Warranty Manager	To ensure that all valid warranty claims are addressed timeously and to manage the demands within budget	Materials and bought in components perform at or above stated specification	35%
Procurement	To ensure that all purchased items conform to specification at or better than allocated budget	That the best balance between cost and value are achieved in line with the company's strategic objectives	25%
Marketing	To ensure that the product meets defined specifications as called for in business case	The ability to create attractive value propositions and marketing collateral to meet revenue and profit targets	15%
Others?	Etc.	Etc.	

Much of the information required to populate this table will come from the salesperson. The purpose here is to identify who the principal decision-makers are in the buying process, and to ensure that their needs and expectations are properly considered. If a key decider is forgotten about, it means that an important element of value analysis is omitted. This could lead to the wrong value proposition being delivered and also the wrong price being calculated.

Let's eavesdrop on the salesperson's conversation with one of these interested customers – the Dealer Warranty Manager – the executive in charge of managing warranty claims through the dealer network.

Salesman: Our new lighting assembly is built with cutting edge halogen lamp technology and equipped with sensors which can automatically adjust to ambient light conditions.
W/Manager: So what?
Salesman: It's safer for the driver because she will have the right level of illumination at all times.
W/Manager: What does that matter to me?
Salesman: Well, it's made with state of the art technology.

W/Manager:	So it is a new concept which can go wrong at any time?
Salesman:	Yes, it is new and innovative but it's been fully tested.
W/Manager:	So you are guaranteeing it won't go wrong and cause my people all sorts of problems sorting it all out?
Salesman:	Well, no but it's really cool for the customer.
W/Manager:	What do I care?

This dialogue is not going anywhere fast. The Warranty Manager frankly does not care anything about the "coolness" of the driver's experience. Why should he? He can't afford to own this car personally, so this assertion is completely irrelevant. He cares more about the leading edge technology, but not in quite the way the salesperson hopes. This manager sees new technology as a source of hassle, based on his years of experience repairing clever components that have failed after a few days use. So this is not a really compelling value argument for him. The salesperson simply has not thought the whole thing through from this stakeholder's point of view.

He has failed to prepare a really solid, credible argument for this stakeholder and not surprisingly his presentation is a disaster! He should really have done the analysis in Step 3 below.

Step 3 Undertake a So What? Analysis

We use the So What Analysis and the Value Triad© framework to examine things from the Warranty Manager's perspective:

Table 2 So What? Analysis – Warranty Manager

Attribute	So What?	So What?	Decision
Innovative product design	Can help drivers see round corners	Neutral for this stakeholder	Don't care
Very latest in halogen lamp technology	Much greater illumination of road in dark conditions	New technology => teething problems => costs to replace => cost and hassle Negative for this stakeholder	Don't like – will cause me hassle and increase repair costs during warranty period
Ambient light sensors	Switch lights on when conditions warrant	Same as above Negative for this stakeholder	Same as above
Made with robust materials	More resistant to road use wear and tear	More durable => lasts longer => less replacement RG, CR	Like it but need evidence/proof
Plug in design	Easy and quick to fit replacement unit	With competitive units usually hard to do in workshop = >saves time, money, hassle RG, CR, EC	Like it but need proof
The average time before failure is months longer than competitors' products	Replacement during warranty period much less likely	Can reduce warranty repair incidents saving time, money, hassle. Also means time saved can	Like it but need proof

	be used for other things RG, CR, EC

We do this analysis for each stakeholder in the customer's organisation (in B2B). For B2C it is a lot easier…we can go up a level from consumer to segment. If the segmentation has been done correctly, and we have really tightly profiled value-oriented segments, the applicable value drivers for the consumer will be identical or very similar to those of the segment to which he belongs.

Some of these are economic in nature (Cost Reduction, Improved Operational Efficiency) and others are more psychological/emotional in nature (Reduced Hassle and Peace of Mind). This set of drivers is quite different from those of the Chief Designer and different again from the end-customer's perspective.

So, what does the Warranty Manager really want, bearing in mind the So What Analysis output? Let's try again.

Salesman: Our new lighting assembly is built with cutting edge halogen lamp technology and equipped with sensors which can automatically adjust to ambient light conditions. This means a great experience for the driver. It also means failure is almost unheard of within the first two years.

W/Manager: How often does the lighting system fail?

Salesman: The chance of a system failing is less than 0.005% within two years. So you could see 200 cars without a single warranty claim based on lighting system failure.

W/Manager: So what?

Salesman: Because of the way the system is designed, not only is the failure rate lower than any competitive system, but it is quick and easy to replace. Just pull out and plug a replacement component back in again.

W/Manager: Thinking…So you are saying it can save my people time in dealing with warranty replacements and paperwork?

Salesman: Absolutely. Here are some independent studies…

This is much better. Whether this imaginary conversation would play out this way in the real world does not really matter - there are obviously other factors at play. What does matter – and matters profoundly - is that a competent value analysis must be undertaken before making any client contact. Or, for that matter, before creating any value proposition or developing any marketing collateral.

Step 4 Assess the economic contribution of each driver on the business and the emotional impact on each stakeholder.

Of all the Value Drivers listed in Table 2 only five have traction with this particular buyer. Do not try to short-circuit this analysis, especially in B2B work. Many individuals have an input to a purchase decision (especially for a first-time purchase of something new or innovative). Your proposition must have something tangible (and intangible) for each decision-maker. Quantify this impact wherever possible.

Decreased costs (the Warranty Manager must work to a budget, after all);
Improved Operational Efficiency (this will be part of the pushback from his customers in the channel, associated with some level of hassle, too, no doubt);
Reduced Hassle;
Greater Peace of Mind (knowing that he has eliminated one important and recurring problem with the right purchase);
Reliability.

Let's drill down a little into these five Value Drivers

If you are not very mathematical, you might find it easier to understand and use Word Equations. (Anderson, Narus and van Rossum 2006). A Word Equation is an expression in words explaining how to translate Value Drivers into quantified economic value. The economic impact of tangible value drivers can be estimated in this way. Intangibles are rather more difficult to quantify, and here we would use tools like Conjoint Analysis and von Westendorp to assist us here (Lipovetsky, Magnan and Zanetti-Polzi, 2012). These are specialist pricing research tools and are beyond the scope of this paper.

Table 3 Estimating Economic Improvement

Value Driver	Route to Quantify
Decreased costs	Previous year's warranty costs minus this year's warranty costs = total number of claims x average cost per claim last year minus total number of claims x average cost per claim this year
Improved operational efficiency	Number of hours spent on warranty work last year minus number of hours spent on warranty work this year
Reduced hassle	Difficult to quantify objectively
Greater peace of mind	Difficult to quantify objectively

You are now in great shape to understand and use Value Based Pricing in your organisation!

Value-Based Pricing

Value Based Pricing (VBP) is a relatively recent, and very important addition to the pricing toolbox. Unlike other pricing methods, VBP focuses on the benefits that buyers gain through the purchase of a supplier's products or services. The price charged to the customer is calculated from the estimated economic and emotional gains. VBP is used today in manufactured goods, services, FMCG and in retail.

About Knowhow

By way of illustrating what Value Based Pricing is all about, let's start with a simple, but fairly typical scenario.

"Okay, Dave. I'll be right there." As Jack put down the phone and made his way to No 2 building he reflected on his long and successful career as production director at the Zenith chemicals processing complex. Dave was his most recent employee (and the brightest with a brand new PhD in chemical engineering), but he still seemed quite unable to understand how this process plant worked. After checking a few dials and turning a few control valves the whole operation started up again. That same afternoon Jack was due to go to his retirement presentation. In three days his 35 years' service would come to an end. At the retirement event the CEO said: "Jack, no one knows this place like you do. If we ever have any problems, I will be sure to give you a call. Would you be willing to help?"

"Of course", Jack had said. "No problem!"

A few days later the phone rang and it was Dave again. "Jack there is a blockage in Reactor 3. Can you come and sort it out?

As Jack went through the main entrance he was met by his ex-assistant and went straight to the reactor. The CEO was already there, striding up and down impatiently.

"Jack – please! Get this @@@@ thing working again. Fast."

Jack did his usual walk up and down, looked at a few dials, tweaked a few valves and knocked on a few pipes. He made one chalk mark and told Dave that if he opened up the panel right where the chalk mark was placed, he would be able to trace the blockage, resolve it quickly and get the whole process working smoothly again.

The CEO said "Thanks Jack. Please just send in your invoice."

A day or two later the CEO was on the line, shouting down the phone.

"How on earth did you come up with £20,000? I want an itemised bill. Jack, of course, complied. His invoice showed:

For making one chalk mark - £1
For knowing where to put it - £19,999

The story might be made up but the message is very clear. What Jack possessed was a lifetime of knowledge and experience. He knew, better than anyone else, that if the production processes were to go off-line for any more than a few hours the cost to Zenith would be hundreds of thousands of pounds. Knowing just exactly where to place a chalk mark represented Jack's unique expertise - expertise which nobody else in Zenith possessed and which took decades of experience to accumulate.

Jack did not underestimate the value of his service to Zenith, and held his ground when challenged. Do you underestimate the worth of your products to your customers? Do you capitulate when a discount is demanded? Or do you do the right thing and hold your ground.

What is VBP?

If a Martian asked us what Value Based Pricing is, this is what we would say:

"In Value Based pricing, we think carefully about how our product benefits our customer in economic and emotional terms. We then work out exactly the economic worth of each of these benefits, where we can. We then build our price around these numbers."

Simples. Well, actually, no, not all that "simples". There is actually a bit more to it than that. Let's drill down further with a rather more robust definition of Value Based Pricing.

A Value-Based Price is designed and communicated such that all parties understand, recognise and accept the distinctive worth of products and services purchased in the transaction and participate optimally in the gains created by their use (Macdivitt and Wilkinson, 2012)

There are important elements of this definition you should be aware of.

Firstly, a VBP is designed – not invented. It is not plucked from the ether or hallucinated in a dream! It is designed rigorously from a deep understanding of the economic and emotional impacts of your product or service on the customer's life or business.

Secondly, it is communicated in terms of the customer's context. This communication is done by a salesperson, supported by properly crafted collateral. This demands superior sales skills and MARCOMS materials that focus on customer impact rather on sterile lists of specifications.

Third, understanding is important – the offer may be a bit more complex to explain because the argument is not just about a number (price) it is about impact. The customer needs to recognise this argument and acknowledge and accept it. Without that you cannot progress. Note that some customers will resist your attempts to explain value, bringing discussion back time and again to price. These are not customers with whom you should discuss VBP. It is pointless and a waste of time.

Next, the distinctive worth of our product is our compelling value proposition based on our differentiation. If we have no differentiation, it is hard to see how we can price on differential value.

The final point is optimal participation in the gains created. VBP must lead to a win-win (or even win-win-win if we are working through channels). This is not about "gouging" the customer. It is about ensuring that he gains from the transaction what he wants or needs, and creates a platform for future win-win transactions. Where we create a win-lose, in reality we end up creating a lose-lose further downstream!

Value Based Pricing is different from all other pricing methodologies because it seeks explicitly to build the price up from the sum of the individual economic gains accruing to a customer from the purchase and use of your product or service. We can really make this calculation only if the product or service offers a demonstrable (and measurable) differential advantage compared to the customer's next best alternative. This calculation is at the heart of VBP and is the source of the real superiority of this approach to pricing.

The key elements of constructing a VBP are:

- Verify that there are indeed quantifiable differential advantages and that these are substantial enough to justify a VBP approach.
- Use the Value Triad to identify, in a given scenario, the economic and emotional enhancements that the customer can realistically gain for your product.
- Calculate the Revenue Gain (RG) and Cost Reduction (CR) elements, and wherever possible make a realistic assessment of Emotional Contribution components also.
- Use the VBP Worksheet to create the VBP in this scenario from the various advantages offered by the product.

A little story about value based pricing – a true one this time!
Alan and Rachel had just purchased their dream home in a village in the North of England, just a few miles south of the Scottish border. The house was beautiful with plenty of room for the family. It was set in its own grounds consisting of 1.5 acres of mature, well maintained landscaped garden. At the rear of the property were another four acres of unspoiled woodland currently owned by the local council and which the council was willing to sell. Rachel had longed to have access to woodland like this, and it was just too much to resist. The house was to be both a home and an investment and their "final" home once Alan had retired from his job as a sales vice president. Alan spent most of his time working abroad and, when not travelling to various factories around Europe, lived in a small flat in Amsterdam.

They were very friendly with their next-door neighbours, Paul and Liz, who owned a similar property. The woodland extended to the rear of their property also. Paul was a barrister and spent many months of the year in London. Paul and Liz had similar ambitions for their retirement. Alan obtained a quotation from the local council for purchase of the whole parcel of woodland. The price of £3000 an acre was confirmed as reasonable by a local estate agent. Alan put in motion the purchase process, and submitted a bid for £12,000 for the full four acres. Unknown to him, however, Paul had done exactly the same, offering the council the same sum. Over the next few weeks, each tried to outbid the other and when the price finally reached £24,000 per acre, Alan pulled out, much to Rachel's severe disappointment. Paul finally purchased the land for a total of £96,000. Relationships between the couples were now distinctly frosty.

A few months later, Alan received a call from Paul offering to sell two acres, and could Alan make him an offer? Initially, Alan was tempted to tell Paul to "get lost", but Rachel persisted and Alan made an offer of £3000 per acre. This was, as expected, rejected out of hand. When Alan asked what Paul would accept he was told £48,000. Alan's immediate response was to say "forget it! The original valuation was £3000 and "while I am happy to go a bit higher than that, £24,000 is completely out of the question".

Paul's response completely amazed Alan: "Get your house valued again, firstly without the woodland, and then again with the woodland attached. When you've done that, come back to me and we'll talk again". Convinced that his bid would not change, Alan agreed to do so. The estate agent who had initially valued both the house and the woodland separately now re-valued both. The initial valuation of the house at £450,000 had barely changed. But with the woodland added, the surveyor estimated a fair sale price of just over £950,000! Astonished, Alan paid Paul, the very same day, a cheque for £48,000 making an immediate profit on paper of well over 900%.

This is a true story although of course the names of individuals, the figures and the geography have been altered for obvious reasons. It demonstrates how a value-based approach to pricing can be very attractive. The key issues are:

- the elements of the property, when valued individually were £450,000 for the house plus £48,000 for the woodland.
- each part of the package represents a "specification" market value. By linking both house and woodland as part of a "bundle", the whole nature of the package became different... and (almost) unique.
- the winners in this little scenario were Alan and Paul. Paul’s insight led to both parties gaining enormous advantage and a real win-win outcome.
- The loser was the local council. By valuing the woodland on a per acre basis they failed to identify the real commercial value and left a lot of money on the table. Some thought might have resulted in a much better deal for them and a win-win-win situation.

The epilogue came a few weeks later when Alan related his experience to a colleague in his office. Alan commented ruefully that he was beaten to the deal. He was willing to accept that it was by a lawyer. But if an estate agent had told him (a very experienced sales vice president!) how to sell, he would have retired on the spot and spent the rest of his life playing golf! By now, Alan and Paul had resumed their friendly relations and, more importantly, the couples resumed friendly relations.

Constructing a Value Based Price

Value Triad© analysis is essential if we want to be successful in VBP. Customer Value may be related to reducing his costs, to increasing his productivity, to reducing hassle or to improving his peace of mind. The first two elements of the Triad - Revenue Gains and Cost Reductions - are generally relatively easy to quantify. It is more difficult to put an economic value on Emotional Contribution. That does not mean that Emotional Contribution is unimportant. Of course not! We use it as part of our selling argument. There is another important element in the make-up of the VBP - the Reference Price. This is the price that the customer is accustomed to paying for a product or service similar to the one that you are offering – i.e. the Reference Product. It would be the one he would choose if your option was not available – his "next best alternative", if you will. If our product offers nothing more than the reference product then there is neither Revenue Gain nor Cost Reduction. Therefore we cannot use VBP. The diagram below shows how a VBP is built up from these building blocks.

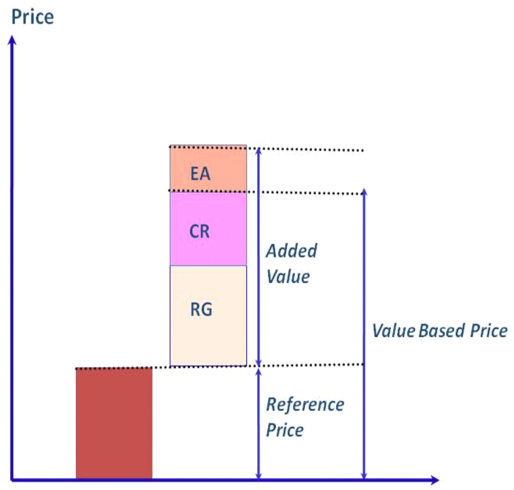


Figure 3 Building the Value Based Price

We need to know quite a lot about our customers' businesses to be able to assess how our product or service enhances revenue streams or helps eliminate costs. However once we have this information, and we are able to justify our calculations, then it is pretty straightforward to estimate a target VBP.

Assessing the economic value to the customer

Perhaps an illustrative example will make the process clearer.

A company has developed a new earth-moving machine for construction customers. The typical customer is already using a competitive machine which is coming to the end of its useful life. The replacement price is £100,000. Over its lifetime that machine is known to have generated revenue of £500,000. Fuel costs, spare parts and maintenance labour were £75,000 £35,000 and £60,000 respectively (and this is not expected to change with a re-purchase). Our machine is built using different technology and over its life is expected to generate £750,000 in revenues (this figure comes from field trials). Fuel, spare parts and maintenance labour costs are £68,000, £30,000 and £34,000 respectively over the life of the equipment. The Revenue Gain - the additional productivity our machine offers the customer compared to the alternative - is an extra £250,000; the cost reduction is £38,000. So the total Value Based Price we can justify on the basis of superior performance and cost reduction is £388,000. We calculate this using the formula:

Maximum Value Based Price = Reference Price + Revenue Gain + Cost Reduction

	Competitor's Machine	**Our Machine**	**Our Value Added**	**Comments**
Price	£100,000			
Revenue	£500,000	£750,000	£250,000	Better performance leads to better productivity
Costs:				
Fuel	£75,000	£68,000	£7,000	9.3% less fuel
Spare Parts	£35,000	£30,000	£5,000	14.3% fewer spare parts
Maintenance Labour	£60,000	£34,000	£26,000	43.3% less maintenance labour
Total Added Value			£288,000	
Maximum VBP			£388,000	

Our machine is actually more robust and will last at least two years longer than the alternative. Certain aspects of product design, mostly to do with ease of access for repair and servicing, means that in case of a breakdown, spare parts are easy and quick to replace. Our new machine comes with two years supply of parts. These items could easily be costed in but to keep the calculations simple and straightforward we have ignored them. Similarly, because of this, the "hassle" factor is almost eliminated. This, too, is ignored for the purpose of this calculation but it is a strong feature of the customer testimonials prepared by the marketing team.

The Negotiation Corridor

A consistent theme in VBP is the Negotiation Corridor.

Figure 3 Negotiation Corridor

Our motivation is to try to win the deal that is close to the “Maximum VBP” at the top of the diagram. Naturally, your buyer’s motivation is to buy at the lower end, certainly at very little more than the Reference Price, and conceivably even less. How do we bridge this gap?

The poor salesperson will “cave” when the customer rejects out of hand his initial high proposition and may even offer an immediate discount.

The good salesperson will introduce a range of arguments setting out that his proposition is not only correct for the customer’s situation but that it also makes sound economic sense. Here he will bring into play the economic arguments that have been the subject of his pre-sales research.

To be successful in navigating the Negotiation Corridor, we need to understand as fully as possible the business context within which the customer is operating – to understand his constraints, aspirations and pain points”. This is precisely where our work in using the Value Triad bears fruit. Everywhere in your pricing work, you should be using the Value Triad and the associated “So What?” questions. Nowhere is this more important than when we are standing in front of the customer at the start of a negotiation session.

We need to collect evidence to support the revenue and productivity improvements and emotional benefits flowing from the transaction.

We need to collect and be ready to present evidence to support cost reduction claims, perhaps by bringing to bear testimonials, case studies, reports, calculations, etc.

Don’t forget the person either! Think through which intangible benefits are relevant to him (and perhaps also to his colleagues).

Returning to the new machine scenario, we are faced with this key question: “Will the customer purchase a new product at the maximum VBP that we can justify on objective data? Or is he more likely to choose to repurchase the same machine as before”.

In fact there is no advantage to him in buying a new machine at the maximum VBP. In this case he is no better off. Economists call this an *indifference price*. We need to factor in time value of money and the fact that he may be able to realise the cost savings on his next best alternative purchase by spending a little effort “tweaking” the equipment. The negotiating corridor is created by the added value. Negotiation is required to ensure that both parties gain from the process. We want our negotiation to lead to a win-win situation – one in which both parties will gain. How high a price we are able to achieve depends on the strength of our arguments, our ability as negotiators and the ability of the buyer to negotiate against us. The Value Triad driven preparation we undertake will pay enormous dividends here.

How Does VBP Compare to Conventional Pricing Methods?

Cost-Based Pricing and Competition-Based Pricing are used in almost every company throughout Europe and the United States. These methods have been in use for decades and are familiar to most business people.

In Cost-Based pricing we total up the costs to us of delivering a service or creating a product. We add on a percentage (which we call our "mark-up"). This creates a price. Easy and quick.

In Competition-Based Pricing we try to position the product in line with other similar competitive products being offered to the market at the same time and, based on specifications, make a judgment of just where the price should be pitched. If our product is a little better, we price it a little higher. If our product is not as good as the competition, we price it a little bit lower.

Most companies use both Cost- and Competition-Based approaches in making pricing decisions. This calls for a bit of judgement, but it is, at least in principle, also easy and quick. The big problem, however, is that neither of these approaches captures fully the value delivered to customers. We may have immense experience or unique expertise which benefits our customers. But by positioning our price at around the average in the market we are giving away far, far too much, and giving customers a fantastic deal. Basing it on cost alone may be even worse! We could do so much better!

A Value Based Price is calculated on the basis of the advantages that our product or service delivers to the customer. This is the only pricing methodology that captures value and usually generates superior economic returns. Even though this approach to pricing can, when used properly, generate much greater profits and better customer relationships than conventional pricing methods, relatively few companies are yet using VBP. Nevertheless, the number of users is growing as managers realise that conventional methods are working less and less well and as they seek ways to improve wafer thin margins.

There are a few critical points to be aware of in VBP.

First, and vitally important, we need to be able clearly to differentiate our products or services from those of the competition. If we have no clear differentiation then we simply cannot claim superior customer value. So we cannot possibly price on differential customer value. If we cannot find some meaningful differentiate advantage, we run the risk of commoditisation and all the misery that goes along with it.

Secondly we need to know a great deal about the context of our customers' lives, businesses or markets. Without this information it will be very difficult to identify relevant value or to quantify the advantages that we bring. This demands both research and a good sales process to capture and validate this information.

Thirdly, since each customer is different, our products and services will offer different advantages to each. In each case we will charge a different price. It is also possible that, although the price is the same, the underlying "deal" is different.

Fourthly, don't lose sight of the fact that any product that a customer purchases represents value to him. He might be the only one in the planet willing to pay. Or he may be a representative member of a whole category of customers. Just because we don't understand this value does not mean that it is not very real or very compelling to the buyer. Our job is to make the effort to understand this value.

Comparing Conventional and Value-Based Approaches to Pricing
In the table below we compare conventional approaches (cost-based and competition based) to VBP across a number of dimensions. While it is clear that VBP potentially can offer greater advantages to the user than conventional approaches, we need to use VBP carefully. It is not a panacea and it should not be used in every situation. We certainly do not encourage re-building of price lists using VBP exclusively. This could be very dangerous indeed!

Table 4 Comparison of Conventional and VBP Methods

	Competition Based	**Cost Based**	**Value Based**
Focus	Competitors' price levels	Internal costs	Win-Win
Encourages	Pursuit of market share – not profit	Formula based approach	Cooperation, partnership and deep customer knowledge
Customer relationships	Not well developed	Not well developed	Central to all transactions
Reward for innovation	Minimal	Minimal	High and sustainable returns
Selling efforts	Transactional	Transactional	Consultancy and solutions based
Inducement to buy	Discounting	Discounting	Demonstrable economic advantages
Value capture	Limited	Limited	Complete, or as well as your salespeople can negotiate

There are occasions where we should consider using VBP:

- New or enhanced products and services where these offer significant improvements in two or more areas of the Value Triad.
- Products incorporating novel technology which offer dramatically improved performance or significantly reduced costs-in-use.
- Products completely new to the world with no viable alternatives.
- Where we are introducing existing products and services into a new geography where again they represent a major improvements in performance compared to methods existing in that geography.

Where the customer is conditioned through usage to expect high performance at unrealistically low costs, some re-education of the customer will be necessary. We are entitled to a fair return on the value we create!

Please do not fall into the trap of believing that VBP is a panacea and should be used in every situation. It is not, and if you were to attempt to re-price all your products on a VBP basis, you would seriously damage your business – and your credibility!

There are some circumstance in which you should not consider applying VBP.

- Where your product or service offers no differential advantage;
- Where the value of the offer cannot be sustained in the market by your organisation's people or resources;
- Where the market is deeply mired in commoditised offers and will reject without hesitation a product which stands out from the crowd at a very high relative price;
- Where your market consists exclusively of price buyers;
- Where it is difficult or impossible to identify sufficiently credibly or provably the economic gains.

Implementing Value Based Pricing

Companies in industries such as chemicals, biotechnology, professional services, agriculture, engineering products, logistics, mobile telecommunications and energy among many others are all currently implementing VBP. Some of these companies have tried and failed, others have been successful and other still are on the "journey". Some consistent messages have emerged from those case studies.

Management Support

VBP initiatives need to be driven by top management and supported positively by all other levels of management throughout the business. The creation of value in a company is "owned" by top management and is a priority for progressive businesses. In companies where VBP has been implemented effectively, top level managers are visibly seen to be driving the process. (Liozu and Hinterhuber, 2012)

VBP demands a very professional approach to Selling

VBP requires products and services to be sold consultatively rather than transactionally. In companies implementing VBP, salespeople increasingly adopt the role of consultant and try to find ways of enhancing the overall effectiveness of their customers' value creating processes. This usually requires significant sales skills development and sometimes recruitment of new salespeople.

VBP is a Journey

Effective implementation of VBP demands that the company as a whole embraces a commitment to creating and delivering value. This may require significant changes in emphasis, attitude and even organisation and will take time to implement fully. Companies need time to make the necessary changes and adjust to them.

Management needs to be motivated to build better business

VBP is not merely about improved profits, although improved profits will result from effective implementation. VBP is about generating better business through focusing on customers who understand and will pay for value, by defining the value that is created in objective economic terms and developing better client relationships with different executives in the client organisation. VBP leads to win-win situations. It does mean we need to be "choosier" about who we retain as clients. But then, if we are generating better business, we can afford to lose some of the dead wood!

Summary

VBP is a new and attractive approach to pricing. It is the only approach that will genuinely reward us fully for the ingenuity and creativity of the people in our organisation who conceived, designed and built products and solutions for our customers. It is also the only ricing approach that will allow us to identify specifically, and quantify, the benefits gained by the customer. VBP is easy to understand and the numbers are relatively straightforward to calculate (if you are able to obtain robust and defensible data). The real challenges are deeper engagement in value creation and delivery at all levels in our company and deeper understanding of our customers' value chains. Effective implementation of VBP is utterly dependent on professional salespeople being able to capture customers' needs in terms that allow them to build viable value propositions and to deliver them convincingly and compellingly to their customers. The reward from doing this is greater profitability, better relationships and better business.

Session Summary

This session introduced and defined the concept of *Customer Value* and applied this to the creation of a Customer *Value Based Price*.

Value is the underlying focus of every business transaction – sales, marketing, business development, investment, innovation, and pricing. It is also the business of every manager in the business. Whatever his or her business card may proclaim, at the heart of every manager's job description is the term *Value Manager*!

In the field of value, anything that a customer is willing to buy possesses value – at least for him. In pricing work we are particularly interested in creating and exploiting *differential advantage* and to ensuring that such value is optimised across all of our target customers and the segments they represent.

The *Value Triad*© is the primary analytical tool to use in identifying and characterising value. It comprises three components – *Revenue Gain, Cost reduction* and *Emotional Contribution*. For every product or service it is our job to understand fully, and wherever possible to quantify, each of these Value Triad© elements and how these relate to the lives and work of our customers. This is the process of *Value Analysis*. A properly conducted Value Analysis will yield a set of *Value Drivers* of particular importance to this customer, or class of customers. Our task is to quantify each of these value drivers in such a manner as we can weave them into a set of compelling arguments to present to the customer in the form of a *Value Proposition* and to build them into the design of a *Value Based Price.*

Many companies today are using, or building their capabilities to introduce Value Based Pricing. This is much, much more than re-arranging numbers on a spreadsheet. It is all about bringing about a new approach to business based on a coherent thread of value running through the whole organisation.

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