Editor’s questions for the Rutage Magazine

What’s the power of pricing?

Simon: The following statement which the famous investor Warren Buffett made in 2011 says it all: “The single most important business decision in evaluating a business is pricing power.” Pricing power means that you are able to get the prices which you need to make a good profit. And to raise prices if costs increase. In the global pricing study of Simon-Kucher only 34% of the 3000 managers we interviewed see their company commanding pricing power.

You are stating that every company needs pricing. If so, why pricing doesn’t always work in the real world? Why each business has to develop its own pricing policy and carry it out appropriately? How can the scientists and business-consultants help to solve this problem?

Simon: There is no free lunch. Each product, each service has a price – I am not talking here of charities, but of businesses. The customer’s willingness to pay is the reflection of the perceived value. Each company offers a different value. Even if the product as such is a commodity, there are typically differences in services, logistics, trust, competencies. The old Romans understood the equation. In Latin the word for value and price is the same, pretium. If values are specific prices have to be specific. Each company must understand this equation for its business. Specialized consultants help in understanding and ultimately quantifying the value – and thus the price. Because the price is always a number. There is no “qualitative” price, only a quantitative one.

There are lots of specialized approaches to pricing and the main goal is to put theory into practice. Do you use any theoretical concepts in your consulting firm? Which ones?

Simon: Simon-Kucher & Partners, the consultancy I founded, is today the global leader in price consulting. And in all modesty, we are also the thought leader. We put practically all concepts developed in theory, by academicians, by researchers into practice. Often we do this in steps. Let me give you an example. In the early 1980s a Stanford professor developed a theory for nonlinear pricing and bundling. My doctoral student Georg Tacke wrote a doctoral dissertation on how to apply this concept in practice. In the next step we invented the “BahnCard” for the German Railroad Corporation. It is a two-dimensional price structure. You pay 500 Euros for the card and get 50% discount on tickets for the duration of one year. The BahnCard has become a huge success. More than 5 million people in Germany have it. Dr. Georg Tacke is today CEO of Simon-Kucher and commands 1000 pricing experts. Dr. Georg Wuebker did something similar for price bundling. There are dozens of other pricing concepts and methodologies which we apply, e.g. Freemium, Multi-Person-Pricing, Flatrates, Pay per Use. One of the newest ideas is “negative prices”, think of electric power from renewable energies or negative interest rates.

Do you think there is a “pricing culture”? Can you give examples of companies and industries where the pricing culture really exists?

Simon: Firstly, there is indeed a pricing culture. And secondly, it is extremely important. Let me give you two examples. Geberit is the global market leader in so-called “behind the wall” sanitary products. Its chairman Albert Baehny is obsessed with pricing. He instills the following message into his team: "When you have a well-defined pricing process margins can be significantly and sustainably increased. If you do not organize your pricing processes or, the worst case, leave pricing to the market you will not rise above mediocrity." Geberit has revenue of 2.3 billion Swiss Francs and a market capitalization of 12 billion Swiss Francs. Its operative margin is over 25%. Or take Wendelin Wiedeking, who stated time and again as CEO of Porsche: "We have a policy of keeping prices stable to protect our brand and to prevent a drop in prices for used cars.“ Porsche has the highest profit margin in the global auto industry. A pricing culture is equally important at the lower end. Aldi, the hard discounter, leaves no doubts that they it will undercut the competition. And Aldi can afford it because of its lower costs. The profit margin of Aldi is two to three times higher than the industry average.

It’s impossible to set prices without studying consumer psychology in order to understand how they make purchasing decisions. We’ve got the whole new branch now – behavioral economics. What does it mean in the context of pricing?

Simon: Behavioral economics is indeed a revolution. We have to thank Nobel Prize Winner Daniel Kahnemann and his colleagues for new, important, surprising insights. It seems that in many cases and situations the consumer doesn’t behave rationally. I am not convinced that this behavior is actually irrational. Let’s take the “magic of the middle price”. In a restaurant most consumers choose the wine whose price is in the middle of the price range offered. Thus, if you add a more expensive wine to the list, e.g. you go from 20 Euros to 30 Euros for the most expensive wine, more people will choose more expensive wines. The average price increases. Is this behavior irrational? Not necessarily. If you know little about wines choosing the middle category is not a bad decision rule. You may both avoid bad quality and paying too much. Similar considerations apply to many of the behavioral patterns detected by behavioral economics, e.g. anchor prices, using prices as indicators of quality, endowment effects etc.

Over many centuries some products and services didn’t have any price. You could walk the streets, study at school free of charge and many services were included in the total cost. But everything changed and today we come across prices at every step – sometimes in quite unexpected situations. It is clear that management’s goal is to get profit, but in some cases this goal contradicts ethics, doesn’t it?

Simon: This is indeed a difficult issue. Less in economic rather than in ethical terms. Of course, the products and services you are talking of were not free. Their production cost money. But the costs were covered by the state, by the churches, by charities or just individuals (help by neighbors). Now we see prices invading more and more areas, education, medicine, social services, organ transplants, child bearing, security, wars etc. Whether to open a sector to the price mechanism is a political decision. Society has to confront these new situations. The need to evaluating human lives will become more important. Think of autonomous driving. How does the automatic pilot decide when a decision between killing an old person and a child is unavoidable. We don’t know how the human driver decides today, he or she will probably not know either. This doesn’t look like a pricing problem, but it is close.

What kind of price strategy is the most promising?

Simon: A general recommendation is impossible. I am personally a fan of offering premium value at a premium price. Of course, this works only if you are able to create a premium product or service in the first place. But aggressive pricing can also be very successful, given that you can provide the service at a lower cost than your competition. IKEA, Ryanair, H&M and Zara are proof that aggressive pricing can lead to both growth and profit. There are also some very good luxury firms with skyscraper prices and extraordinarily high prices based on superior quality, strong brands, exquisite stores and sophisticated communication. Even some ultra low price strategies are successful. Think of the Dacia Logan, whose price is about half the price of a Volkswagen Golf. Renault sold several millions of this very cheap car.

In your book you write: "The pursuit of profit is both a driver of excellent pricing and an outcome of it; there is no way to separate the two topics. Profit is ultimately the only valid metric for guiding your company". What about market share, sales and capacity utilization?

Simon: Market share, sales volume, capacity utilization aren't ultimate goals but means to achieve the ultimate goal of survival of the company. And profit is the cost of survival. This doesn't mean that market share etc. cannot be employed as intermediate goals. For instance in the early stages of a product's life cycle it can make sense to strive for a certain market share, sales volume or capacity utilization. Why is profit the only valid metric for guiding a company? Because it's the only one which observes both sides of the coin, namely revenue and costs. All other metrics are one-sided.

Talking about pricing it's impossible to avoid the subject of price wars. You believe that "Starting a price war in an industry is easy, but a price war is hard to stop, creates tremendous mistrust, and leaves behind scorched earth". What factors encourage price wars? Why are they damaging for pricing?

Simon: According to our most recent global pricing study from August 2016 49% of all companies say that they are in a price war. And more than 80% of those contend that the competition started the war. This is nonsense! The biggest drivers of price wars are overcapacities and lack of market growth. In price wars aggressiveness and illusions abound. One company cuts the price, hopes for a price advantage and an increase in sales. But the competition follows suit. Thus, there is no price advantage. Sales do not increase. People simply don't buy more milk because the milk price falls 20%. But the price is in the basement. The damage is done, the margins are ruined. Getting out of this mass is very difficult and time-consuming. Unless you have a price leader recognized by all contestants it may prove impossible.

Do you believe there are differences in pricing between industrial segments and countries? Is it possible to copy successful schemes without considering other factors – for example, location, cultural traditions etc.?

Simon: Had you asked me this question 40 years ago when I was a young professor I would have played down these differences and said that the mechanics of pricing are more or less the same everywhere. Today I know that there are marked differences between industry sectors, countries and segments. History and traditions play an equally important role as do trade practices, consumer habits and the role of the government. For instance, one shouldn't transfer the BahnCard-concept described above to an airline. The reasons lie in the so-called "long-tail phenomenon" and are a little too complex to be explained here. Or think of pharmaceuticals where reimbursement policies strongly differ between countries. Pricing has to adjust to these conditions.

How does the use of high tech in business influence pricing? Tell us about the tendencies. What do you think about the e-sales' influence on pricing?

Simon: The impact of the Internet on pricing can hardly be overestimated. There are many facets. Obviously the Internet has dramatically increased price transparency. But in the long-term value transparency may become at least as important. If a product or service receives bad feedback on the Internet, price cuts become ineffective, price increases virtually impossible. Another less obvious effect is that for many Internet services marginal costs are zero (or close to zero). Thus, the short-term lower price limit is zero. Marketing investments can be made in the form of "negative prices" instead of classical promotion campaigns. We have seen more pricing innovations in the last 20 years than in the century before. However, thoses are not only due to the Internet. Measurement and sensor technologies also play a role. If we can easily measure the actual "use" of a product or service we can price its use accordingly. To employ an old example. When I grew up on a farm there were no water meters. To set the price of water the number of heads in the family and of the cattle were used. When water meters were introduced around 1960 the cubic meter became the unit for the water price. Before that the price was a flatrate per head and water was essentially a free good. The price was independent of the actual consumption.

What kind of pricing instruments do you currently use in your company and which ones do you consider to use in future?

Simon: We are using a whole tool box of analytical instruments. Among them are expert judgment, numerous variants of conjoint measurement, van Westendorp, market simulation and others. In the future – actually already now – big data analysis and quick price tests on the Internet are on the rise.

What do you think about pricing strategies in the age of globalization? Which ones don't work anymore and which ones are most promising?

Simon: International or global pricing are occupying us a lot. The interrelatedness of markets dramatically increases the complexity of pricing. On the one hand you want to suppress grey imports which requires alignment of prices across countries. On the other hand you strive to exploit differences in willingness to pay which requires price differentiation. We developed the so-called Interprice-System to find a compromise between these countervailing forces – it is another case of Simon-Kucher's thought leadership. Part of the problem is the power fight between corporate headquarters and country subsidiaries. Finding an optimal solution is not only an analytical but equally a political challenge.

To what extent do you think the market systems – and prices - will get hold of our lives in future?

Simon: Market systems will prevail and get more traction. They are simply more efficient than government intervention. The current situation of the milk price in Europe is a telling illustration. From 2014 til today the milk price per liter halfed from about 40 to roughly 20 cents. Of course, this extremely low price levels endangers the existence of dairy farmers. It provokes government subsidies which are, however, likely to prolong the imbalance between supply and demand. It would be better to leave the adjustment to the market. Capacities would be reduced and prices would go up again. On the other hand, there are areas where government intervention is necessary, e.g. in organ transplants, evaluation of humans. We can't leave this to "free pricing".

UK has made the decision to leave the EU. What impact this may have on the global pricing policy?

Simon: The Brexit will not have a significant impact on global pricing. Either the UK stays within the European market (whatever the solutions on other fronts such as immigration may be). Then nothing changes. If the UK leaves the European market we may see duties on various products and services. This will increase costs in both directions. Thus, lead to higher prices both in the UK and in the rest of the European Union. UK products will become more expensive and less competitive on the continent. The same is true for European products imported into the UK.

There are lots of subjects in your book which we didn't address, but will be interesting to the readers. What do you think is the value of your book for the Russian business?

Simon: The discrepancy between the short term and the long term is a tricky issue and in the same time very important. We will also see more power fights over pricing. One unusual interpretation of pricing and power goes back to the French sociologist Gabriel Tarde (1843-1904), who considered every price agreement to be equivalent to military truce. Price negotiations are similar to war, eventually ending in a truce. In August 2016 we saw such a power fight between Volkswagen and a small, but mission-critical supplier. This supplier interrupted delivery and forced the huge VW-plant in Wolfsburg to stop production for three days. Price negotiations are getting tougher. The dominant father of pricing until today remains Karl Marx. We can say that his labor value theory is the mother of cost plus pricing which – in spite of its weaknesses - is still the most popular pricing method. The main inspiration for Russian readers and businesses should be to adopt a value-oriented approach to pricing. By value I mean one and only one thing: the value perceived by the customer. The customers decide what they are willing to pay and they decide this based on the perceived value. This leads us back to the equation of the Romans: Pretium = Value = Price!

How would you continue the phrase "The future pricing is…"?

Simon: A very clear answer. "The future pricing is value-driven" – without neglecting the costs, the competition and the long-term. Value-driven pricing requires that you create value, communicate value and extract value. Sustainability will become a crucial aspect of this value chain.