

WITHER PRICING

By Robert MacAvoy and Ed Keating, Easton Consultants

The forces facilitating variable pricing may be the most important societal change in the last hundred years. And, if the opportunity to increase profits through variable pricing and insights into costs is significant now, it will grow by an order of magnitude in the not-too-distant future.

Recently, an article in a major metropolitan newspaper explored the creeping growth in variable pricing, suggesting we are moving to a new era, in which goods and services will be priced according to nuances in the offering and demand at the time. Baseball games between hot rivals will be priced higher because the offering is richer and the demand is greater. Bridge tolls will be higher priced during rush hour as the demand is greater even though the offering is poorer. Soft drinks will be higher priced when the thermometer soars as people are thirstier. And, although less was said about it in the article, costs of providing the product or service can vary as well in different situations.

These are interesting dimensions to consider: the relationships among price, the nature of an offering and the composition of costs to satisfy.

The article had echoes of that much-maligned “New Economy” drumbeat. But, as Andy Grove said in an interview with *Wired* magazine, “What’s so new about it?” In baseball, there have been doubleheaders, matinees and old timer’s day specials for quite a while. Season box seat prices essentially trade off revenue uncertainty for predictability.

Commuter train tickets are cheaper per ride than single tickets, as are off-peak tickets, and both have been around for a few generations. On a hot day, if you want a soft drink in two minutes and are on the road, stop by the gas station. If you are willing to wait 20 minutes, go shopping at Safeway for a two-liter bottle and bag of ice.

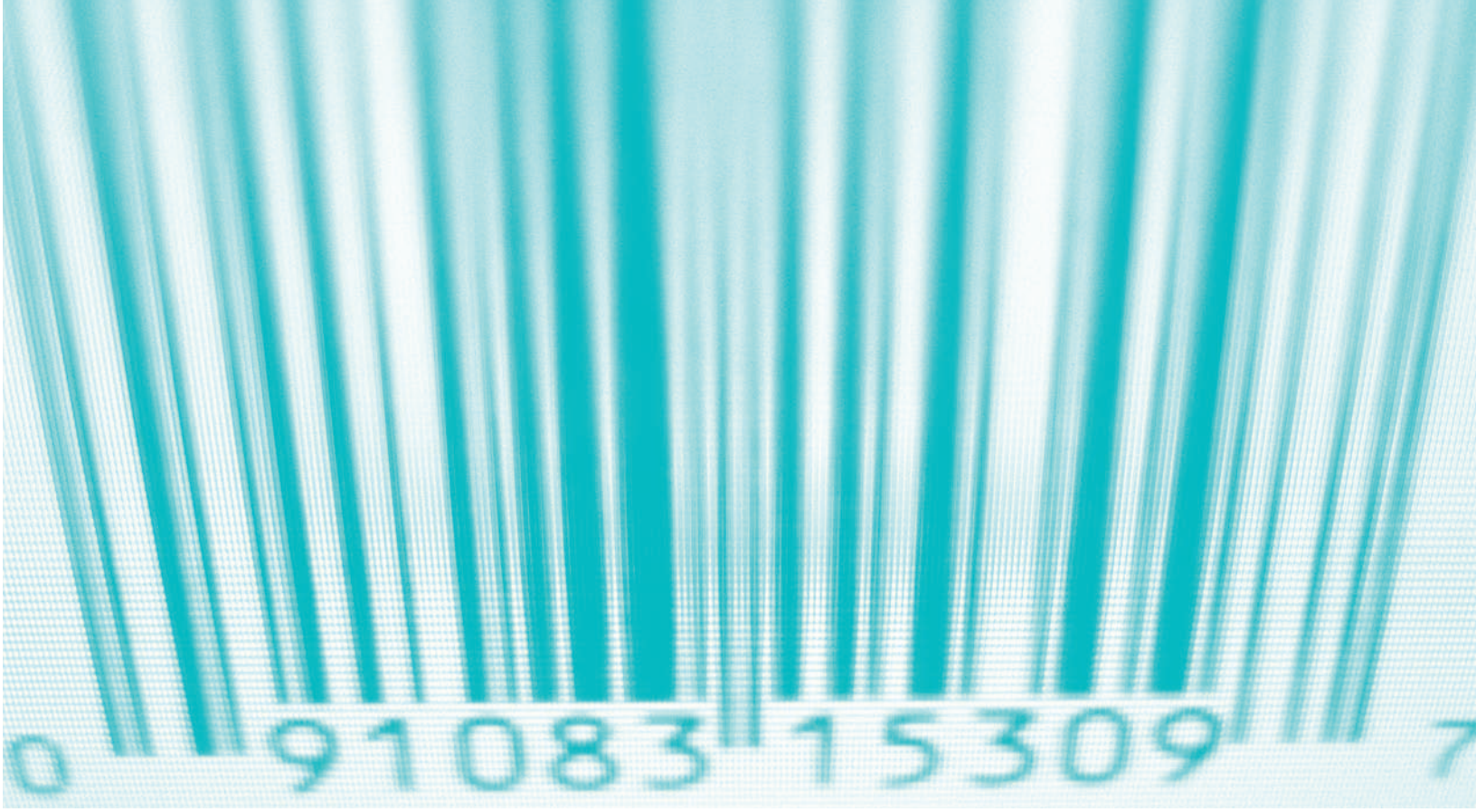
Yet, as Grove went on to say, in fact, *everything* is new about it. He argues the forces facilitating such phenomena as variable pricing may be the most important societal change in the last hundred years. Surely it will have a profound economic impact as well. Yes, the concepts remain the same, but the speed and refinement with which these pricing concepts can be deployed in the economy are vastly superior. Insightful and agile pricing management can significantly improve revenue. Superior information on the dynamics of costs and how they vary not only over volume but also by time of day, month or year can also contribute powerfully to overall cost control. Relating the two creates extraordinary opportunities to lift profits in your business.

And, if the opportunity to increase profits through variable pricing and insights into costs is significant now, it will grow by an order of magnitude in the

not-too-distant future. This will occur as economic models change to accommodate lower variable costs as a component of total costs and with the improvements in technology that track content provision and consumption. This phenomenon will unlock “virtual” market segments that have been hidden because price points were historically kept high to cover the variable costs. These markets can now be profitably served, and publishers can reap the benefits.

Pricing Considerations

Pricing is one of the most important elements of a company’s strategy, and in many businesses today, it holds the potential for higher revenue and profit growth. Pricing seems a tempting lever to many companies because it is the easiest thing to change in the marketing mix. The truth is, it may be easy to change compared with, say, revamping your distribution channels or re-branding your product, but it is a dangerous thing to change without considering the longer term potential effect on the business. Firms that take a broader view of pricing can frequently find approaches that can have a profound effect on strategic position. To do this, consider price levels, structure and dynamics before tweaking pricing.



Price levels: The importance of price levels is the most obvious as information providers can increase, decrease or hold prices the same. The important question to answer is what is your objective? If you are trying to increase revenue, you could raise or lower prices. Raising makes sense if there is little elasticity of demand and you have a unique product. Lowering the price can also increase sales if it allows consumers to buy more or brings new users into the market. An example of this occurs when trade show promoters offer discounts for multiple attendees of the same company. Finally, if the overriding objective is to keep renewal rates high, the provider may hold the line on prices and not change the level.

Price structure: Don't change pricing levels without carefully considering price structure. In the information industry, services typically sell "by the drink"/usage, subscription, site license, concurrent use or by the feed. Many providers employ several of these structures to drive consumers toward predictable revenue schemes. For example, the "by the drink" model is usually priced high enough to drive users rapidly toward a subscription. Similarly, the subscriptions may be priced to drive accounts to purchase a site license.

Thanks to advances in technology, the cost disparity in serving content to casual and consistent users is narrowing ferociously even though most providers strive to sell massive site installations based on number of "seats." This type of pricing is dangerous for obvious reasons. One way around this is to customize the information service to the user organization so the offering is unique in the marketplace. Documenting needs and the customer's business model can help identify the best structural approach. For example, in the product movement information business, retail store chains consider the information more valuable when grouped into categories the chain uses to run its business. The categories may or may not be the same as those preferred by other retailers. This type of analysis can help you retain an account and provide pricing relief, especially if your product becomes embedded in the customer's workflow.

Dynamics: Frequently the dynamics of prices, or the pricing philosophy over time, are the most ignored. For many businesses, the right price is the one that retains customer loyalty. Two things are important to consider in embracing pricing concepts over time. Pricing over time can be designed to make it increasingly unlikely for customers to abandon

the service. For new customers, competitive prices can be matched while long-term commitments can be honored with a discount for existing customers. For those customers unwilling to enter into long-term contract agreements because of special conditions, they can be enticed to remain loyal by a progressive discounting of renewal prices or by holding price but systematically providing more and more value in the form of additional or better content.

This works particularly well in a low-variable-cost model. For the provider, there is a powerful advantage to a more stable customer base and a more predictable revenue flow. Ordinarily, business enhancement costs can be undertaken with less risk as firms are more able to undertake multiyear platform improvements when the revenues are more assured. It is precisely this type of platform investment that helps drive down the marginal costs of providing the service and may produce the side benefit of reducing customer "churn" and therefore service costs.

Optimal Pricing

In pricing practice, companies achieve maximum advantage by identifying the optimal level, structure and dynamics, *over time* to maximize raw profits. To

help determine the right mix it is useful to evaluate customer acquisition costs and revenue potential.

Customer acquisition costs: For many firms in mature industries, customer acquisition costs are increasing. Everyone knows where the customers are, and they strive to increase sales by stealing share. There are many strategy approaches to achieve this, but the reality is that these new approaches have marginal impact because of blocking competitive moves.

For example, if Firm X decides to offer a low price to a competitor's customer, the competitor is likely to broadcast that fact to as many of Firm X's accounts as it can find. Price cutting to win incremental business, even when done with some strategic intent, rarely works and often starts a "race to the bottom." Interestingly, this can lead to a counter-intuitive pricing strategy. If competitor analysis indicates your competitor's fixed (and hence possibly ignored) costs are roughly the same as yours, "losing" account business through aggressive pricing may be advisable. While your competitor focuses on these accounts, you can secure the new accounts that can be profitably served because of your superior understanding of costs and pricing.

Revenue potential: Pricing on marginal costs can be a fast way to the poorhouse. Pricing on the margin for new accounts or to serve market segments with unattractive profit characteristics is usually questionable. How many CEOs have heard the argument from a major customer that it expects a special price because it's providing "the volume base" for the vendor? The automotive companies are periodically tempted to sell cars at a significant discount to car rental companies. Over time this strategy can hurt the brand and create expectations of ever-decreasing prices. It can also cause financial ruin if the marginal cost is very high.

However, in businesses in which more and more of the assets are "fixed" and depreciate not through use but through "half-life decay," the incremental sales from new customers who previously could not afford the product can be quite strategic. Drug and information businesses are excellent examples. In both cases,



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a highly fixed investment has produced a perishable asset. In the case of the drug companies, the life of the asset erodes over the period of patent protection. In the case of the information company, the life could be conceivably over tomorrow morning. If a publisher can extract marginal revenue from these newly found accounts, it can be quite profitable. As an example, *The New York Times* can now be bought for only 50 cents (half off the cover price), if you wait until 3 p.m. to make your purchase. The publisher is reaching a market that may not have been buying the product or had been priced out during the last rate increase. It may even be stealing share from the other dailies.

Changing the pricing approach can grow revenue within the current customer base and, because of improved information technology, reduce costs to serve old and new customers. For example, in the publishing world, some reference materials are issued yearly, but frequently smaller customers buy them only every other year, and some potential customers do not buy them at all but rely on research libraries. Creative approaches to pricing can improve the

subscription renewal rate and gain new subscribers at the same time. In general, the major thrust of the pricing strategy is to capture a better price by providing a "deal" on current rather than stale data to customers who heretofore would not buy it at all.

Empty Roads of Midnight

"The empty roads of midnight" is a phrase first coined by Nicholas Negroponte to describe the unused capacity of a fixed-cost asset. New technologies make it possible to change the nature of the curves that characterize demand and cost.

These new technologies provide a way to manage price essentially in real time. This can allow firms to custom tailor price not only for various market segments but for different time periods as well. Pricing to value may be possible in cases of differentiated product. For example, a Bloomberg feed is not the same as a Reuters feed. Lexis-Nexis is not the same as a West (close, though). Lowering pricing can uncover virtual markets that can be served, in this new world of low variable costs, with profitable results.

This equation works both ways, however. Just as publishers will make use of these tools to fine-tune their pricing, customers will use the technology to painstakingly track their usage and consumption patterns. They will use this granular data to negotiate better contracts that reflect their true usage and consumption.

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