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Test Your Pricing Strategy, Sandy Reminds CFOs

The gas shortage serves to remind CFOs about the ways pricing strategies can affect consumers and producers.

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Many of us in the U.S. Northeast have struggled with storm damage, electricity outages, and gas shortages since Superstorm Sandy ravaged the area a few weeks ago and tensions have flared. Perhaps the most widespread frustration has been with the gasoline shortages ,and many economists believe it didn’t have to be this way.

In the days following the storm, there were heated discussions of “price gouging” in local newspapers and on television and radio. Indeed, New York State has laws that prohibit an “excessive price" during an "abnormal disruption."

Though these laws may be beneficial to the general public, this artificial cap on gas prices reduced the economic incentive for suppliers to make the large and rapid investments necessary to repair their broken infrastructure and get the gas flowing to stations quickly. Supply would have risen faster.

Higher prices for a short period of time would also have reduced demand. Those less dependent on gasoline for their livelihood would not have hoarded fuel, thereby making it more available for emergency vehicles, buses, and taxicab drivers. The latter would also have been willing to pay a premium to avoid spending most of their workdays in line waiting to fuel up.

The impact gas prices are having on these unfortunate events make the importance of pricing strategy awfully clear. We often don’t appreciate the value of something until we miss it. Gas may be a commodity and the shortage may be temporary. But some of these pricing dynamics should be considered more carefully by many companies.

OPINION

Prices drive supply and demand, so finance executives must take the bull by the horns when setting pricing strategy as it is one of the most important

drivers of business success.

Indeed, some companies still view pricing strategy as a "cost plus" exercise. They slap a fixed profit margin on top of their costs, feeling that this is reasonable and fair. But such an approach can squelch demand for products that cannot support the price level and for products for which the company has real desirable differentiation. The price can be so low that money is needlessly left on the table.

Most companies have a mix of products that are more or less differentiated from the competition. Marketing teams often wax eloquent about product virtues, but often finance executives don't know for sure how differentiated their companies' products really are. Therefore, such CFOs should take the following four steps to improve their companies pricing strategies.

Step 1: Develop a better understanding of how differentiated your products and services really are by testing the market.

Economists use the "price elasticity of demand" metric to identify how purchase patterns change in response to price changes. In practice, many companies don't have the data for the price elasticity curve and they worry about losing sales if they raise prices. Sometimes testing the water with higher and lower pricing is the only way to know for sure how differentiated a product is.

We have all experienced this as consumers. A few years ago, a relative complained to me about the high price of his favorite brand of breakfast cereal. I asked if he bought any less of it in the face of these price hikes, and he told me he had not. He really enjoys that particular brand – it's valuable to him - and though he is frustrated by the price escalations, he hasn't strayed.

Contrast that situation with the willingness of many consumers to buy milk wherever it is cheapest. Milk is not a strongly branded product because most brands of milk are considered very similar. Where there is no apparent differentiation, most of us tend to buy at the lowest price we can find.

Step 2: Actively vary pricing for your more or less differentiated products and services.

By varying pricing based on what customers are willing to pay, companies get better signals of what their customers really value. For the well-managed company, such consumer information

can inform their product development and reinvestment strategies. They invest more where customers are willing to pay more. In turn, that helps make their companies stronger over time.

In the case of products that cannot support desirable pricing, they either need to be improved or phased out.

Such decisions can be hidden when pricing isn't varied, especially where products are sold in bundles. Customers may get a good deal on some products, making them willing to pay a bit too much for others. But as a result of the bundling. management doesn't learn where to put its strategic emphasis and growth capital.

Step 3: Avoid situations where you only win on price.

To be sure, testing price strategies can be frightening. Many executives believe they only win business by having a low price, and the thought of raising prices leads to fear that sales may slump.

Of course, sales sometime do slump when prices are raised. But when a company only wins on price it rarely wins overall. Knowing customers are unwilling to pay enough for a product should be good information to steer management toward taking action to either improve the product so it is better differentiated or develop one that truly is differentiated.

Step 4: Be actively involved in pricing strategy and policy.

Poor pricing strategies can lead to substandard profit margins and rates of return in the short run and an ineffective product portfolio in the long run. These are important business drivers that can drag down a company's performance. CFOs shouldn't leave pricing to the marketing department alone. It's an important enough driver of strategy and success that finance chiefs should be heavily involved.

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