Does Your Pricing Hide Your Company's True Value to Customers?

By John W. Myrna

Early in my career, I worked at Scientific Time Sharing Corporation (STSC) for 15 years, beginning in 1969, when they had only six employees. In addition to the happy bonus of being the place where I found the love of my life, my partner and wife Mary, STSC was also where I experienced the power of strategic planning and the danger of being wrong about pricing.

To me – and no doubt to the rest of my colleagues – it seemed that STSC was in the business of developing and selling access to the most powerful and productive IBM mainframe-based computer time-sharing service in existence. This was a natural assumption, given that we billed our customers based on their access to our centralized computer. We billed customers monthly for the total number of minutes each company's users were dialed into our computer, the number of mainframe CPU seconds those users consumed, and the bytes of data they stored.

I thought our pricing reflected the value our customers received from us. I was wrong! While that may have been true for the first few months of STSC's existence, in fact, the true value our top customers received was our ability to help them rapidly develop custom applications and support their use nationally through our extensive branch offices. Our business model was simple. We would develop and extend customer applications for free, making our money every time the application ran. STSC grew by supporting an application at each of the customer's remote locations. Better application development support led to more applications. Better support of each customer's application led to more users for each application. More application users led to more usage of our computer, which meant rapid revenue growth for STSC.

For a long time it didn't matter how we priced. Our customers couldn't afford to purchase and operate the specialized hardware and software required to match our service. Since the users were billed for minutes, seconds, and bytes, they assumed that was what they were paying for. They were wrong, too.

Our collective wrong-headedness didn't matter – at least until technology advanced to a point where our customers could afford to purchase hardware themselves. Then STSC's customers started leaping to the obvious, albeit incorrect,

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conclusion that they were being ripped off, and began making comments about the billing. Sample comments:

- *"I can buy a disk drive for less than what I pay STSC for a year's storage."*
- *"My IT manager tells me he can lease a dedicated computer to run my applications for less than I pay STSC monthly."*

We even provided free training to anyone who wanted to learn how to develop applications, even if they didn't run those applications on our service. (As the old American proverb warns, we were fattening frogs for another snake.)

The difference between value and billing

My philosophy is that profit generated by a product or service is the value we create from our stewardship of the resources consumed. Billing, on the other hand, is the tactical mechanism for obtaining that fair value from the customer. Billing must be cost effective to implement as well as appear to correlate to the value received.

I explained to complaining customers that although STSC was billing them based on CPU cycles, access time, and bytes of information stored, what they were actually paying for was access to a nationwide application development and support organization at their beck and call 24/7. Unfortunately, most customers remained unconvinced – it was too late in the game to change their perception of the value proposition. Because they were comparing apple pie with oranges, they had trouble recognizing the value of the development and support services we had always provided for free. I've found that people don't trust a value proposition discussion after they have come to believe they've been ripped off. The reality is you need to change the customer's perception of the value proposition *before* they raise an issue.

The initial impact of appearing to be "too costly" was a decline in the growth of new applications being built to run on our service. Times were good and our client companies' managers were focused on developing new systems and capabilities, not reducing the cost of a working system. If it's not broke, why fix it, even if it's somewhat expensive? After all, there was a non-trivial risk and cost to moving an application in-house. Then along came back-to-back recessions, prompting managers to shift their focus to cutting costs. Overnight, all outside services were targeted. Applications were rapidly moved in-house with the aid of motivated IT managers and hardware suppliers. Some end users even began to take control of their applications using newfangled PCs.

The computer time-sharing market collapsed, with one service company after another biting the dust. STSC, with its misdirected pricing, was an early victim of this shift.

I made a point of talking to our lost STSC customers a year after they transferred their applications. They'd say: "You were right, John. It now costs us a lot more to run and support those applications than it did when we had them on your service. But that's water under the bridge, it's too bad we can't shift them back." In retrospect, we could have at least slowed the decline if we had briefed our customers earlier on how to transition their applications while still utilizing major elements of our service. Supporting our briefings with specific case studies that outlined ***all*** the costs and risks would have given our customers the tools to resist the pressure coming from their accounting and IT departments. One of our competitors took that path, repackaging their product offerings to retain a substantial revenue stream even as their largest customers transitioned selected applications to their own in-house IT departments.

The dark side of a partially unbundled pricing strategy

I share my personal story to emphasize that you are at risk whenever you bill the client this way. You are vulnerable to inappropriate price comparisons when a substantial portion of your value is hidden from your customers' view. Your value proposition may include non-obvious features like these:

- The capital reserves required to provide 60-90 day extended payment terms.
- The extra capacity required to handle surge and emergency orders.
- The manufacturing process quality assurance that eliminates the need to inspect.
- The senior technical staff maintained to assist a client's product trouble-shooting.
- The spare parts warehoused to enable product repair over its life.

All these provide value, albeit intangible, for your customers and create substantial additional costs for your operations.

You will look over-priced if you allow your customer to do price comparisons with other suppliers without putting a dollar value on all these beneficial features. If the customer insists on ignoring those "intangible" features, you have no choice but to sell totally unbundled and price for every individual service.

It's important that your executive team understands which elements of your products and services the customers truly value. A well-run strategic planning process helps keep everyone on the same page on many key issues, including pricing, which is a multidimensional issue.

While the issue of pricing sometimes comes up directly during strategic discussions, more often the team comes at it in multiple contexts. For example, in a discussion about weaknesses, the sales executive may share that the sales team is seeing more RFPs that place a large value on smaller quantities and tighter delivery schedules. The operations executive may identify an opportunity to increase value by solving a customer's longstanding quality issues by using a new press that eliminates an expensive step in the customer's process. The financial executive may identify a financial strength that would enable the company to build and warehouse parts, thus enabling customers to avoid building new warehouses of their own. Understanding what is valuable to the customer *today* not only enables smart marketing and pricing, it also motivates every member of your team to support that smartness.

How to avoid getting McKinseyed

There are many ways to lose key customers, and one of the most insidious – and most related to pricing – is getting "McKinseyed." Here's how it works: Every few years, one of our strategic planning clients – let's call it Service Company Supreme – comes under price pressure. One of SCS's customers hires a consulting firm, often McKinsey, to help them improve profitability. The consultant bombards all that customer's vendors, including SCS, with endless questions about how long it takes the vendor to perform each little microstep in delivering the service. The consultant then conceptually unbundles each vendor's service, identifying each of the microsteps that costs more than a competitor's or which they, the consultant, consider to be valueless. The consultant then insists that the vendors, including our client SCS, must reduce their price to match the consultant's analysis.

However, it's unreasonable to expect a vendor to continue to provide a high-value-added bundled service at a dramatically reduced price. The only response to being McKinseyed is to totally unbundle your service. Update your service agreements to make explicit what clients receive for the new, reduced price. Establish charges for anything outside this service agreement. And – this is the hardest part – *charge for everything.* Here are examples of how some companies handle this challenge:

- A company that created parts catalogues for its clients traditionally priced their service simply by the final page count. After being "McKinseyed," they had to reduce their price-per-page to retain the business. In the new contract, they specified what the client received for that reduced price. They identified the maximum number of graphic images per page, the number of times a page could be reviewed and revised, the minimum turn-around time, as well as the other purposes each page could be used for. They had to upgrade their systems and company culture to capture all the additional billing information.
- After seeing its profit per-part driven to zero, a manufacturing firm instituted additional charges for documentation, expedited shipping, monthly minimum charges, design changes, and engineering support.

Totally unbundling your service, done correctly, paradoxically increases the customer's costs. It also puts you and your customer somewhat at odds. The less efficient you are, the more money you make. Think of how this motivates law firms to stretch out lawsuits to increase billable hours or doctors to prescribe more visits, tests, and procedures to earn enough to repay school loans.

Totally unbundled pricing also increases unpredictability. Government contractors are notorious for winning contracts with low-ball bids and then making a "fortune" when they have huge overruns in execution. If you negotiate a fixed price for a project, you and the contractor are then on the same side. He is motivated to put his most productive people on the project to deliver it quickly and maximize profitability. When he is being paid on a time and materials basis, he is motivated to put his least productive people on the project and stretch the project out as long as possible to maximize revenue.

The challenge of charging differently

Changing your company's pricing and service culture is always a challenge. A strategic decision to "charge for everything" cannot be successfully implemented when individual employees and their support systems are driven by a culture that says:

- Do whatever it takes to make the customer happy, regardless of cost.
- Don't nickel and dime the customer.

A company's pricing culture has a direct impact on how individual employees choose to prioritize their daily activities. Employees "know" what's in the company's best interest, and when management asks them to do something they consider "stupid," they give it low priority. If the market changes and nickel-and-diming is what it takes to remain profitable, then you will need to supervise and re-direct employees' daily activities until they internalize the new priorities reflected in the new pricing structure.

We have all lived through an economic tsunami in the past couple of years, a wave that has dramatically changed the value proposition for many industries, companies, and individuals. It's time to get your executive team together and revisit your corporate strategy – and your pricing. Start by making sure everyone is on the same page with regards to:

- where are you today?
- where do you want to be in the future – 1 year, 3-5 years, and beyond?
- what do you need to be focused on today, this month, this quarter to get there?

Make sure your value proposition correlates with your customer's reality. Keep your value proposition in front of the customer at all times, and don't allow that value to be obscured by the mechanics of billing.

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