Obstacles to Implementing Value-Based Pricing

By Stefan Michel and Patrick Pfäffli, 2012

In theory, value-based pricing is superior to cost-based and competition-based pricing. In practice however, cost-based pricing remains dominant. This article offers an overview of the special costs and difficulties associated with implementing value-based pricing, with a goal of helping managers weigh the costs and benefits, and anticipate the difficulties, of their own implementations of value-based pricing.

In theory and practice, three basic principles of pricing can be distinguished: cost-based, competition-based, and value-based pricing (Nagle/Hogan 2007; Hinterhuber 2008; Siems 2009). Figure 1 compares these principles and indicates their corresponding strengths and weaknesses.

Practitioners and researchers largely agree: Value-based pricing (VBP) leads to higher profits than cost- or competition-based pricing (Kühn/Pfäffli 2007). Different customers evaluate a product or service differently and assign different levels of benefit to it, leading to different degrees of willingness to pay. Unlike cost- or competition-based pricing, VBP tries to gauge this willingness to pay and, to the extent possible, take maximum advantage of it, which normally leads to higher profits. Figure 2 illustrates these sequences.

Yet despite the fundamental superiority of VBP, multisector, multicountry studies (Cavusgil et al. 2003; Avlonitis/Indounas 2006; Hinterhuber 2008) continually show that in practice, cost- and competition-based pricing remain widespread. This apparent paradox likely results from the various obstacles that must be overcome to implement VBP (Simon/Dolan 1997; Xia et al. 2004; Hunt/Forman 2006; Court et al. 2007; Diller 2008; Hinterhuber 2008; Maxwell 2008; Srinivasan et al. 2008).

This article explains those obstacles to value-based pricing that are of central importance in a practical sense, using a three-part categorization.

Category A: Costs specific to value-based pricing

- Benefit differentiation through versioning requires investments
- Danger of price erosion through arbitrage and costs of avoiding arbitrage through fencing
- Expense of assessing differentiated customer value and related market research costs
- Cost and complexity of price setting and communication for thousands of stock keeping units (SKUs)

Category B: Difficulties of implementing value-based pricing

- Market segmentation challenges and determination of segment-specific prices
- Difficulty of communicating differentiated customer value
- Customer resistance, resulting from perceived unfairness

Category C: Legal limits to value-based pricing

- Legal restrictions on price differentiation

This overview supports three insights: First, it allows for a specific cost–benefit analysis of introducing VBP, using transparent criteria.
Second, if the cost–benefit analysis is positive, it helps managers perceive and anticipate obstacles to implementation, and perhaps overcome them. Third, managers can learn about potential legal issues.

In the interest of brevity, it is not possible to address Category C in full. Therefore,

**FIGURE 1: COMPARISON OF THREE MOST IMPORTANT PRICING PRINCIPLES**

<table>
<thead>
<tr>
<th></th>
<th>Cost-Based Pricing</th>
<th>Competition-Based Pricing</th>
<th>Value-Based Pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Description</strong></td>
<td>Based primarily on data from cost calculations</td>
<td>Based primarily on information about competitors’ prices and products or services offered</td>
<td>Based primarily on information about the value that the customer attaches or can be induced to attach offerings</td>
</tr>
<tr>
<td><strong>Examples for concrete action</strong></td>
<td>Cost plus pricing: Calculating the cost and determining a markup for profit</td>
<td>Research of competitors’ prices (using specific competitors or average prices), followed by determination of a target price difference (e.g., comparisons of products or services offered)</td>
<td>Determination of added value of a product or service for the customer, or else empirical determination of customer’s willingness to pay for a given product, then identifying the resulting contribution to profit</td>
</tr>
<tr>
<td><strong>Strengths</strong></td>
<td>Basic data relatively easy to obtain; often perceived as “fair” by the customer</td>
<td>Basic data relatively easy to obtain; takes into account price pressure arising from the competitive situation</td>
<td>Can come close to exhausting the customer’s willingness to pay while taking into account the competitive situation and financial consequences</td>
</tr>
<tr>
<td><strong>Weaknesses</strong></td>
<td>Neglects customer needs and the competition; leads to suboptimal prices that are either too low and waste the margin or too high and discourage sales</td>
<td>Tends to encourage mechanistic reactions to the competition’s price behavior and can lead to price wars; neglects customer needs and leads to “product-oriented” assessments of differences in products offered, which are irrelevant to needs; in some markets, there is no information on market price or the competitive prices</td>
<td>Difficult and usually costly to obtain basic information; implementation can involve additional costs and lead to resistance; customers may perceive certain aspects as unfair</td>
</tr>
</tbody>
</table>

Special costs of using value-based pricing

Benefit differentiation by versioning requires investments
For a company to establish differentiated prices, it usually must offer a fundamental service or a core product with different versions. Consider the A and B Mail postal rates in Switzerland: With A Mail, the postal service promises next-day delivery, whereas B Mail delivery within Switzerland may take up to three days. The post office charges a premium of 15 centimes (+18% of the 85 centimes B Mail price) for customers who want faster delivery. Apple’s iPod is offered in various versions, ranging in price from SFr. 119 to SFr. 379. The price range for VW Golf IV models extends from SFr. 22,900 to SFr. 43,800.

Versioning can help exhaust different levels of customers’ willingness to pay, thereby increasing earnings. But after a certain point, the costs of additional versioning may be higher than the additional earnings. Companies must take into consideration not only production costs but also the administrative costs of a greater product range and the guarantee and service costs that they might incur for decades to come. It thus is not surprising, in view of the cost of maintaining two independent logistic chains, dual product management functions, and two segments of higher administration, that the Swiss Post Office is thinking of merging A and B Mail. For electronic products or services though, differentiated offers are common, because additional versions can be produced at low additional cost.

Dangers of price erosion through arbitrage, costs of avoiding arbitrage by fencing
Value-based pricing often results in a price structure with higher prices than the reference price for some customers, while allowing a price reduction for other customer groups. The danger is that customers who would be willing to pay more may enjoy unintended price reductions—an effect known as arbitrage.

Case: Pricing Mistakes
McKinsey has estimated the cost of pricing mistakes for a business-to-business company with sales of US$2 billion: The costs of correcting the pricing mistakes were approximately US$2 million, the direct loss in sales was approximately US$20 million, and the cost of customer dissatisfaction is inestimable (Marn et al. 2005, p. 163).

Obviously, it is essential that customers willing to pay more not enjoy offers intended for customers with a lower degree of willingness to pay. To avoid that occasion, students offered a lower price for tickets often must show a student ID, to prevent others from enjoying the price discount.

That type of restriction is called “fencing” (in German, Barrieren) (Simon/Dolan 1997, p. 147). In such cases, a priori costs arise not because of the creation of the fence but rather through its enforcement. Rules must be entered into systems, and employees must be trained to enforce them, an effort that is particularly difficult when the company engages in multichannel marketing. In addition, post hoc costs arise when the fence is penetrated. Firms must work with customers, employees and trading partners to identify and eliminate price inconsistencies.
**Figure 2: Sequence of Pricing Considerations**

<table>
<thead>
<tr>
<th>Pricing principle</th>
<th>Starting point</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost-Based Pricing</td>
<td>Offer (product, service)</td>
<td>▶ Cost plus “profit markup”</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Price ▶ Product-oriented sales</td>
</tr>
<tr>
<td>Competition-Based Pricing</td>
<td>Competition (prices, offers)</td>
<td>▶ Positioning in relation to the competition</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Price ▶ Greater competitive pressure, fight for market share</td>
</tr>
<tr>
<td>Value-Based Pricing</td>
<td>Customers (needs, references)</td>
<td>▶ Value-specific benefit attributes from customer’s perspective</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▶ Price ▶ Offer oriented to needs, target costs dependent on price</td>
</tr>
</tbody>
</table>

Source: Authors, with reference to Nagle/Hogan (1997, p. 20).

**Cost of estimating differentiated customer value and market research**

According to Hinterhuber (2008, p. 44), the biggest obstacle to the introduction of VBP lies in estimating the differentiated customer value (i.e., the specific value that a product or service has for a customer) and the associated market research costs. This concern was noted by 79% of the managers questioned.

Why is it so difficult to determine differentiated customer value? In business-to-business situations, the initial difficulty lies in the complexity of the products and services. Customers must have a thorough understanding of processes to assess how much added value one solution can generate, compared with the next-best alternative. In addition, more and more often the key account manager negotiates with procurement managers, who are intent on extracting the lowest possible purchase price. For tactical reasons, procurement managers deny any advantages of an offered product compared with a competing product and refuse to signal any degree of willingness to pay.

In business-to-consumer situations, different levels of willingness to pay can be determined quite reliably through conjoint analysis. However, the costs are significant; conjoint analysis requires expert knowledge if the firm wants to avoid worthless, or possibly even counterproductive, results. A good overview of this method appears on the website of the leading conjoint software supplier, Sawtooth (Johnson/Olberts 1996; Curry 2001).

**Costs and complexity of price setting and price communication for thousands of SKUs (Stock Keeping Units)**

Even medium-sized enterprises must set prices not for a single offering but for thousands, sometimes hundreds of thousands, of products and services (Court et al. 2007). A company with 1,000 SKUs that operates four channels and offers four discount levels already must manage 16,000 individual prices. When regional promotions and bundling prices are added, the number of price items to be determined jumps over 100,000. In any such situation, pricing mistakes are likely.
The problem of quantity increases significantly with the use of VBP, particularly when the effort to exhaust different degrees of willingness to pay through differentiation of benefits or versioning leads to an increase in the number of SKUs. In addition, it usually is assumed that with VBP, the greater complexity of pricing decisions achieved by estimating customer value means that more SKUs result in significantly higher pricing costs than would be the case for cost- and competition-based pricing, which are easier to standardize.

Companies like Zilliant or PROS Revenue Management have geared their business models to such challenges and offer software solutions for automated price analysis, price setting, and price monitoring. In the United States alone, providers in these markets have achieved sales of more than US$1 billion annually and double-digit growth rates. However, these figures do not include the costs to the companies of setting up and integrating IT systems and databanks.

**Difficulties of market segmentation and setting segment-specific prices**

Value-based pricing requires that the price correspond to the value perceived by the customer. Theoretically, every customer must have a new price offer. In practice, that is rarely feasible. As in other marketing areas (e.g., product innovation, advertising, distribution), for pricing, the solution to the dilemma between mass market (low costs) and total individualization (high sales) is sought through segmentation. Segment-specific prices should increase sales while ensuring that any additional costs do not cancel out increased earnings. For many companies, the problem is that traditional principles of segmentation are unsuited to VBP. Within a given segment, customers rarely exhibit equal willingness to pay. Therefore, value-based pricing requires a specific type of segmentation, “price segmentation” (Diller 2008), which takes particular account of price interest, price knowledge, and price intentions as consumer, and hence segment, characteristics (Diller/Stamer 2003).

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**Case: Behavioral Segments at a Swiss Bank**

A pricing project for a Swiss financial service provider aimed to form different price segments. Historic transaction and stock data led to the determination of statistical clusters with different degrees of willingness to pay. However, the key account managers rejected this new segmentation, preferring their own (diamond, platinum, gold, and silver customers) segmentation scheme. The project implementation therefore included both segmentation principles. But during specific sales talks with customers about the new price structure, the key account managers quickly realized that the new segmentation made it possible to tailor their arguments to each customer.

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**Difficulties of communicating differentiated customer value**

After identifying price-specific segments, the company must communicate the differentiated customer value. This communication often takes place through various marketing channels (the Internet is cheaper than a warehouse store, a warehouse store is cheaper than a specialized shop) or a multimarket strategy.
**Case: Cutting costs for branding at Migros**

In early 2009 the management of the major Swiss retailer Migros decided to cut its 350 million franc marketing budget, much of which previously had been invested in marketing a constantly increasing number of Migros’s own brands. As part of the new communication strategy, it drastically reduced the number of brands and devoted more of the budget for those brands remaining in the portfolio, even as it invested more resources in the umbrella brand. The cutbacks did not result in lower sales.

The Swatch group is a good example of how to exhaust the willingness to pay for a product. Several price segments are served, starting with the 60 franc Swatch, ranging through Tissot, Omega, Rado, and Blancpain, and then extending up to the Breguet—costing a quarter of a million francs. However, the costs of a multi-market strategy are substantial, as Migros learned (see box).

**Customer resistance due to perceived unfairness**

Value-based pricing means that customers pay different prices for the same or a very similar product or service. This differentiation can lead to negative reactions among customers and the wider public if that price differentiation seems unfair in some way (Maxwell 2008).

Customers form an opinion of fairness by comparing the price (and the underlying price system) against a reference price (or reference process) (Xia et al. 2004). On Amazon for example, most customers regard the price indicated on the website as the price that applies to all customers. The situation differs for airlines and hotels though, because these customers are used to seeing substantial differences in prices depending on the date of departure, date of reservation, sales channel, and customer status.

**Case: Perceived Unfairness of VBP at Amazon**

In September 2000, the online retail Amazon.com began to adjust its book prices to purchasing behavior. A tremendous uproar resulted when a customer noticed that the price for a given book fell from US$26.24 to US$22.74 when he deactivated the cookie in his browser, then rose again to the higher price when he reactivated the cookie. Amazon.com received thousands of negative e-mails and suffered major image damage. Loyal customers felt betrayed, which meant lasting harm to their relationship with the firm. What is interesting here is not just the negative reaction but rather that customers willingly accept similar price differentiation from enterprises such as hotels, airlines, or mobile phone providers—seemingly without question.

Fundamentally, a differentiation in price should be communicated in such a way that it reinforces the highest price as the reference price and ensures that lower prices are linked to conditions that seem both understandable and fair (Tversky/Kahneman 1991).
Bibliography


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