THE VALUE OF PRICE

Calculating the right cost model for your product is a fine art, when price and value aren't necessarily interchangeable.

By Fiona Baron

You're about to launch a new product into the market. But at what price? Conventional wisdom says it's time to go to your accountant to find out just how much your costs are. That way you can calculate your mark up and hey presto, there's your price. Right?

Wrong.

Yet that's the approach a large majority of businesses take. "About 70 to 80 percent use the traditional cost-plus pricing model," says Jon Manning, founder of PricingProphets.com.

He understands the attraction. "It's about financial prudence. You have the comfort of knowing you're covering your costs."

Nonetheless, it's a mistake. Calculating costs can be arbitrary, explains Manning. You're relying on historical costs rather than pricing for current and future sales. There's also the risk of focusing more on managing costs rather than your revenue.

Then there's the issue of demand, says Manning. "If Sydney has strong demand compared to Melbourne, there's a reason for pricing them differently."
Instead, businesses should be focusing on value. “Customers don’t buy because of the cost but because of the value your product or service provides.” Manning believes a value-based pricing model is ultimately more sustainable. “It comes down to understanding your customer and the value you can provide,” he explains.

Of course, it’s based on the assumption your customers are willing to pay for value over and above your costs. But, as Manning points out, “You don’t have a product if it doesn’t exceed your costs.”

Focus on competitive value
The model also relies on you providing more value than your competition. Consider how you’d approach selling a dog. One person offers a dog for $200. Another person offers an identical dog for $200. However, the second offer includes the promise that your cheque won’t be cashed for four weeks and if you’re not happy with the dog in that month you’re able to return it. You also receive a collar and bowl for free. That shows an understanding of the customer’s needs, says Manning. You eliminate risk and offer a superior value proposition.

Explore your options
There are many alternative pricing models, strategies and tactics worth exploring. Apart from value-based models, there are options such as time-based pricing, price experiments, unbundling and paired products. Then there are those strategies that relate to specific areas. In software, pricing models can be user-based, usage-based, time-based and location-based. In digital, there’s what’s known as ‘freemium’ — which denotes a free service with payment for premium content. There are also such strategies as ‘pay what you want’, and direct and indirect cross-subsidies.

Putting a price on mental health
A Melbourne-based company has developed an executive mental health check. The program is designed to assess senior executives’ mental health through an online questionnaire and a face-to-face meeting with a psychologist. The idea is that mental health problems can be largely avoided if detected early.

PricingProphets’ experts suggested that the price of the service should be tied to an individual business’s potential cost savings. The company could use its knowledge of senior executives’ pay – readily gleaned from corporate reports – to estimate the potential productivity loss a business would suffer if a mental health issue went unnoticed.

“Pricing is the most powerful profit lever available to a business.”
An entrepreneur in India has created a text-messaging service which he was selling to the parents of children in private schools. The aim of the service is to let parents know where their children are at any given time.

The entrepreneur was selling the service as a monthly subscription. PricingProphets' experts decided this wasn't the optimal form of pricing. Rather, it made more sense to sell the product directly to the schools, the price then set as a percentage of school fees. The underlying logic here was that school fees invariably rise.

Of course, changing pricing models involves some work, notes Jon Manning, founder of PricingProphets. The entrepreneur had to ensure he had the right sales people to sell to the schools instead of parents. "It's a different skill set."

Marketing problem, which may be fixed with more advertising, "says Manning. He views this as misguided. "Pricing is the most powerful profit lever available to a business."

Crucial conversations
You might not get your pricing model right initially. Or you might be keen to increase your profit. So how do you approach a price increase with your customers?

According to Jon, "It's all in the execution." He advises drawing up a detailed plan which sets out the series of steps to be taken. You need to decide who you have to talk to face-to-face and who you can email, says Manning.

You also need to decide how you're going to rationalise the price increase, particularly if it involves an entirely different approach to pricing.

Manning cites a start-up that launched the wrong pricing model. Realising its mistake, it went from a pay-per-use model to a monthly subscription. Manning says the start-up's people contacted all the customers in person or by email giving the reason for the price change. Explaining to them that it was costing the business money even when a consumer wasn't using the service, they ended the discussion, or message, by explaining that they had no alternative and the business entirely understood if the customer went elsewhere. "They didn't lose one single customer," says Manning. "Twelve months later their revenue was up by 20 percent."

Above all, says Manning, you don't want the new pricing to come across as a money grab. "You have to show respect for the customer." That sits well with a value-based model. "A value-based price increase always comes across better than a cost-driven increase.

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Manning's PricingProphets.com, which provides experts online to help businesses formulate a pricing model suitable to their product or service, has found many people have little understanding of the power of pricing. "When an SME is struggling to place their product, they tend to think of it as a sales problem, which may be fixed with more discounting, or a