

# Product Based to Relationship Pricing

The way that organisations price their products or services may be changing. New approaches to pricing are emerging based on the customer relationship rather than on pricing products or services for individual transactions. Here, Professor Lynette Ryals reviews traditional product-based pricing approaches and their advantages and disadvantages. She then explores new approaches to pricing based on customer relationships.

**Traditionally, pricing decisions have been product-based; that is, companies have generally set prices for their products or services based on their costs of manufacturing the product or providing the service (cost-plus pricing), or relative to what competitors were charging (competitor pricing). Broadly, this meant that prices for the same product or service would be the same to all customers and adjustments to those prices (in the form of discounts or rebates) would tend to follow volume purchases of that specific product or service.**

Recently, there have been signs of change, with increasing interest in customer-based pricing, where prices are influenced by the customers' overall relationship with the supplier, including their purchases of other goods and services. This change has a lot to do with the emergence of relationship marketing. Relationship marketing has as its emphasis the lifetime relationship that customers have with a company. Researchers in relationship marketing have demonstrated that loyal, retained customers can be considerably more profitable than new customers, in part because the cost of acquiring new customers (advertising, selling etc) is so high.

## Product-based pricing

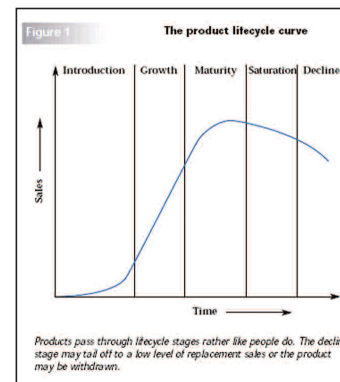
Traditional corporate pricing strategies have tended to fall into two broad categories, cost-plus and competitor-based. Cost-plus pricing, probably the most widely used approach, describes a method of pricing based on calculating product costs and adding a margin. Competitive pricing is pricing relative to key competitors. Provided that product costs are calculated accurately, cost plus pricing guarantees a profit as long as there are customers out there prepared to pay those prices.

However, if competitors have a lower cost base, cost plus pricing might be uncompetitive and competitor pricing (setting prices relative to the competition) might become necessary.

Competitor based pricing tends to favour those companies with a lower cost base and has in the past led to price wars, damaging both short and long term profitability for all the players involved.

## Product-based pricing tools

Underlying cost-plus or competitor pricing strategies may be adapted from time to time to reflect market conditions affecting certain products or product groups. Three tools for product-based pricing are considered here. They are: the 'product lifecycle curve', the 'skimming/penetration' pricing model and the 'diffusion of innovation curve'. The 'product lifecycle curve' (PLC) is a marketing tool that draws an analogy between products and biological organisms or populations (see Figure 1). The PLC suggests that new products have an 'introduction' period, during



which sales are very low and slow-growing, in part because it takes customers a while to find out about the new product. Then follows a period of 'growth' in which sales increase rapidly. During 'maturity', sales are still increasing but not at

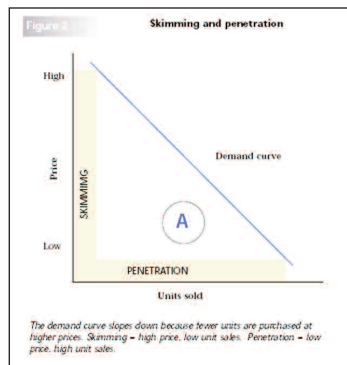
the same rate. This leads to 'saturation', during which sales stagnate, followed by 'decline'. Sometimes, decline might lead to the product being gradually withdrawn, as in the case of glass milk bottles; or it might lead to volumes steadying at lower levels mainly of replacement sales, as in the case of central heating boilers.

Occasionally, products in the decline phase will experience a sudden resurgence, either because they are rebranded and remarketed as in the case of Lucozade, Gillette and Ryvita, or because they suddenly come back into fashion, as happened recently with Yo-Yos.

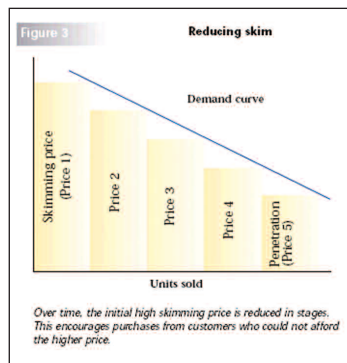
The PLC can be useful in developing product-based pricing strategies. Pricing during the introduction phase usually follows the 'skimming and penetration' model outlined below. During the growth phase, prices may rise if demand for the product creates a scarcity value or if new features or product variants are introduced during this stage; or prices may be driven down if competitors launch competing products. Later, in the growth and maturity phases, there may be price fragmentation as new product variants emerge and new channels or segments are explored. Saturation and decline phases are usually characterised by cost cutting, including product simplification and reduced advertising and promotion; the concomitant pricing strategy is usually price reductions, special offers etc.

'Skimming vs penetration' pricing decisions are associated with new product introductions. A skimming strategy sets the price of the new product high, in the expectation that fewer units will be sold but at a very high margin over cost. Penetration pricing sets prices low so that more units

will be sold (see Figure 2), relying on economies of scale to reduce costs sufficiently so that the company makes a profit on each product sale. Either strategy, however, leaves a large area of potential value untapped (area A). The area below the demand curve represents potential purchasers;



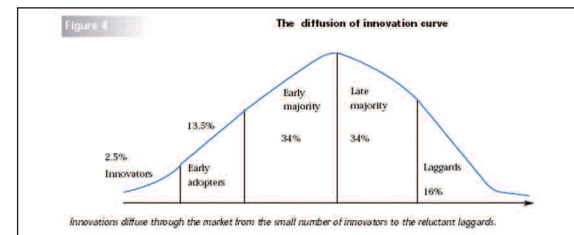
to capture more of this value many companies use the combination pricing strategy known as 'reducing skim' illustrated in Figure 3, where the skimming price is gradually reduced over time.



The 'diffusion of innovation curve' provides a further rationale for the use of a reducing skim product pricing strategy. This curve suggests that new products or services diffuse through the population in a pattern that follows willingness to adopt new products and innovative solutions

(see Figure 4). 'Early adopters', it is argued, are highly motivated to try new things and are relatively price-insensitive. This influential group will be attracted by

promotional campaigns stressing the newness of a product or service and will be prepared to pay higher prices, although most customers will prefer to wait a little longer

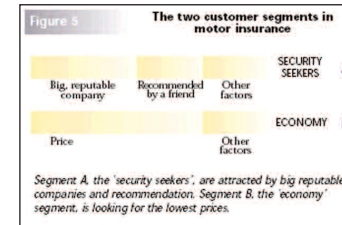


before committing themselves to purchase and may be attracted by lower prices.

### Customer-based strategies: segmentation and value-in-use pricing

The 'diffusion of innovation curve' illustrates product-based pricing being adjusted over time to attract new groups of customers. However, it may be more effective for an organisation to target different customer segments simultaneously with slightly different product-price combinations. A segment is a group of customers with similar needs. Because different segments have different needs, different customer segments will value the same product differently. This will affect the price they are prepared to pay. Figure 5 shows part of a segmentation exercise conducted by an insurance company. One segment was very price-sensitive; another was more interested in insuring with a reputable company.

The price-sensitive segment could be attracted through lower prices, although a more profitable strategy for the insurance company might be to attract more of the



security-conscious customers.

Supporting a high proportion of very price-sensitive customers in the customer base can undermine profits in

the longer term as the demands of such customers and the actions of competitors drive prices ever lower. Still worse, in order to keep prices low enough to attract very price-conscious customers in the first place, the company might have to cut product research and development, damaging its longer term profits. Value-in-use pricing aims to identify the value that the customer obtains through use of the product or service, and then price accordingly. Value-in-use pricing may also identify features of the product or service that customers do not value, allowing the supplying organisation to tailor its products or services more closely to customer requirements without necessarily increasing costs. Value-in-use pricing has become of greater interest to organisations over the past few years with the emergence of new techniques and new technology that can help answer the vital question: how much would customers be prepared to pay, and why?

Value-in-use pricing is still, however, largely a transactional approach, focused on the individual sale rather than on the lifetime relationship with the customer.

However, it has made it clearer that price carries a message to consumers. Generally, it is easier to reduce prices over time than to raise them; however, research into value in-use pricing tells us that the act of reducing prices can send

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adverse signals about the quality or desirability of the product. Over the past decade, the growing importance of relationship marketing has led to a fresh approach to pricing. As evidence has emerged of the link between customer profitability and shareholder value, companies have begun to recognise that maximising their price on an individual transaction might damage their long term relationship with the customer. Thus, a shift from transactional to relationship pricing is occurring.

## From transactional to relationship pricing

The disadvantage of product-based pricing is that it suggests that products are the key driver of profits, not customers. Relationship marketing has demonstrated that, provided the product or service meets the customers' needs, it is the customer relationship that drives profit. The function of marketing becomes to identify, target and retain the most profitable customers. Recently, two sophisticated forms of pricing have emerged: relationship pricing, and risk-based pricing. Both approaches involve the development of pricing strategies aimed at maximising the value a company can obtain from its customers over the entire relationship lifetime.

## Relationship pricing

Relationship pricing regards the company's relationship with the customer as the main driver of profits. Rather than pricing based on individual transactions, relationship pricing takes into account the entire portfolio of products or services purchased by that customer. Many different aspects of pricing (such as discounts, rebates, payment holidays, special offers on additional purchases) may be used. Figure 6 illustrates some relationship pricing offers from a bank.

**Figure 6 Relationship pricing**

ACCOUNTS HELD	POTENTIAL BENEFITS OFFERED
Personal loan or travel insurance	5% discount on car insurance
Mortgage OR current account OR savings account	No visa card fee for the first year
Mortgage AND current account	Six month mortgage repayment holiday

*Relationship pricing used to target more valuable customers and increase cross-selling.*

This is in stark contrast to product-based price discounting strategies, which encourage frequent switching and discriminate against loyalty. Relationship pricing helps initiate a virtuous circle. Because customers are rewarded for buying more products from a company they increase their share of spend with that company. The wider the range of products or services they buy, the more likely they are to remain loyal to that supplier. Relationship pricing strategies also offer better protection against competition.

Some organisations have adopted relationship pricing to enable customers to tailor the product/price offering to their own particular needs. In order to do relationship pricing successfully, companies need information systems that enable them to view the whole picture of their relationship with customers. Some companies are even using technology to help them identify not just their existing customer relationships but also to predict what their customers or potential customers might buy in the future. It is uncertain what customers will or will not do in the future but, by quantifying this uncertainty, a few leading-edge organisations are able to experiment with new, risk-based approaches to pricing.

A major advantage of relationship pricing is that it rewards customers for loyalty and for increasing the share of spend they place with a company.

## Risk-based pricing

Risk-based pricing is a complex and sophisticated process that uses predictive modelling to forecast potential future revenues from a customer and the risks associated with those revenues. This risk may be translated into a probability forecast or expressed as a high discount rate that reflects the risk of that customer. Techniques such as simulations may be used to examine a range of possible outcomes.

One international insurance company came to realise that it thought of the risk of its corporate clients purely in terms of insurance risk (the risk of a large claim). In many ways just as significant was the risk that these huge corporate clients would decide not to renew their annual insurance contract and switch to another insurance provider. The insurance company termed this second type of risk 'relationship risk'. They built risk scorecards to express relationship risk as a probability that the corporate client would renew. The higher the relationship risk, the lower the probability of renewal.

An extract from one of these relationship risk scorecards is shown in Figure 8. Companies using risk-based pricing may work with the customer to try to reduce the risk. This may result in novel pricing strategies; risk may be shared, as in a recent example where a supplier took an equity stake in a promising start-up business in exchange for supplying a business-critical system that the start-up could not afford to purchase for cash.

Other risk reduction strategies may include longer-term contracts so that the supplier can offer lower prices but is ensured of sufficient business to make the relationship profitable; or variable pricing to reflect the risk of the customer.

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Figure 8 Extract from relationship risk scorecard

RELATIONSHIP RISK FACTOR	VALUE	PROBABILITY OF RENEWAL
<b>A Relationship dimensions</b>		
1 Longevity of relationship (years to date)	1	40%
2 Number of business lines purchased	3	60%
<b>B Account relationship</b>		
1 Quality of relationship (where 1=poor and 5=excellent)	4	90%
2 Number of contacts at client	6	90%

*Reducing relationship risk could enable longer-term pricing strategies to be put in place.*

## Conclusions

Traditional product-based pricing may not meet the needs of organisations who are developing strategies for customer retention or customer relationship management (CRM), where the emphasis is on maximising the value of that customer relationship throughout its lifetime.

Companies wanting to develop a relationship orientation should re-evaluate their pricing strategies and consider moving to a relationship pricing approach.