The Great Unknown
Find the most profitable price that can take hold

By David Chopko

(Editor’s note: As the first stage of the business recovery emerges throughout our market, senior executives are turning their attention to their pricing practices. These decisions are so important that we’re proud to kick off a new series of articles by one of our finest writers, David Chopko, who investigates best practices regarding the craft and art of establishing the most profitable price.)

Which functional area is least understood by the typical business professional but has the greatest influence on his bottom line? Pricing. Look at how Netflix crushed its share price by instituting an ill-advised and poorly timed price increase and how Verizon alienated a large portion of its customer base by floating a $2.00 extra payment charge (really a selective price increase, poorly disguised).

Pricing is part art and part science. Strategic pricing involves aspects of finance, corporate/product strategy, and marketing.
Business professionals make pricing decisions everyday. The question they face is, Do I change the price on any or all of my products today? If the seller on that day for that sale holds the price of the product, she has made a conscious or maybe unconscious pricing decision. Research has shown that this pricing decision has more influence on the bottom line than any other decision she’ll make during that day.

A short example will illustrate the power of pricing. John’s Deli sells its average sandwiches for $7.50. After covering all costs, John Jr., its owner, makes 50 cents profit per sandwich. If John could raise his price by only 50 cents (7 percent), he could double his profits. But John rarely thinks about raising his price. He doesn’t think about it because Sam, who owns Sam’s Sub Shop, 1 mile away, hasn’t raised his prices in the last year. John closely watches his bread and meat costs, frets over the amount he pays his help, cusses the credit card fees he pays, and thinks about going to cash-only sales, but he doesn’t really look at his price. Heck, raising prices would force him to print all new menus, and printing menus is an extra cost he certainly doesn’t need.

John’s and Sam’s prices were set by their fathers 40 years ago. You might ask how that could be. Each father told his son that you take the cost of the meal ingredients, add $2.50 to this cost, and that is a “fair” price. And this is what their boys have dutifully done. What John’s father never envisioned was that his son would develop a secret sauce that would have customers driving miles just to get the “special” sandwich. Or that the ingredients for this special sauce would cost only pennies more than the standard ingredients, so John would price this special sandwich at $2.50 more than its cost, or essentially the same as his other sandwiches. Lots of people love John’s special sandwich, but John is making only a small percent of the profit he could be making on its sales.

This story would be funny if it weren’t for the fact that 95 percent of all businesses follow this same philosophy. The people making pricing decisions for the large multinationals are typically no better than Sam and John in this business skill. When costs rise, they consider raising their prices. And when costs fall, they consider lowering their prices. Or when whoever they consider their key competitor raises or lowers his prices, they then consider raising or lowering their prices.

Prices should not be based on costs, but rather on value. Price should be based on the value that your product provides to your customers compared to the Next Best Competitive Alternative (NBCA) that your customer can purchase to satisfy a specific need. When you analyze it, it is easy to understand that your customers don’t care about your costs, or alternatively, an increase in your costs does nothing to increase the product’s value to your customer. Again a simple example will illustrate this point. The dry cleaner charging $1.99 to clean a shirt decides to increase her employee’s wages by 20 percent. To cover this additional cost, she increases prices to $2.25/shirt. Is her service now worth 26 cents/shirt more the day after she raised her prices? No. The only way that her price has a chance of being justified (and sticking) is if her closest competitors, her customers’ NBCAs, also increase their prices by 26 cents. Whether or not they increase their prices to cover wage increases to their employees or simply to make greater profits, it doesn’t make a difference. What is critical is that her customers’ benchmark has increased 26 cents/shirt.

So how should business owners handle the problem of pricing to cover costs? They shouldn’t. Certainly a business owner shouldn’t sell his products at prices below his costs. What he should do is ensure that his products offer the greatest value possible to his customers and then expend his energy, time, and money (marketing dollars) to make his customers aware of the value provided by his products. A good start to reforming your pricing policy would be to totally ignore your costs and then revisit them only after prices are set.

David Chopko (chopkod@udel.edu) teaches pricing and market planning at the University of Delaware’s Lerner Graduate School of Business.