Chapter 6
Product & Service Pricing: Maximizing Revenue

"When money is at stake, never be the
first to mention sums"   Sheikh Ahmed Yamani

Cost Plus or Value Based?

Maximizing prices and revenue is extremely important for any business. Research indicates that a 1% improvement in revenue typically creates an 11% improvement in operating profit. Therefore price optimization can have a very significant impact on the bottom line (M.Mam and R. Rosiello, Harvard Business Review, Sept 1992). But how do you set the price of a new technology product?

In the world of classical economics and perfect competition, we are all supposed to figure out what our cost of production is for the goods we sell (preferably before we have even launched the product), and then bid in the open market place for customers. Competition will ensure that the consumers will be able to purchase products only at reasonable profit margins to the producers. Inefficient producers with a high production cost will withdraw from the market and excess profits will cause other producers to enter the market, so prices will be set rationally. If you work for a technology company, you probably don't recognize this as a picture of your market, and will not find it a useful concept.

If you were to take the "cost plus" route to determining prices, how does one determine the product cost? In the technology field, where product cost is to a large extent determined by the amortized development cost, the likely sales volume has a big impact on the product unit cost. But the sales volume is determined by the chosen sale price. So the result is "Tell me the sale price, and I'll tell you the cost price, which we'll then use to determine the sale price"!

It's a lot easier to start with the price for which you think you can sell the product, and then work backwards to see if the product is likely to be profitable on the anticipated sales volume.

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Value based pricing is a better approach, which is where you price the product based on the value it gives to the purchaser. In other words, you look at the benefits that the purchaser is willing to pay for, rather than the cost of production.

> **Tip # 40**
>
> Value based pricing is the best approach for technology products.

Why is this possible in technology markets? First because there are few "commodity" products in such markets; almost every product is differentiated in some way (or should be if you have any sense). Second, because often your products are protected by patents or copyright. The prospective buyer simply can't legally purchase equivalent products elsewhere, so it's more a question of convincing him to purchase your product rather than do nothing. After all, everyone has the choice not to spend money, and lethargy or "price resistance" is one of the common barriers to closing a sale.

Pricing as a Behavioral Science

The stock market is often seen as a "perfect" market in that fundamental company data and hard news should determine the price of a stock. However it has become very clear over the last few years that many stock prices are determined to a large extent by the psychological behavior of traders. And so they are if you look at the behavior of buyers and sellers in technology product markets.

One is rarely setting prices in a vacuum. It is a rare product that has no competition at all in the market place, or no comparable class of products, which tend to provide some reference framework for buyers. One may well have direct competitors who have already set a price, and hence have set market expectations for your product price. Try not to enter markets where the market leader has set such a price that they consistently lose money—not an unusual situation in some software markets.

One also has to consider how price sensitive are your customers and how they value your product. Let us consider the latter subject first.

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Perceived Value

How does a technology product buyer determine whether they are getting good value for money? In practice they can't. For most high technology products, it is not immediately apparent what they cost to produce. In most cases the purchaser will not comprehend the technical details of how it was produced, or even understand the inner operation of the product. An extreme example is software, which is typically a "black box" to the purchaser. They can't see the lines of code or the development effort that went into the product. In fact buying technology products is often like buying a bottle of wine—you don't know if it's any good until you have consumed it. Looking at the exterior of the bottle only gives limited clues as to the contents. The purchaser's perception of the product "value" will therefore depend on the following:

1. The price of the product. Yes price determines perceived value, just as it can do when buying a bottle of wine!

2. The exterior packaging of the product, and such matters as the quality and size of the supporting documentation.

3. The apparent investment by the producing company in the development of the product (this is one reason why technology companies typically boast about how much they spend on Research and Development).

4. References from third parties—yes it's important to obtain and to publicize those good customer references, to get good PR stories placed in appropriate publications, to get mentions and cross reference links on the internet, and generally be seen as a reputable and reliable producer.

5. The price of similar or complementary products—just adding another higher price product to your product portfolio can make your other products appear cheaper.

The buyers will tend to consider the above factors when judging whether you are asking a fair price for your product or not. Clearly though the overriding consideration of the purchaser will be whether your product gives them a good financial return on their investment.

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For major items of capital expenditure, when your buyer presents a proposal to his company board, they are much more likely to approve it if there is a quick, certain and good pay back on the investment. It can be helpful to have such information provided to buyers in the form of a Discounted Cash Flow (D.C.F.) calculation.

Another way you can influence the perceived price of a product is to pitch it at just less than a significant price point. When you shop in a supermarket you will see those $49.99 or $99.95 items fairly frequently, because it is well known that these have a positive effect on purchasing decisions. Now if you are selling to business technology purchasers, you may find that they are not quite that dumb but I believe it still makes sense to adjust prices to ensure a positive initial reaction. So for example, it would be better to have a product price of $9,700 than $10,000—you can probably make up the extra $300 on service or delivery charges if necessary.

Tip # 41

Watch your price points and avoid direct price comparisons.

At the product design stage, it clearly helps if you bear in mind what the likely price point will be so that you are not pricing your product at $10,500 when your competitors are in the $9,500 to $9,900 range. Although your product features may well justify the extra 10% cost to the buyer, and pricing 10% higher may be a good way of establishing a superior value (see rule 1 above), it may meet psychological resistance if it is just above a "price point". You might find it better to differentiate features and price even further so as to avoid direct comparison.

Price Sensitivity

Another major factor to consider is price sensitivity in the buyers. In other words, what is the likely marginal impact on sales of increasing or decreasing the sale price. If you halve the sale price, would you double the sales volume, or would it make little difference? In most technology markets, it tends to be more often the latter than the former. Why is this? I would put forward the following reasons:

1. Corporate buyers tend to be risk averse. They prefer to buy an assured solution rather than take a risk. There is more chance of dropping down the corporate ladder from implementation failure, than from spending too much money—hence the well

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known saying in the IT world of "nobody ever got fired for buying IBM". In fact, spending more money can actually lead to a bigger corporate empire and hence increased status and salary, so there is usually little incentive for professional managers to spend less money.

2. As pointed out above, the purchasers often have difficulty in judging the quality of the product, or whether in fact it will work. They may tend to equate price to value and hence assume that the more expensive product is the better.

3. Supplier continuity is important to businesses. They may think that producers with cheap products with low profit margins will sooner or later go out of business. They won't be able to get maintenance or support on the product, and replacement or upgrades will no longer be purchasable.

4. They may value timeliness of delivery, quality of service, good supplier/customer relationship, reliability of the product and other intangibles as much more important than product price.

5. The price of the product may have little direct impact on the overall profitability or cost structure of the purchasers business. For someone buying IT products to use in their internal systems, for example, the price of the product will have negligible impact on their overall business operations.

Price sensitivity does vary between different kinds of purchasers though. Educational establishments are clearly going to be more price sensitive than banks. Some organizations or company departments will have specific budgets, and if your price is not within the budget you will not make the sale. It would therefore be wrong to say that you should never compete on price, but you may find it best to do so when you have few other competitive advantages.

Charging Some Customers More than Others

The concept of value based pricing leads us immediately into the question of whether your product has the same value to all your customers. Of course it does not. Some customers will get more use out of your product than others. Some might rate it as absolutely essential to their future business plans, while others may simply rate it as

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something nice to have. Not every prospective customer is wildly keen to buy your product at first contact—some will take more persuading and education before a sale can be closed. Not every customer will have the same capacity to spend money on your product—some will have tighter capital expenditure budgets because their own business is not performing well. For those reasons, some customers will value your product more highly than others.

Why therefore do you charge the same price for the same product to different customers? You don't have to.

Now classical economists have studied this phenomenon of course. One common example is that of doctors who traditionally used to charge their wealthier clients more than they charged their poor patients. Was this simply altruism, or sound business policy? In fact you can demonstrate that you can maximize overall income by using such an approach, because a higher price will not deter the wealthier clients, while a lower price will attract more poor clients. In effect, some clients are less price sensitive than others and a policy of differentiation and market segmentation by price can help to maximize revenue. Another typical example of price segmentation is the selling of airline seats, where you can often sit next to people who paid several times more or less than what you paid for an identical seat. In effect the airlines charge more for seats sold to business travelers than they do to price sensitive tourists, although in return the latter may have to put up with some minor restrictions which deter the business traveler from buying the same tickets.

Tip # 42

Market segmentation and product differentiation maximizes revenue.

The key question facing technology product vendors is how to implement such a policy in practice. Clearly in some cases it is not practical, and could indeed be illegal. Retailers usually have a marked price on the goods they display, and don't vary it depending on the apparent wealth of the customer (at least not unless you are in an Arabian bazaar). However, one practice they can operate is to have different variants of the product which are in reality very much the same, but are priced differently and aimed at different markets. For example, there are standard jeans for the average customer, but "designer" jeans for the more "selective" purchaser. The only difference between the two may be the product price and the label.

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Clearly there are analogies in technology markets, where for example, a minor product enhancement can lead to major price escalation, particularly if the enhancement is more of a luxury than an essential. For example, look at how that well known technology product, the automobile, is priced. Often even within the same model, there is an infinite variety of options such that the final price can vary by a factor of two to one depending on which options are chosen.

What are the other ways of implementing price variation so as to cope with different price sensitivity among your customers:

1. Selective discounting for certain types of customers. This can be stated policy on the price list (eg. "educational" or "charity" discounts for good causes), or simply that you give your sales people flexibility to reduce the price when they run into a cheapskate prospect or are up against tough competition. Any good sales person can usually think up a valid, rational reason which justifies giving a customer a discount!

2. Price discounts for larger deals, which encourage the customers with larger budgets to spend more.

3. Exchange rate discrimination, where you convert your prices to local currency at a rate different to the normal exchange rate. In the software field for example, prices are usually lower in the USA than in Europe so you typically convert at a worse rate to give the Euro price. Why is this—well the vendors justify it on the higher cost of doing business in Europe, but if you have spent much time in the USA you will realize that in general Americans are more price sensitive than Europeans—they will walk further down the street to save a buck. In other markets, like Russia or Eastern Europe, you may want to pitch your prices lower than normal because the customers are simply poorer.

4. Product modularization so the number of modules or options a customer purchases simply relates to how much they have to spend.

5. Product market differentiation where you produce different versions of the same product to meet the needs of different markets (which are actually different in terms of price sensitiv-

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ity). For example, banks may be less price sensitive than manufacturing companies, so you vary the product accordingly. The selected price does not have to reflect the cost of product adaptation.

6. Time sensitive pricing. You price based on how urgent is the customer's requirement. If they are in a hurry, they pay more. This is a very common practice. Want some seats at the last minute for a big ball game? You will almost certainly pay more.

7. Location based pricing. In wealthier neighborhoods, retailers may offer higher price products and charge more. Likewise in wealthier countries you may be able to charge more than in poorer countries. The cost of transport and other market inefficiencies maintains the price differential.

How do you tell how price sensitive your customers are? One way is to look at what they have already purchased, and then you fit your product price to match. For example, in the software industry, if your product is going to be used with the SAP ERP application then you may want to charge them more than if it is to be used with another ERP system (SAP was traditionally bought by larger companies with larger budgets).

In fact the software industry contains lots of wonderful examples of this kind of tactic. For example, product price may vary dependent on what computer the software is installed on or how many users are going to be using it. This is totally unrelated to the cost of producing or installing the software (the software delivered is usually identical), but is purely a device to charge wealthier clients more—and apologies to all my former customers if they didn't realize this. Of course, the key is to come up with some rational explanation of how the price is worked out so your sales person doesn't look too avaricious. One justification for this pricing strategy is of course the same as the doctors: if the wealthier clients didn't pay more, and cross subsidize the poorer clients, then the supplier may go out of business, and everyone would be worse off. Yes all those software vendors are really closet socialists.

Tip # 43

It helps to have a rational explanation of your pricing structure to hand.

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You don't think that such manipulative pricing could happen in the hardware field? Well a few years ago, a certain computer hardware manufacturer decided that it was more economic to "slug" their latest high-capacity disc drive, than produce a new mid-range model. So they simply added an internal switch which disabled half the disc drive tracks. The cheaper model was delivered with the switch set one way, the more expensive model with the switch set the other way. The other beauty of this arrangement was that it was possible to sell an "upgrade" from one to the other. If you ordered the upgrade then an engineer came along, flicked the switch, and stuck a new label on the outside.

Such technological opportunism relies of course on people not being too aware of what is in the box, but who does with most modern technology? It also has occurred to me that this concept has been sorely under used in the modern world, but it brings us back to the original point—that you should charge your customers for the value you supply, not what it costs you to provide it.

Consumption Based Pricing

Another very useful technique when pricing products is to charge your customers on the basis of how much they use the product. This was the traditional technique for charging for photocopiers where a "lease" of the equipment was accompanied by a "per page" charge. It is also commonly used in certain sectors of the software industry where software can be rented on a "per transaction" charge. In telecoms it might be structured on a "per call" or "per connected subscriber" basis.

> **Tip # 44**
>
> Usage based pricing has many advantages.

This kind of arrangement has a number of advantages. In photocopiers it was a good sales tactic because customers would typically underestimate their likely usage of the machine (after all put a new, better quality, faster copier more local to the consumer, and usage would obviously increase). Also, your "sales" rise as your customer's business grows. As the general economy grows at maybe 5% per annum, you are likely to get that rate of sales growth without doing anything at all to win it.

The only thing to be wary of with such arrangements is that you need to be sure that your customer is not overstating their likely usage of the service when you set the initial rate.

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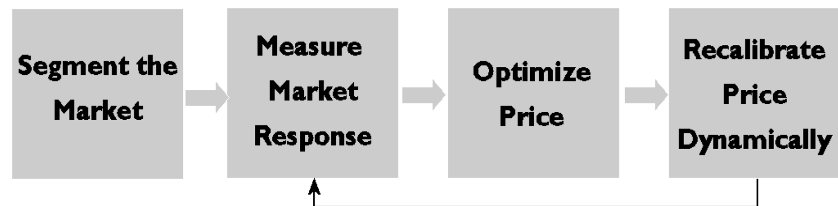
Price & Revenue Optimization

Price optimization using computer systems to model and control product availability and price has become fashionable of late. Where you have high volumes of sales, with the ability to dynamically vary price, it is possible to measure the response to different price levels and then recalibrate a suitable price to maximize revenue. For example, in the airline industry where "yield management" (the maximizing of revenue from a fixed number of airplane seats which fly whether they are filled or not) is extremely important for profit maximization, these techniques have become widespread. With e-commerce and internet retail sites becoming common sales channels, it is easy to vary prices from hour to hour, or even minute to minute. Such Price Revenue Optimization (PRO) systems are now available as part of many ERP and SCM application systems. Such systems depend on segmenting the market and predicting the buying behavior of each segment in a mathematical model, so they do require considerable volumes of data to be effective.



Giving It Away for Free

The concept of offering your product or service free of charge has become quite prevalent recently. For example, many internet sites offer free services, particularly information, on the basis that the revenue to finance the site will come from advertising. Likewise there are free newspapers, and even free telephone services (you have to put up with your phone calls being interrupted every so often by advertisements). Some software products are initially introduced on a free basis so as to try and rapidly establish them as the "de-facto" standard.

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Alternatively, this tactic can be used to undermine a well established competitor particularly where the latter may be seen as a strategic threat (as for instance allegedly happened with Microsoft Windows Explorer® versus Netscape Communicator® although we will leave it to the courts to decide whether that was the motivation or intention). Other products are offered as a base version for free, with a more sophisticated version offered at a real price. Or sometimes the purchaser is simply asked to pay a donation if they are satisfied, or the vendor tries to make his profit margins from service and support (as is the case with the Linux operating system).

There is also the traditional promotional item, where you give a low value product away for free, so as to get marketing leads for your real business. Internet Service Providers (ISPs) went down this route when they basically decided to offer their service at very low cost on the basis that later on they would be able to sell their customers something of real value, or collect a slice of transaction revenue—but they failed to collect later.

These kinds of tactics are particularly common in the software and telecoms fields, where the marginal cost of another customer, or copy of the product is negligible. Of course, often it is a delusion, because if you don't have some means of recouping your capital investment, then it's bound to be a bad business. In the software business, this lack of marginal cost also creates the problem that sometimes your customers will ask why they are expected to pay real money for a product because the cost of replicating another copy for them is nothing!

Tip # 45

Beware of the delusion of zero marginal cost.

Does giving a product away work with higher value products? For example, you may want to introduce a major new product into a market with well established competitors. Maybe nobody can be found to take a risk on your complex new technology. Unfortunately it is not normally an effective strategy. Remember price equates to value in such markets, and if the customers are not price sensitive, having a zero price is not a good psychological persuader. Also larger value items typically require significant effort by the customer to install, change their own systems, train their staff and otherwise implement the product. Unless you can sell them on the superior benefits and cost justification for purchasing your product anyway, you won't make a sale.

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In such circumstances, offering some incentive or "introductory" discount may be seen as reasonable and fair, and may entice interest as a marketing tool, without nullifying your general pricing strategy and product credibility.

High to Low, or Low to High?

One of the dilemmas people face when launching a new product is whether to price it low or high. Do you pitch it low to build up rapid sales volume and customer acceptance (possibly at low or negative profit margins), or high to capitalize on the fact that with a unique new product there is always someone with a particular problem who will pay a high price for the solution. In the latter case, you will pitch the price higher than you may expect the normal, later customer to pay, and you may initially earn excess profits over your normal profit margins, at the expense of low volume.

The issue here is how unique is your new product? If it is protected by patent then you may be effectively in a monopoly situation. In this case you can reduce your customer demand and hence output, by raising prices, but increase your revenue. Of course the demand reduction may actually be welcome if you have a new technology product where teething troubles in use or production may still be present.

In reality most technology products are more in a position of "oligopoly" where there is a complex network of overlapping competition, possibly with different technical features, and at different prices. There is no simple advice in those circumstances, but one approach is to look at the "dynamics" of the market. What will be the reaction if you introduce the new product at a given price? Will it destabilize existing price structures, possibly lead to cannibalization of other product lines you market, or create a competitive response? If you set a high price for a new product initially, it might actually encourage competitors to enter the market as they see your excess profit margins.

On the other hand, setting a low price initially may not necessarily particularly promote rapid adoption. As already noted, many technology markets are price insensitive so lowering the price may simply reduce your profits without increasing volume. And don't forget that profits are what you reinvest into marketing and sales budgets, so any reduction in those is likely to impact future growth.

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In fact people tend to exhibit lower price sensitivity when new products are put in front of them. This is typically because they have few "reference" points for comparison, no previous purchasing experience, and few perceived substitutes available. As a product becomes better known, price sensitivity will increase.

Particularly in technology markets, beware of setting an initial price that is way too low. You frequently come across start-up ventures who expect their product to sell in millions and hence initially price their product in hundreds of dollars. Resistance to the new innovation, the time to educate the market and simple over-optimism in their sales forecasts, results in much fewer sales however. Consistent financial loss is the result. Only recently I saw a story on a software company that was losing money when it sold a product at $100, so they moved to a price of $10,000 or more and are now well on the road to success.

Tip # 46

Price sensitivity to new products is low, so beware of setting too low a price.

Often with technology products there is a natural rate of expansion in terms of your production, support, training and fault resolution capabilities from which it would be folly to step outside. It takes time to gear up your own staff, to recruit sufficient expertise to sell and support the product and to provide adequate training for your staff and distributors, so it is best to set your planned product volumes and pricing around those constraints.

As a general rule of thumb, with software products, I found it best to start at a relatively low price (in terms of market perception) and as the product became more established, to gradually increase it. Glowing customer references can later justify a higher price quite easily, and the known reliability and quality of the product helps to justify a higher price.

With new products, a lower price encourages those first risk takers to take a chance on product purchase from the excess return on their investment over what would normally be expected. When I say "lower" here I am talking about 20% to 30% less than the anticipated "normal" price, not more than that, and for a very limited period of time.

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Note that there are other ways to encourage initial adoption of a new product rather than low price. Offering free trial periods, or rental deals that they can terminate if not satisfied are better ways of overcoming buyer reluctance to new innovations.

Is the Price Right?

After you have launched a new product at a certain price, how do you determine whether the price is right or not? There are several indicators you can use to help.

One good indicator that your price may be too low is if nobody complains about the price! If the product is clearly providing more benefits than it costs to everyone, then you probably are not maximizing your profits.

You should of course listen to your sales staff and distributors. If your sales staff are on commission, and they are experienced, then it is in their interest to raise the price rather than lower it. However, it will be they who are first likely to see price resistance. If they continuously have to back-track after quoting a ball park figure to a prospective client, then this is a clear sign that your price may be too high.

Look at why you are losing sales to your competitors. As mentioned above, most technology purchasers are not price sensitive so if you are losing sales because of your price, rather than on other grounds, then you may well be 2 or 3 times your competitor's price. Formal reports of lost sales are a useful technique to capture that information and other useful data, as sales staff are unfortunately usually not keen to talk about lost business.

Monitor your competitor's prices. Even if they don't publish them you can usually find out this information one way or another. In technology markets where oligopoly reigns, if can often be in every suppliers interest to have some understanding of where their competitors stand (otherwise purchasing managers can be gross sources of disinformation about what your competitors are charging as they like to play one supplier off against another). Most technology product suppliers would rather compete on features rather than price. Of course the competitor's products are rarely identical but make sure that any product feature differences justify the higher or lower price against your competition.

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Note that reacting quickly to competitor's price changes is extremely important. They can only gain advantage from a price cut while there is a gap with your own prices. If they perceive that you are consistently slow to respond, they are more likely to try to gain a short term advantage than they would if you reacted immediately. Having an operational system that enables you to gain knowledge of competitor price changes quickly, take a fast management decision on any required response and distribute a new price list expeditiously, is an essential characteristic of success. Clearly having a simple price list which is easy to comprehend makes this process easier!

Service Pricing

So far I have dealt primarily with the pricing of products. What is different about service pricing? The provision of general services (such as staff supply) is often price competitive. However, if you package your service offering as a product or brand, then you will suffer less price sensitivity than if you simply compete as a generic service in the marketplace.

Similarly if your services are aligned with a product offering, or some other special expertise, then you may be able to charge more than you otherwise would. For example, the provision of training or post sale support on a product can clearly be more profitable because it is unlikely that anyone else can easily move into offering the same services.

The general business concept of "superior profits can only be maintained if there are barriers to entry" is worth remembering. You can only protect your profit margins in services businesses if you are offering some unique capabilities that cannot easily be imitated.

Service pricing is more commonly based on "cost plus" because there is normally a more direct relationship between the cost of the service, which is primarily labor, and the expected price. Maintaining a reasonable gross profit margin over the cost is therefore a good approach to pricing services. The common mistake is often to have insufficient gross margin such that you don't recover the overhead costs in selling, managing, administering, billing and supporting the service provision. Also there is often insufficient distinction between long term contracts and short term ones in pricing, and the latter obviously incur a lot more in overhead costs than the former.

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Avoiding Fixed Price Contracts

Fixed price contracts for services are a nightmare for many businesses. We have all seen such requests. Examples might be "build me a new ecommerce web site so I can take business over the internet", or "develop a new machine to automate this process". Normally these requests are made before the final design of what is going to be built is finished, and indeed there may be a significant "R & D" element in the requirement. Such requests are actually becoming more common in some fields such as defense and government projects. No more "cost plus" deals in the former, and in Europe there is a strong move to "private finance" projects for major capital expenditure projects such as transport infrastructure and medical facilities. Unfortunately for taxpayers, these contracts are often more political gestures than real "fixed price" deals.

> **Tip # 47**
>
> Avoid fixed prices for services if possible.

The suppliers typically avoid a real fixed price, and do not take on the project development risk, nor are even responsible for their own mistakes. How do they (and you) avoid such risk, while still quoting a nominal fixed price? Suggested contract terms should include:

1. Make sure you have a term that says something like "this quotation is subject to adjustment following production of a detailed specification of the new system".

2. Make sure there is a term that says "if the market or environment changes, or the business requirement changes, or the customer varies the requirement in any way, then the price is subject to change". Similarly include clauses that protect you against market changes in the cost of labor and materials, and ensure you are protected against disasters that are outside your control (such as mistakes by third parties even if you have appointed them as sub-contractors).

3. Another contract term should be "there will be a formal written sign off procedure for all system changes which must be consented to and re-priced by the supplier". In practice this will prove exceedingly tedious and convoluted and if the project starts falling apart you will be able to complain that these procedures have not been properly followed by the customer.

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4. If the project runs into unexpected difficulties, make sure you have a term that protects you against "technology risk" so you can pass the buck.

5. Include a term that says something like "if there is any delay in the provision of services or information by the customer, or in the decisions required to progress the project in a timely manner, or in any amendments to the schedule that are outside the control of the supplier then the price is subject to variation". In reality, on any large project, the customer will likely create delays from their own internal project problems. Implementation often gets delayed because the customers are not ready to accept delivery, do not have their staff trained, cannot provide the required supporting services, have other contractors who are behind schedule, cannot take decisions promptly, and for numerous other reasons.

6. Try to obtain "preferred bidder" status without spelling out your contract terms so you can avoid arguing the details until it is too late for the customer to back out of the deal; indeed sometimes the project even starts without contract terms being finalized because the customer is in such a hurry. That is usually to the supplier's advantage.

The above can be included quite openly in contracts, and indeed often are, without any apparent bias in favor of the supplier if they are carefully worded. If you wish to go further, you could do what a competitor did to me when we were bidding on a large project for a major charity customer. The customer, being somewhat unused to the commercial standards in some parts of the IT world, fell prey to the following tactics:

7. Making the contract terms so complicated that nobody can really understand them without weeks of study. In the small print, you put in lots of loopholes to duck responsibility for failure.

8. Dressing the whole thing up in legal mumbo jumbo so that you can argue that any cost overrun is not down to you, even if the first page of your contract suggests it is a fixed price deal. Remember, appearances are what really matters here!

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They won the contract and we lost, because our price included reasonable provision for likely cost overruns and project uncertainties whereas theirs did not.

Of course, if you are purchasing such services rather than selling them, look out for all the above.

As a supplier, never take on a real fixed price contract unless:

1. The development to be implemented is specified in absolute detail.
2. There are no technological uncertainties.
3. You have the resources in hand to implement the project.
4. It is a relatively short term contract (ie. a few weeks duration at most).
5. The value of the contract is minimal in relation to your total sales revenue.

Tip # 48

For large projects, staged contracts are the solution.

Incidentally the best approach for both parties on larger, uncertain projects is to contract in stages, with a fixed price for an outline design. At the end of that a fixed price for the next stage should be capable of being agreed, and so on.

Negotiating Prices

Prices and other contract terms for supplying products or services are often negotiated in the business world. Here are some tips for negotiating:

1. Prices can only ever be negotiated downwards, so if you are likely to be negotiating prices, add 10% up front to allow some leeway. In fact, in some markets your list prices should probably include some provision for a discount that you are likely to give to almost everyone.

2. If the quoted price is a problem for your customer, try to re-package the overall price so that the “headline” figure is lower while maintaining the overall revenue. For example, increase the price of supporting services or training. Often customers

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"revenue" budgets are separate to "capital" budgets, or purchasing departments have targets for saving a certain percentage of quoted prices so a simple face saving measure will suffice.

3. Try to negotiate on everything but price. If necessary, say that you have to refer any price concessions to head office in Timbuktu which will no doubt delay the negotiations and the boss typically rejects all such requests anyway. Of course, many purchasing managers will try this tactic in reverse with phrases such as "can't concede on this point—it is corporate policy which we never vary and would require the CEO's authority to override but he is on holiday".

4. Drag the contract negotiation out with a form of "brinkmanship". If ultimately both of you want to do the deal, there comes a point when the customer will need delivery of the product or service to meet his own internal schedules. Of course, if the purchaser realizes you have your own deadlines, for getting sales into a quarter for example, then they can use that in reverse so be careful what you say. As a general principle, avoid delivering any product or service before the contract is finalized and signed, otherwise it could drag on for ever.

5. Make sure there are some things in your contract that you can concede on. Every purchaser likes to think that they have got something out of the negotiation phase. If you are stuck at an impasse, try to create some new concession or otherwise restructure the contract to allow more "give and take".

6. Never give a customer something for nothing in a sales negotiation, even if it costs you zero. They will not appreciate it and you will be unlikely to offset the goodwill created against any real item that is later important to you. Remember that negotiation needs to be a reciprocal process for it to work properly!

7. When negotiating, it is important to give away things that cost you little but may have significant benefit to the customer. For example, if you normally have technical staff available in other offices worldwide you may be able to offer 24-hour support (for which you might normally charge 50% extra) in return for an order this month. The cost to you is almost zero while the perceived benefit to the prospective customer is 50% of the price.

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8. Negotiating complex contracts is often just as much about understanding the deal, and understanding your customer's objections and motivations, as arguing the price or deal terms. In other words, as with any good sales process, it's as much about listening and learning, followed by creative thought, than it is about confrontation.

9. Good negotiation requires lots of practice. Make sure you use an experienced person to do it, or take some training courses.

How do you stop sales staff from negotiating discounts that are unprofitable? After all if your profit margins are 40% and the sales person gives a 20% discount to the customer, half of your profits have just disappeared. Unfortunately selling on "value" typically takes more effort by a sales person than selling on "price" so they have a direct incentive to close the deal quickly and move on to the next sale—where the mistake is then repeated.

First you should insist on strict guidelines on permitted discounts by sales staff. Anything above a certain level should be specifically authorized by their manager.

Second, change the commission structure so it is based on the gross profit margin rather than the sale price. This should be particularly applied where the margin achieved on different elements of your product or service portfolio varies, so that you encourage your sales people to spend more time on the most profitable items.

If you are going to permit your sales staff to negotiate prices, particularly if they are going to follow a price segmentation policy whereby they charge what the customer is likely to stand, then it is very important that background information on the customer is collected. Such information as the size of the buying organization, how profitable they are, what business sector they operate in, where the individual purchaser sits within the organization, whether he has a budget for the item concerned or requires more senior management approval, are all relevant pieces of information that a well briefed sales person will require. Collecting this information is known as prospect "qualification" of course.

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Outright Sale versus Lease/Rental

One of the ways to overcome capital budget limitations in customers is to offer financing terms. Often you can do this through a third party.

In some markets, such as software, you may be able to offer rental terms; as there is no capital cost in that case, it is simply a matter of revenue deferment. This obviously does not improve the short term cash flow but does enable a very stable flow of future income which can be a major advantage for any business. Unfortunately, even if you offer both outright purchase and rental prices, it is often more a matter of what is traditional in the applicable market place that determines acceptability to the customer, rather than the financial merits of the comparable prices.

You should use the D.C.F. technique to determine the current value of a future rental stream so as to set comparable rental and capital prices, but determining the appropriate discount rate is not always easy, and you need to allow for the extra administration involved in rental contracts and for the risks of early termination or customer default. You will also need to decide whether ongoing support or maintenance is included in the rental price, whereas it would normally be separate to the outright purchase cost.

Clearly the likely rental period, and whether you allow early termination has a big impact on the profitability of individual rental deals. From my experience though, customers often underestimate how long they are likely to be renting a product. If they have chosen rental as opposed to purchase because they are anticipating some change to their business that will remove the need for a products use in the future, they often underestimate the timescale involved.

Sometimes offering a rental proposition can overcome customer resistance to purchasing at all. For example the company may have a pending corporate acquisition that would affect the requirement and hence is undecided whether to go ahead. One useful option for those clients generally opposed to rental terms is to have a rental contract which gives the customer the right to convert to outright purchase at any time in the future. If they choose to convert, then they can offset a proportion of the rental fees paid to date against the purchase price.

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Sales Events and Price Promotions

When I worked in a retailing business, we used to run "sales" for about half the year. Particularly after Christmas, and during the summer period, this was a way of life. Now the academics will tell you that some businesses whose sales are affected by seasonality do this to encourage increased volume and hence cover their fixed overheads during times of low sales volumes. Does this apply to technology products? In general, no. In any case, as already mentioned, technology buyers are not generally influenced by price. Cutting prices aggressively will not usually help to close a sale, or get your purchase order through your suppliers labyrinthine budgeting and purchasing procedures any more quickly.

Price promotions are often aimed at gaining market share, as if that was a route to greater profits; which it is but only so long as profit margins are maintained! Unfortunately reducing prices even temporarily may simply reduce the perceived value or "reference" price of your product, leading to longer term buyer resistance to higher price levels.

Sales events and product price promotions should therefore be viewed with a jaundiced eye. Temporary price cuts may be a quick "fix" for your short term sales volume, at the peril of long term price stability.

Because of the length of the sales process in many technology businesses, you may also simply be giving money away to customers already in the sales pipeline unnecessarily. Or in the worst case, you will get requests for a refund from customers who bought the same product last week at the higher price, based on the rationale that the sales person never told them about the pending price decrease although they were clearly aware of it!

Sales events and promotions are really only useful to attract casual purchasers, or to bring forward sales that otherwise might happen later.

In the latter regard, special promotions on products may be useful. For example a special introductory discount on a new product connected with a product launch when in reality you may well need to price it lower to get the product moving anyway. But be careful. Some buyers will simply say "if they have lowered the price to get it shifted there must be something wrong with it".

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Pricing During a Recession

Sooner or later, you will be running your business and a general economic recession hits. Sales are sticky, sales people complain that lead times are drifting out and competition gets more aggressive. Your sales staff will no doubt suggest that price cutting may help to restore sales volumes. Is this sensible or not? No it isn't!

During a recession, your sales volumes are likely to drop anyway. There will simply be less demand for your product, whether you reduce prices or not. Your customers will put blanket freezes on discretionary expenditure, delay new projects and generally defer non-essential expenditure. Reducing prices may not help much.

Bear in mind that if you kept your prices constant, with reduced volume you will be generating lower total income. If one assumes that the business overheads are fixed, clearly profit will be reduced. If your overheads are truly fixed, it might actually make more sense to raise your prices to cover those overheads on lower volumes!

Incidentally, one consequence of this logic is that in a recession one of the most important things to do is to reduce your fixed costs, so overhead reduction is a prime target.

Tip # 49

Avoid premature or excessive reaction to price competition.

But in a recession your competitors will no doubt take an aggressive price stance, or even reduce their prices (they may not be as sensible as you). Yes you may need to follow them to some extent, but do not lead them—that path is suicidal. It is a good idea to send out messages in the form of disguised press releases that your competitors are likely to read indicating that you are opposed to price reductions and price competition, or that any price reduction is only a temporary measure.

Reacting to price discounting by competitors may be necessary in a tactical sense, but try to respond by measures which do not directly impact your short term profit margins. For example, offer more free services to support the product (after all you may have underutilized staff resources in a recession).

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It Will be more Expensive Tomorrow

A final pricing tactic which is worth mentioning, and may help close a deal, is to instill fear in your customer that if they don't buy today, it will be more expensive tomorrow. The artist J.M.W. Turner was a master of this approach. To quote from his biography by Anthony Bailey, "He asked high prices for his pictures, and if buyers caviled, he asked higher prices…… giving his clients the impression that if they resisted his first price, his pictures would cost more, not less.". It is of course quite surprising how often when one talks to sales people that a price increase is pending.

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