



Interested in the Quickest Route  
to New Profits and Growth?  
*Focus on Your Pricing*  
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# *What Prices Should You Charge For Your Products and Services?*

There is a fundamental “profit disconnect” in business today. Companies work to bring a product to market by investing significant effort and money in research and development, distribution, and marketing strategies. But when it comes to setting a price - how businesses get compensated for their hard work and financial risk - most companies drop the ball. Critical pricing decisions are often made using arbitrary “this is the way we’ve always done it” methods. Companies are shortchanging themselves every day.

Most managers aren’t comfortable setting prices. With few pricing “golden rules” and little practical guidance for improvement, it’s understandable why firms have continued with the status quo. How are companies setting prices today? Most react. Instead of a driver of new profits, prices are a mix of marking-up costs, maintaining margins, fly-by-the-seat analyses, matching competitors, and doing things the way they’ve always been done.

Since pricing is an underutilized strategy, it is fertile ground for new profits. Focusing on better pricing is a quick path to new profits and growth. Most business improvement initiatives require significant capital investment and long “seed-to-harvest” periods to determine whether or not the effort pays off. In contrast, many of the concepts that I will discuss are straightforward to implement and can start producing profits almost immediately. Consider Costco’s signature \$1.50 quarter pound hot dog and soda special. A small increase to \$1.52 (and carrying this percentage increase across all of Costco’s prices) would boost this warehouse club’s operating profits by 48%. And here’s the best part, prices can be changed on Sunday night and new profits will start flowing in on Monday morning. I’ve seen it.

Most companies don't realize the direct link between prices and their profits. It's this connection that makes pricing one of the most powerful strategies available to businesses today. A manufacturing company I work with has operating profits of 5% - it banks 5 cents of every dollar of revenue it collects. If this company raised prices by just 1% (charged, say, \$1.01 instead of \$1.00), it would earn an extra penny per revenue dollar (its profits would be 6 cents instead of 5). This extra penny translates into a 20% increase in operating profits (1 extra cent/5 current cents of profit). This calculation, of course, assumes that demand for the product remains constant at an elevated price. The point is that a small change in price can have a big effect on a company's financial bottom line.

## A 1% price increase can produce a financial windfall for most companies.

A 1% price increase can produce a financial windfall for most companies. A study by McKinsey & Company of the Global 1200 found that if they increased their prices by just 1%, and demand remained constant, on average their operating profits would increase by 11%. Based on my analysis of revenue and operating income data from 2008 annual financial statements, here's how a 1% price increase would boost the operating incomes of the following well-known companies: Sears, 155%; McKesson, 100%, Tyson, 81%, Land O'Lakes, 58%, Whirlpool, 35%.

These are very powerful results. As I tell my clients, "1% is a small number...and achievable."

## A Pricing Roadmap to Profits and Growth

Every company in the world shares the same fundamental challenge: “what prices should be set for their products and services?” Most managers view pricing as a two lever strategy; raise prices or lower them. Pricing has far more capabilities and new profits accrue to those who fully capitalize on this potential. The ideas and strategies in this article build a foundation to create a pricing strategy for every company: any product or service, domestic or international, B2B or B2C, sole proprietors to conglomerates, even non-profits.

I highlight the financial effects of a 1% price increase to illustrate the power of pricing and its direct link to the bottom line. And while companies often have the opportunity to profitably raise prices, I do not advocate a draconian across-the-board price hike. There are many “win-win” pricing strategies that benefit both companies and their customers. In particular, companies should consider:

- Setting value-based prices.
- Using the power of versioning to add product variations.
- Activating dormant customers with pick-a-plan.
- Offering different prices for the same product.

“1% is a small number...and achievable.”

## Set a Value-Based Price

Many companies incorrectly set their prices based on what it costs to manufacture a product. While easy to implement, these cost-plus prices bear no relation to the amount that consumers are willing to pay. As a result, profits are left on the table daily. The price that consumers are willing to pay depends on the value they place on a product, not how much it costs to make it.

Street vendors in Central Park understand value-based pricing. At the first hint of rain, they raise the price of their umbrellas. This increase has nothing to do with costs; instead, it's all about the increased value that customers place on an immediate haven from rain. The right way to set prices involves capturing the value that customers place on a product by "thinking like a customer." Customers evaluate a product and its next best alternative(s) and then ask themselves, "Are the extra bells and whistles worth the price premium (organic vs. regular) or does the discount stripped down model make sense (private label vs. brand name). They choose the product that provides the best deal (price vs. attributes).

To be clear, value doesn't necessarily mean the lowest price. For your personal purchases, how do you decide if a product's price is acceptable? Most of us evaluate a few products and choose the one with the attributes and price that offers the best deal (value) among the various alternatives. It's important to emphasize that the value of a product or service differs by customer. After all, many people happily pay \$200 for Dom Perignon champagne while others celebrate with \$10 Korbel sparkling wine.

Here's an example of how to set a value-based price. Suppose Orange, a hypothetical technology company, charges \$100 for its myPod MP3 player (by using its "that's how we always do it" method of marking up costs by 33%). The myPod's \$75 manufacturing cost translates into a \$100 price.

However, if it establishes a value-based price, the process is as follows:

1. Identify the myPod's target customers and their next best alternative, and use that price as a starting point: the \$80 Apple iPod.
2. Determine how the myPod player differs from the iPod: Orange offers a sleeker style and hipper brand.
3. Use experienced judgment from field experience to determine what discount or premium the average customer will pay for an Orange myPod player relative to the \$80 iPod: assume experienced minds agree a \$30 premium is warranted.
4. Ensure that using the \$80 iPod price as a starting point is realistic. If this price is too high—that is, customers are not willing to pay it—then it is not valid to use. But the \$80 price is reasonable, as many iPods are being sold for that amount.

This leads to a \$110 value-based price (\$80 starting point plus \$30 premium). This additional \$30 is pure profit, resulting in a 40% increase in profit (\$30 in new profits added to the \$25 of current profits).

While the intuition of value-based pricing and its price setting process is straightforward, most companies don't set prices to capture the value customers place on their products. Implementing value-based prices provides an advantage over competitors and is integral to reaping a pricing windfall.

The price that consumers are willing to pay depends on the value they place on a product, not how much it costs to make it.

## The Strategy of Pricing: Meet the Needs of Customers

In virtually every facet of business, companies develop strategies based on the truism that their customers differ from each other. Diverse customers are courted with a variety of products (different styles, colors, add-ons), a mix of marketing strategies, and multiple distribution points. However, when it comes to pricing, most companies behave as though their customers are identical by setting just one price for their product.

The epiphany to better pricing is to understand—actually, to embrace—the same insight that companies use to create strategies and profit in other parts of their business: a wide variety of customers are interested in buying their product and these customers differ from each other. These differences are what make pricing a creative business strategy instead of a search for one “perfect” price. The strategy of pricing involves acknowledging that customers are different and then making efforts to profit from these differences.

## Customer Differences and Associated Pricing Strategies

If a company isn't serving its potential customer base's diverse pricing needs, it is missing opportunities. To profit and grow, in addition to offering a value-based price, a comprehensive pricing plan also includes pick-a-plan (new pricing plans), versioning (variations of a product to meet unique customer needs), and differential pricing (an array of different prices).

Customer Difference		Strategy
Desire a Different Pricing Plan	→	Pick-a-Plan
Have Unique Product Needs	→	Versioning
Value a Product Differently	→	Differential Pricing

## Roll Out New Pricing Plans (Pick-a-Plan)

Sometimes customers are interested in a product but refrain from purchasing because the selling strategy does not work for them. A pick-a-plan strategy activates these dormant customers. Providing a pricing plan that satisfies a key pricing need of an underserved segment attracts new customers. Beach resorts that offer “all-inclusive” pricing satisfy an important need of customers who value and are willing to pay a premium for the freedom of not having to think about the price of every meal, drink, or activity while on vacation. Simply offering this pricing option moves a resort to the top of the list for these vacationers.

Consider offering pricing plans that:

- Provide ownership alternatives (rental, lease, interval ownership, Netflix model).
- Lower the risk associated with uncertain value (success fees, auctions, licenses, future to buy options).
- Offer price assurance (guarantee future prices, all-you-can-eat, flat rates, warehouse club two-part pricing).
- Overcome consumer constraints (financing plans, lay away, prepaid, job loss protection).

Orange, the example company, can meet the needs of potential customers by creating new pricing plans such as: (1) Short term leases, (2) Options to trade-in an old myPod for a new one (for customers who want to own the latest myPod) and (3) A value bundle that includes unlimited music downloads.

Pick-a-Plan serves new customers (who otherwise wouldn't purchase) with a plan that best suits their needs. This sales growth alone can easily generate dollars toward a better pricing initiative.



## Create a Line of Products (Versioning)

Versioning is the practice of offering a range of products that are based on a core product. Versioning can generate new profits and growth in two distinct manners. First, offering new products to serve customers with unique needs. Drivers in warm climates (which don't require a high number of cranking amps to start a vehicle) can purchase Sears' \$79.99 DieHard South automobile battery. Sears also offers a \$179.99 Platinum version for drivers in frigid areas who need a more powerful battery (higher cranking amps). Second, offering good, better, and best products allows customers to choose how much to pay (a consumer's choice reveals their true valuation). McDonald's sells both \$1 McDoubles and \$3.59 Quarter Pounders. For the most part, the ingredients in these two sandwiches are similar. Price sensitive customers purchase McDoubles while those with larger budgets choose premium-priced Quarter Pounders.

Creating a versioned product can be implemented via three primary methods:

- Premium (higher quality, guaranteed access, faster, priority service, low deductibles/better coverage).
- Stripped down (lower quality, more restrictions, off-peak, private label, unbundling, higher deductibles/lower benefits).
- Meet unique customers needs (package size, extended and enhanced warranties, monthly clubs, bundling, platforms, different usage).

In addition to its base price and new pricing plans, Orange (the hypothetical electronics manufacturer) can offer higher and lower priced product versions. Both a discounted stripped down Shuffle (no video screen) and a premium priced full-featured (wide video screen, Wi-Fi web enabled) Touch can be added to the product line.

Versioning attracts new customers (with unique needs), as well as derives different profit margins from different customers. Stripped-down products offer discounts while premiums are derived from top-of-the-line versions. Increased profits from these high margin premium versions and new customers (with unique needs, as well as those who buy low-priced versions) are a key component of every company's pricing windfall campaign.

When it comes to pricing, most companies behave as though their customers are identical.

### Offer Higher and Lower Prices (Differential Pricing)

The “law of demand,” as illustrated by a downward sloping demand curve, offers a key pricing principle: some customers are willing to pay more than others for a product. Differential pricing is the strategy of selling the same product to different customers at different prices. Consider the pricing behavior at an auction. Everyone has the same information and bids on the same item. As prices increase, bidders drop out. Those who drop out are in essence saying, “I know others are willing to pay higher prices, but I just don't value the item as much as they do.”

Differential pricing enables companies to profit from their customers' unique valuations by offering different customers different prices for the same product. At a cinema, customers who paid full price, used coupons, received discounts (senior, student, under 12, AAA) or purchased prepaid discount passes from Wal-Mart can all be sitting next to each other watching the same movie. Offering this spectrum of prices enables cinemas to maximize profits by serving customers with a variety of different valuations.

Differential pricing tactics can be grouped as:

- Requiring customers to jump hurdles (coupons, rebates, sales, price match guarantees, time in sales cycle, distribution outlet).
- Customer characteristics (different prices based on where customer lives, readily available traits such as age, affiliations, purchasing history).
- Selling characteristics (discounts for volume purchases, bundles, different next best alternatives).
- Selling strategy (negotiation, razor/razor blade pricing, metering, dynamic pricing).

Returning to the Orange myPod example, higher and lower differential prices can be built on to the \$110 base price. Lower prices can be offered at Costco, via student discounts, through a \$10 off coupon, and to those willing to wait six months after a new model's release. Higher prices can be set at luxury retailers and for customers who want the latest myPod on the day of its release.

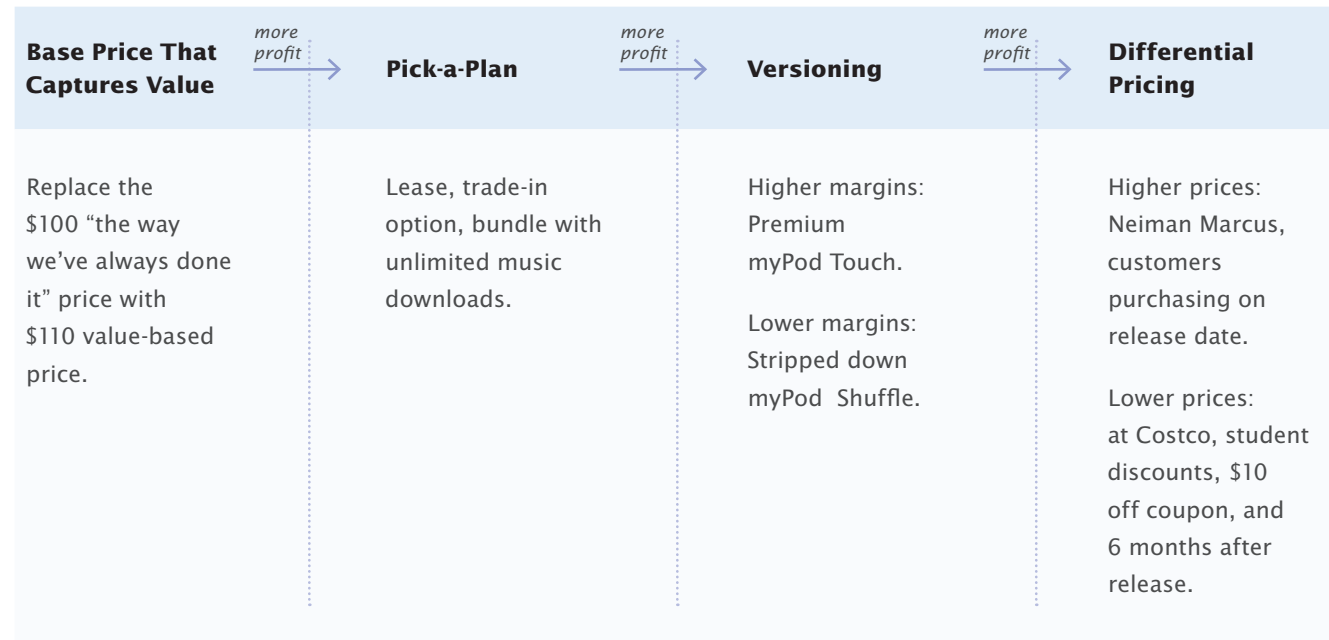
The range of prices created by differential pricing contributes to the pricing windfall with larger margins from higher prices and growth by using discounts to sell to more customers.

If a company isn't serving its potential customer base's diverse pricing needs, it is missing opportunities.

## Reaping a Financial Windfall: Multi-Price Strategy

The end result of implementing these four strategies is a multi-price strategy. By this, I mean a set of publicly known prices and plans for a company's products composed of: (1) a value-based price, (2) new pricing plans, (3) versions, and (4) a range of prices.

Creating a multi-price strategy generates profits and growth for Orange Corp. by capitalizing on both value and the simple fact that each product attracts a variety of different customers.



Think how much more profit Orange can make from a multi-price strategy compared to its initial "that's the way we always do it" \$100 cost-based price.

## Creating a Pricing Game Plan

Reaping a company's pricing windfall involves creating a multi-price strategy to offer a handful of prices and plans. To avoid confusing customers, don't offer too many options. These are good rules of thumb to follow when creating a multi-price strategy:

- *Always* set a value based price.
- There is a *fair* chance of implementing pick-a-plan strategy (one to two tactics).
- *Always* practice differential pricing (two to three tactics).
- It is *highly likely* that good, better, and best versions that are designed to capture different customer valuations can be offered (two to three tactics).
- There is a *good chance* of being able to offer targeted product versions to meet specific customer needs (one to three tactics).

Companies should think of their potential customer base as a giant jigsaw puzzle. Each new pricing tactic adds another customer segment piece to the puzzle. Normal Normans buy at full price (value-based price), Discount Davids are added by offering 10% off on Tuesday promotions (valuation), Non-committal Nancys come for leases (pricing plans), and High-end Harrys buy premium versions (product needs). Employing differential pricing, versioning, and pick-a-plan pricing tactics adds the pricing-related segments necessary to complete a company's potential customer puzzle. By offering choices to meet diverse needs, a multi-price strategy serves the largest number of customers. A multi-price strategy also provides options for customers to reveal their true valuations of a product. Price sensitive customers purchase lower quality versions, wait for end-of-season discounts, and redeem coupons. Those with higher valuations purchase immediately when a new product is released, select premium versions, and buy at fashionable retail boutiques.

## Now is the Time to Reap a Financial Windfall

At most companies today, pricing is a low priority strategy. Prices are set for every product, of course, but usually by using methods that have been handed down from previous years and annual memos announcing cost of living increases. Since the upside of better pricing has not been clearly articulated nor has a process to set prices been offered, it is understandable why pricing has been relegated to the status quo. Every day companies are missing profit opportunities because of their arcane pricing practices.

Better pricing is an important business strategy because it is:

- Powerful: small changes can lead to big profits.
- Fast-acting: “change prices in the PM, new profits the next AM.”
- Easy-to-implement: as the strategies that I’ve discussed reveal, it is straightforward to improve a company’s pricing practices. *The 1% Windfall* highlights 50 pricing tactics that can generate new profits and growth.
- Of interest to many levels of a company: CEOs searching for fast profits, CFOs focusing on revenue, marketing managers who often set prices, product managers counting on price to help meet their P&L responsibilities, and sales managers seeking new ideas to help with their daily pricing negotiations.

A strong pricing foundation will continue to reap profits as market conditions change and new products are developed.

Better pricing generates short-term and long term-profits. Since historically companies haven't focused on pricing, there are usually significant opportunities. Focusing on pricing also creates a foundation that will produce future profits and growth. A strong pricing foundation will continue to reap profits as market conditions change and new products are developed. And best of all, the majority of the pricing concepts and tactics in a multi-price strategy are win-win for companies and their customers. Instead of one "take it or leave it" price, customers are offered choices of prices, versions, and pricing plans.

Finally, better pricing is especially relevant in today's economy when companies don't have the capital or risk tolerance to make large visionary changes. Instead, modest incremental changes to the everyday business practice of pricing can yield large rewards.

**Now is the time for your company to reap its pricing windfall. 📈**



## BUY THE BOOK

Get more details or buy a copy of Rafi Mohammed's [\*The 1% Windfall\*](#).

## ABOUT THE AUTHOR

Rafi Mohammed, Ph.D. is the author of *The 1% Windfall: How Successful Companies Use Price to Profit and Grow* (HarperBusiness, 2010). He has been working with pricing issues for the last twenty years. As founder of Culture of Profit LLC, a business-consulting company based in Cambridge, Massachusetts, he helps companies develop and improve their pricing strategy. Born in Milwaukee and raised in Cincinnati, he is an economics graduate of Boston University, the London School of Economics, and Cornell University, where he received his PhD.

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This document was created on May 5, 2010 and is based on the best information available at that time.

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