Setting the Right Price at the Right Time

Companies are finding big wins by using customer perceptions of value in their pricing models.

by Theodore Kinni

UNDERSTANDING AND EFFECTIVELY communicating pricing to customers, particularly when it comes to innovative new products, is something of a mystery to most managers, which is why, according to one survey, 70% of companies continue to follow the traditional cost-plus model. But while calculating cost and adding the desired ROI may be relatively simple, it does not necessarily yield the optimal price. Take the case of Cambridge, Mass.–based Biogen and its once grand plans for a new anticoagulant.

Although clinical tests on the drug were promising, Biogen's projected costs of goods sold showed that the new drug would have to be priced at $1,000 per dose to achieve an acceptable return on investment. Meanwhile, the well-established generic anticoagulant heparin was selling for just $2 per dose. Yes, tests showed that Biogen's drug would be slightly more effective than heparin, but Biogen did not believe that the market would accept the $1,000 per-dose price tag based on the drug's benefits.

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In stepped The Medicines Company (Parsippany, N.J.), which bought the rights to the new drug for several million in up-front payments. Medicines finished development and in 2001 launched the drug with the name Angiomax at a price approaching $400 per dose. In 2003, the company projects Angiomax sales of $70 million to $90 million and believes that the overall market size for the drug could be $300 million annually.

How could Medicines find such success with the very product that Biogen all but abandoned? The answer, says Harvard Business School marketing professor John Gourville in a Harvard Business School case study, lies in Medicines' more sophisticated approach to pricing, one that reached well beyond the conventional cost-plus model. More and more companies are discovering that traditional approaches to pricing do not always yield the greatest ROI and that often the secret to finding the right price for a new product is no secret at all—rather, it is the byproduct of solid research and an integration of pricing strategy into the earliest stages of product development.

Medicines employed the *value-based pricing model,* which recognizes that a product's value to the customer is a critical element in the calculation of price and seeks to understand that value. First, Gourville notes, further clinical testing by Medicines revealed that patients would require significantly less Angiomax than they would heparin. Whereas four doses of heparin were required, "70% of angioplasty patients would require a single dose [of Angiomax], with the other 30% requiring two–three doses," he writes. Next, the company saw an opportunity in the relationship between pricing and production, and was able to cut manufacturing costs to lower the price to a level it felt customers (hospitals) would accept. Finally, the firm was effective in communicating with its customers about the pricing, says Gourville. Medicines demonstrated to hospitals that despite the drug's much higher price compared with heparin, Angiomax's superior reliability and preventive qualities would result in significant savings.

Because price has a multiplicative effect on profits (see sidebar), a less-than-optimal price can have a tremendous negative impact on corporate performance. So how do you learn to set the right price for a product? Here is some current thinking on the subject:

Take an integrated, cross-functional approach

The price tag that gets attached to a new product as it comes off the line is the result of a process. The robustness and accuracy of the process determines whether the tag represents the best price for the market and the company that makes it.

Accordingly, pricing should be an integral part of the product development process, says Thomas Nagle, president and CEO of Strategic Pricing Group (Waltham, Mass.) and coauthor of *The Strategy and Tactics of Pricing* (Prentice Hall, 2002). "Start considering price back at the point that you just have a concept, before you've got a product," he says. "How you are going to build that concept into a product can really vary a whole lot. If you let the engineers develop it, you are going to get the best possible technical product. But the issue of understanding what customers need well enough so that you can produce a cost-effective offering is not necessarily the same thing."

Nagle finds that more U.S. companies have been taking a cue from the Japanese approach to pricing. "They are starting to design products to meet a price point rather than setting prices to cover the costs," he says. This is relevant even to how Medicines turned around Angiomax. Although Medicines did not design the drug per se, the company drastically redesigned the process to produce it. Early in the development process, the company determined that it would need to reduce significantly the selling price of the new drug. Thus it outsourced the manufacturing of the drug and invested almost $10 million in designing a production process that helped reduce Angiomax's cost by 60%.

In addition to integrating pricing and product development, some firms are attacking new product pricing with a cross-functional approach. Earlier in his career, John Hogan, a senior pricer at Strategic Pricing Group and professor of marketing strategy at Boston College's W.E. Carroll School of Management, worked for General Motors. "For years at GM, all the pricing decisions were made by the corporate financial staff and marketing was notified of what the new price would be," he says.

The problem with that model, he notes, is that no single function in an organization has all the information needed to establish the optimal price. So instead of allowing one function to impose a price on the entire organization, companies should establish pricing councils to ensure that different perspectives are taken into account.

"The idea of the pricing council or the pricing committee is that you draw in these people cross-functionally," says Nagle. "You have representatives from sales and from marketing. You would be talking to the people involved in the design and the people in finance and operations. The job of sales and marketing is to identify the value to the customer. The job of finance and operations should be to define the rules by which the price has to be set. Those rules are the tradeoffs you make to be profitable."

Understand the product's value from the customer's perspective

One major limitation of cost-plus pricing is that it doesn't take customers into account. Segway, the innovative human transporter invented by Dean Kamen that inspired a media frenzy in 2001, provides an excellent example of what can happen when customers don't get enough attention in the pricing process.

Segway was developed in an atmosphere of extreme secrecy driven by the fear that potential competitors might steal the technology that enables the vehicle to move in response to how the rider leans. "When I was there, they had almost no marketing research," says Steve Kemper, the journalist who wrote *Code Name Ginger* (Harvard Business School Press, 2003) based on his inside access to the project. "They showed it to some [of the employees'] spouses. They also showed it to a small group called the Boston Riders Panel, which was made up of trusted friends of people involved with the project. They did ask them about the price and it depended completely on whether the person had any kind of technical background at all. If they did, they thought it would be expensive. If they didn't, they thought it would be cheap. In other words, it was not very useful."

In place of customer input, cost became the major basis for Segway's price. As the innovative technology and engineering drove up the cost of making the product and investors demanded a higher ROI, the selling price of Segway's consumer model rose from what Kemper reports was "a few thousand dollars" to $4,950, too hefty a price for a product that many people think of as a sophisticated scooter. As a result, the company was forced to postpone the launch of its consumer model and concentrated instead on the more expensive commercial model. Furthermore, the company's first-year sales estimates of 50,000 to 100,000 units and venture capitalist John Doerr's prediction that Segway LLC would grow to $1 billion in sales faster than any startup in history proved well off the mark.

Customer input might have revealed the flaws in Segway's pricing plan. Recognition that customer input is critical in determining price point is a big reason why the concept of value-based pricing has emerged. The Medicines Company, for example, invested in a series of studies to establish the exact costs that hospitals incurred by using heparin instead of Angiomax.

Some companies try to understand this value by simply asking customers. But customers often do not understand

PRICING'S IMPACT ON THE BOTTOM LINE

A 1% increase in price doesn't sound very impressive—until you consider that the additional revenue goes straight to the bottom line.

Thus, in 2002, a 1% price increase across Microsoft's product line would have added 3.6% to net income. At Biogen, such a price increase would have added 4.8% to net income. At Boeing, which in 2002 reported only $239 million in profit on revenues of $54 billion, a 1% price increase across the board would have added 109% to net income.

the value of new products, particularly revolutionary ones. In these situations, pricers must understand the customers as well as the product. In a business-to-business environment, "if customers are not in a position to understand your product, you have to understand their business," says Strategic Pricing Group's Nagle. "So you use a technique like depth interviewing, which involves not asking them about your product but asking them about their business. Find out how it is that they make money, and then understand how your technology could have an impact on how they make money."

The ultimate goal is to identify the product's value drivers—i.e., those benefits that the product delivers to the customer. "In the process," he says, "you are going to identify six or eight value drivers. Our experience is that you should simplify the world a little bit and focus on the two or three most critical value drivers and that is going to be sufficient to push the process along. You don't want to boil the ocean."

Manage the customer's willingness to pay

A company can set a price for a new product once it understands its value, but before it can realize that price in the marketplace it must convince customers that the value actually exists. "This whole question is something that is facing the Segway scooter these days," HBS's Gourville says. "I think that people look at it and say, 'Boy, that is a neat device.' But then the benefit issue really comes in, and they say, 'But what am I really going to use that for and at $5,000, is it all that much better than my existing alternatives?' So you are getting it at two levels. There is a high sticker price and then there is some level of ambiguity with the product benefits."

The Medicines Company, on the other hand, aggressively managed what Gourville calls "the customer's willingness to buy." Before the FDA approved Angiomax, the company was already educating health care professionals about the potential hidden costs of using heparin. It crafted marketing messages that spoke to the different concerns of the doctors, pharmacists, and administrators who would be purchasing the drug. And it sought to create advocates for the drug by inviting leaders in cardiology and their families on weekend trips that featured eight hours of presentations.

"The last piece here," Boston College's Hogan says, "is you have to design a strategy or an approach for communicating the value that you have created. It is incumbent on you to craft a message that you can put in the hands of your sales force to sell the value that you have created." ◆

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