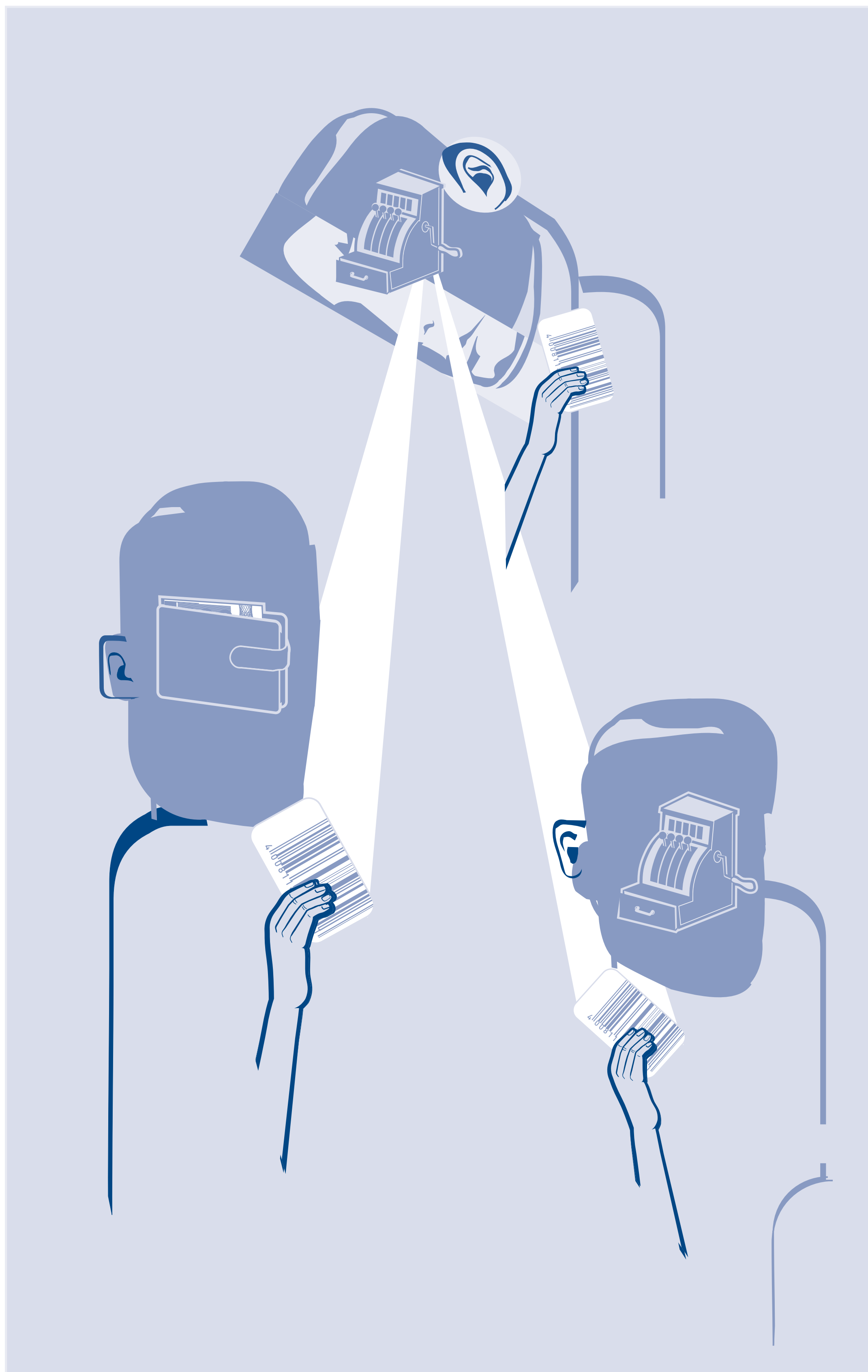

Profitable Pricing with Irrational Competitors and Rational Customers

Daniel Deneffe and Steffen Rüdiger

B2B markets are under pressure from various sides. In the current environment, managing prices is fast becoming one of the main management tools for survival. Deneffe and Rüdiger take a close look at how this environment has changed hitherto fixed pricing rules, what the most efficient pricing policies can look like, and how to implement new negotiation structures and tools on a daily basis in order to ensure that B2B markets do not lose any more ground.

Many markets in B2B environments are facing a number of important challenges:

- Slow economic growth, particularly in Western Europe and Japan. GDP growth for the period 2004 vs. 2003 has been 1.7 percent in Euroland and 2.7 percent in Japan, compared to 7.9 percent in Asia (excluding Japan);
- Skyrocketing feedstock prices, to a great extent linked to the rising cost of oil, where the Brent (year average) rose from US$ 28 a barrel in 2003 to US$ 38 in 2004 (a 34 percent increase) and is hovering between US$ 60 and US$ 70 at the end of 2005;
- Asian players (particularly Indian and Chinese) penetrating the traditional players' core markets with products that are increasingly perceived as being of comparable quality to those of established companies but that command a considerably lower price;
- In some areas, particularly in Europe, increasingly aggressive and overly intrusive competition authorities have largely changed their course over the last 30 years by almost 180 degrees. From initially easily condoning “price diplomacy” between companies, they now put the burden on these companies to prove that simultaneous price increases between them are not the result of tacit price collusion. This is a worrying trend in a period of steadily rising raw material prices which, without any price collusion, are the most logical explanation of observed simultaneous price hikes.

Under these circumstances, pricing excellence becomes increasingly important. Clearly, if feedstock costs rise, prices must rise to retain margins. Pricing excellence is, however, different from what it used to be since the combination of slow growth and entry by new Asian competitors with different pricing objectives and tactics implies that established companies need to define new rules of

the pricing game. And these may be radically different from those that make sense between long- established competitors.

In this paper, we will provide best-practice advice on how and why the changing environment requires a number of changes at different levels:

- **At the strategic level** it requires companies to completely overhaul their pricing rules and create rules that are adapted to this new environment and that can be translated into solid guidelines for the sales force;
- **At the operational/transactional level** it requires companies to revamp their traditional transactional pricing discounting structure at the account level (the "price waterfall") into more effective pricing mechanisms that are aimed at creating extra value both for the seller and the buyer (win-wins) and at extracting some of that value for the seller;
- Further, **implementation** of new pricing mechanisms requires that new effective tools are set up that allow the sales force to apply the new pricing rules and the value identification and extraction to individual accounts.

New Strategic Pricing Rules

We find that many established companies in slow growth markets that have chosen to go for a value rather than volume approach do apply some form of tit-for-tat pricing.

A striking development in tactical price-setting over the last decade or so is the application of smart best-practice pricing rules based on advances in game theory. Specifically, pricing concepts based on findings in experimental economics such as tit-for-tat pricing have become part of marketing managers' vocabulary. We find that many established companies in slow growth markets that have chosen to go for a value rather than volume approach do apply some form of tit-for-tat pricing. They refrain from using price cuts to gain share, but do not hesitate to respond with price cuts should other established players lower price to gain share in the first place. If these aggressors raise price again, then they follow the price hike as well. American Airlines, for instance, is a master at this defensive tactic.

Tit-for-tat pricing has an appeal over earlier pricing rules. It is truly competitive pricing and is based upon explicitly incorporating the reactions of competitors. While elasticity analyses may recommend price cuts, tit-for-tat recognises the futility of price cuts as competitors are correctly assumed to not let go, simply because (in general) they are better off matching a price cut by a major player than being the only player to keep prices at non-competitive levels. Tit-for-tat is also credible. The company using tit-for-tat pricing does not accept being at the short end of the stick and losing share and margin when attacked on price. Rather, the company commits to matching an established price-cutter as margins are typically higher when following a price cut (by a major player) than when keeping prices high, particularly in commodity or commoditising businesses. Tit-for-tat is thus not bluff but credible. It often makes sense. Aware of this credibility, a competitor will not undercut, so the story goes. Should it have done so anyway, having observed the rational price-matching response of its competitor, it will surely no longer go down further.

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So far so good as far as the established environment goes. But is this train of thought still valid in the new competitive setting, with new, largely unknown competitors entering the playing field? For an established player to know how to react to unfamiliar newcomers' low price entry, and hence to determine whether its old pricing rules (such as tit-for-tat) still apply, it must assess two key factors:

- The **price premium** that this established player can command over competitors due to its from higher-value perception by competitors;
- The **new competitor's expected reaction** to the established player's matching of this competitor's price cut.

Understanding your price premium

Established players often underestimate the extra perceived value they command over new, unknown entrants with little reputation in the market. When such entrants undercut, established companies tend to go through some sort of "we must match or we will lose share and margin in no time" hysteria. There is validity to this fear in commodity or commoditising product markets between established players with similar reputations, since for the buyer these competitors' product and service offerings are well known and rather substitutable for each other, and increasing price differences may induce a buyer to switch from one to another established company.

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The fear that the major buyers would radically switch to a new unknown "foreign" player because of the low price entry is, however, often misplaced, even if the products are true commodities. This is because the product may indeed be exactly the same but the buyer often perceives a major risk associated with dealing with the new player and typically does not want to switch a major chunk of business to the newcomer as it is not clear that this new supplier can deliver. The supplier may also only be selling opportunistically in the region and could hit-and-run should some product difficulties emerge. The perception of this risk is real and perception is reality. It is a reality that favours established companies. As a result, established companies' products have a higher perceived value in the eyes of the buyer, whether they are branded consumer durables, medical equipment, FMCGs or pure chemical commodities. The threat of switching in a substantial way to the unknown foreign supplier is often a mere negotiating tactic to elicit price concessions from the established supplier.

As an example, a leading multinational supplier of commodity chemicals has recently come under attack at a number of its most important clients in Europe by a number of low-priced newcomers such as Taiwan's Diren Chemicals Corporation and Iran's NPC. The products supplied by both the established company and Diren are literally commodities in that they have the same molecular structure. Still, from the buyer's perspective the offerings

of both suppliers are perceived to be fundamentally different, enabling the established player to command a price premium for the same product ensuing from a higher perceived supplier reliability, perceived supply guarantee, no matter what the supply/demand balance is in Asia versus Europe. Switching to Diren was perceived to be risky at least insofar as the company was perceived to hold Europe as a non-strategic market in which to sell excess supplies that could temporarily not be sold in China, and thus to present a risk of non-delivery should demand conditions tighten in China, or a risk that the company simply may not be able to supply the large amounts needed when required.

The price premium is often customer-specific, since long-term loyal customers will have a much higher "switching price" with these new competitors than opportunistic price buyers.

In such circumstances, price matching is an unnecessary overreaction. Furthermore, the new entrant may perceive such matching as an invitation to undercut again since it has nothing to lose. Then the ball is rolling. To prevent this from happening, the established player must at least keep a positive price differential with the newcomer that reflects this risk premium.

Detecting your price premium

How can such price premium be detected? Primarily through a combination of (1) examining one's historic supplier share evolutions as a function of price differences with new competitors that have already entered certain accounts, and (2) an open and challenging discussion with the sales force. While neither is rocket science and many factors may well explain share evolutions that have nothing to do with price differences with competitors, this combination nonetheless sheds a far more realistic light on the price premium than, for instance, large-scale preference assessment studies.

The price premium is often customer-specific, since long-term loyal customers will have a much higher "switching price" with these new competitors than opportunistic price buyers. Price elasticity studies based upon individual interviews (e.g., conjoint analysis) do not (or at least should not) reveal such customer-specific information, as they are bound by the anonymity of interviewing rules. Furthermore, there is considerable evidence that numer-

ous types of conjoint analysis do underestimate price sensitivity (as evidenced in a number of technical papers of e.g., Sawtooth Software http://www.sawtoothsoftware.com/techpap.shtml and others). This is also supported by comments from companies that have gone through conjoint studies. One client of a leading telecommunications company told us: “We did a number of conjoint studies and it turns out that we have to divide the forecasts by two or three.” Looking at the evolution of supply shares for specific accounts in combination with a structured open discussion with key account managers is much more effective and leads to much faster results, and reaction speed is key in these situations.

Understanding the New Competitors' Reactions

Matching a price cut by a newcomer is thus an unnecessary overreaction against new entrants, given the price premium that buyers most often attach to dealing with the well known supplier.

Matching a price cut by a newcomer is thus an unnecessary overreaction against new entrants, given the price premium that buyers most often attach to dealing with the well known supplier. Yet, even in the absence of such a premium there is a second reason for changing the pricing rules from established rules such as tit-for-tat. The logic of following price cuts (in the absence of other differentiating options) is that margins are higher when following a price cut than by being the only high-priced supplier and that retaliating against the price cut of the new unknown player will give a credible signal that one does not let aggressors get away with price cuts. This is fine as far as established players are concerned but not so for the new generation of Asian entrants.

First, by the very nature of their small size in the markets in which they wish to penetrate, cutting prices to gain share does not have any major negative side-effects on total profits generated from the small entrants' established customer base, as the latter pretty much does not exist yet. Established dominant competitors, however, have to take this spill-over into consideration when cutting prices in view of gaining or protecting (short-term) share. Knowing that established dominant players would lose a significant amount of margin from following price cuts reduces the credibility of a tit-for-tat response by incumbents. It is then better to leave room for the entrant

than to match it by price, but on your own terms. Explicit commitments to certain segments or regions without running foul of laws that forbid explicit “market splitting” is one way of achieving this.

Further, Asian entrants typically have an often considerably lower cost position than established players, which reinforces the first incentive to cut prices. This is very apparent in, for example, consumer electronics where Philips, JVC and other major players are facing lower-priced LG and Samsung and increasingly newcomers from China such as the Konka Group and Hisense Group Corp, which has just entered Europe with cheap televisions that are, however, still positioned at higher price points than the private labels.

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Finally, Asian players typically have not (yet) put total margin objectives in place that many established companies in low-growth markets have adopted. These established companies understand the futility and disastrous margin effects that share-stealing pricing tactics can have and therefore follow a “price before volume” strategy. For instance, Axel Heitmann, CEO of the German global chemical group Lanxess, recently announced in the interim report for Q2 2005 that the success of Lanxess, whose stock in the first half of 2005 has outperformed all major indices, is due to its “price before volume” strategy, which is consistently and successfully implemented.

Compare this, by way of contrast, with the explicit market share objectives of the new Asian entrants, which are then translated into a policy of undercutting established competitors. Witness, for instance, the aggressive objectives and entry strategy in the UK mobile phone market initially by Samsung, then by LG, with the move by the latter being part of the commitment by CEO S.S. Kim and top management to making LG one of the “global top three” players in digital electronics by 2010. At this stage there are a horde of low-cost players that have entered this market, including fellow Koreans Pantech and VK and low-cost Chinese players such as Haier, TCL and Amoi. To established players, these companies' volume-growth objectives may appear to be “irrational”.

To determine the most appropriate pricing rules, companies need to determine (through simulations) what the most effective pricing rules are.

The implication of the determination to reach "irrational" growth objectives through lower prices, say 10 percent below the established price leader, are severe for established players: If these adopt a tit-for-tat strategy, this will in no time lead to a sequence of price cuts by the "irrational entrant" followed, as tit-for-tat prescribes, by matching by the major player, followed again by undercutting by the new entrant, leading inevitably to deteriorating margins for both players. This is quite a realistic scenario, as our experience in numerous pricing cases is that Asian entrants often use a simple pricing rule along the lines of undercutting the established player's price by a certain percentage, call it x percent.

Does the picture change when the established company uses some modified version of tit-for-tat in which it does not match but allows for a price premium of maximum y percent over the new entrant? As long as x is larger than y the price decline inevitably takes place. And, while we don't have hard data to support this, our experience allows us to tentatively conclude that most often the perceived price premium by the established player is smaller than the amount by which the Asian entrant is determined to undercut the established player.

So what should the established company then really do in this new "irrational" competitive setting?

For one thing, overhaul the old winning pricing rules. They can no longer be blindly applied, as the cost thereof can be prohibitively high (and irreversible). New competitors require new rules as these new competitors do not follow the established rules and are hard to convince of their win-win benefits.

To determine the most appropriate pricing rules, companies need to determine (through simulations) what the most effective pricing rules are. These simulations are fundamentally different from the standard price game simulations as the conclusions of such standard games are driven by hyper-rationality assumptions that in no way reflect the new competitors' mindset. In a nutshell, this requires:

1. First know what game your new competitors are playing, and what (ir)rationality assumptions can be imposed. This requires in-depth competitive **intelligence**;

2. Simulate the **real competitive situation** via carefully prepared workshop simulations and by involving top management;

3. Change the other parameters that affect your best responses to price attacks (share, current margin, price sensitivity, spill-overs across accounts and so on);

4. Pin down and agree on new pricing rules and work them out quantitatively in a **pricing guide** for the sales force. Such a pricing guide determines a pricing tactic at the account level that takes the competitive account situation into consideration and is continuously updated by a pricing co-ordinator from marketing.

The benefit of these simulations is that management puts itself in the position of its competitors in a situation that maximally reflects day-to-day reality. In doing so it is thus forced to go through the objectives of competitors. The take-aways are significant. To our surprise, we often observe CEOs taking on risk-averse (low-price wait-and-see) pricing strategies which create a damaging perception that the company is an aggressive player, triggering further damaging responses from already low-priced competitors.

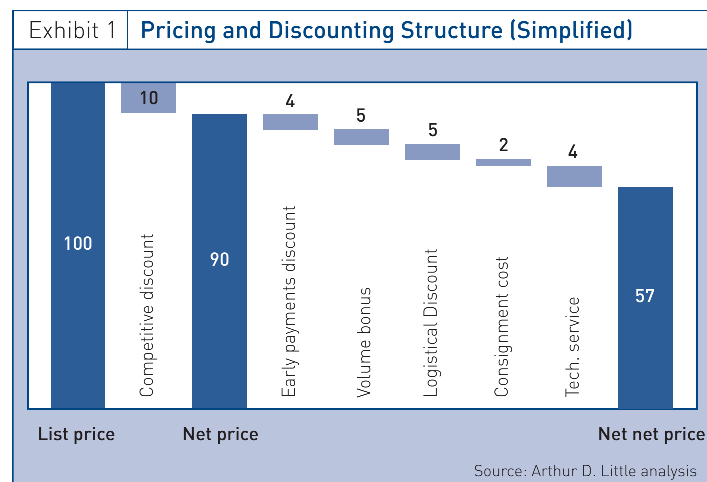
In addition to deriving meaningful pricing rules that are maximally derived from the current reality and operationalised in a pricing guide, further margin gains in this changing environment can be achieved through intelligent operational (transaction) pricing.

Transaction Pricing: Beyond the Price Waterfall

A standard way to put structure on pricing to individual customers is to apply a "price waterfall", where possible discounts from a list price are tied to objective criteria such as savings in the cost-to-serve of a customer following particular customer performances in logistics (such as

full truck delivery) or payment terms (such as payments within 30 days). In such schemes a competitive discount is also initially subtracted from the list, which is a discretionary discount to reflect competitive conditions at the account. After all discounts a "net net price" can be calculated, as illustrated in exhibit 1.

Exhibit 1 Pricing and Discounting Structure (Simplified)



Source: Arthur D. Little analysis

The benefits of structuring discounts to maximally objectifiable criteria are well known. More discipline is expected to emerge in net net pricing which will help to avoid "underperforming" customers (small-sized customers, late payers, etc.).

In practice, however, we often observe that many companies have some pricing and discounting structure worked out but that frequently these companies do not use these structures in actual price setting at the account level.

In practice, however, we often observe that many companies have some pricing and discounting structure worked out but that frequently these companies do not use these structures in actual price setting at the account level. We explain below why we believe this phenomenon happens. In pretty much all cases where it is applied, however, money is left on the table when the pricing and discounting structure is rigidly applied. We explain this in detail below and come up with best-practice recommendations to overcome these limitations.

Use the Pricing Rules to Determine the Initial Price

It is disturbing to observe that pricing and discounting structures are in fact rarely used in practice. The main reason, in our experience, is that the calculated net net price (price after all on and off-invoice discounts) by means of the discounting structure is often non-competitive (too high) and, occasionally, also too low (compared to competitors). In the latter case, working with the structure will set in motion a destructive price de-escalation.

The net effect of having a structure that calculates a net net price that is too high is that sales people will end up asking for an exception to obtain an "extra discount" from their regional manager, who in turn will have to move up to the country manager to ask for an exception, etc. In fact, we find that most often asking for an "exceptional discount" beyond the one prescribed by the discount structure is not the exception but is the rule. In this case, the inherent ineffectiveness of the structure at generating a meaningful competitive net net price creates so much wasteful internal negotiation that it ends up defeating its purpose. More often than not, the discount structure is then tossed out and account-specific discounting is again left to the discretion of sales.

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The key reason for this ultimately non-competitive net net price is that the starting point, the list price, is often no more than an artefact. Subtracting from this artefact a solidly founded discount based upon objective criteria generates a net net price that is also an artefact. Allowing sales to offer a "competitive discount" (see exhibit 1) to generate a more realistic net price is an entirely ad hoc remedy for the problem that list prices are often too removed from the competitive reality. In the extreme case, the "competitive discount" is simply a patch-up that can be used to undo any of the benefits of the other elements of the discount structure.

To have a more meaningful "starting price" than the list price one should use the key element that determines the willingness-to-pay of customers for a particular company's products: the company's existing or potential competitors' prices adjusted for the premium that the company can command over (or below) those prices. Not list price, but competitive prices are most relevant in price setting.

Putting into practice the determination of a most meaningful starting point, we have found it useful to first determine a base product and service offering for which

to define a base price. The base price is then determined by a combination of:

- (Potential) competitors' prices or our best estimate thereof at the account;
- The price premium that we can command over those competitors; and
- The appropriate pricing rules that reflect the new competitive environment.

Not incorporating all three factors above but working out waterfall adjustments from a list price in detail is tantamount to getting the pennies right, when potentially being off by a few pounds and, in the case of inappropriate rules, possibly setting in motion a price de-escalation. Only by starting with a base price that is fed by sensible pricing rules can a pricing waterfall make sense.

Note that such an approach based upon competitive pricing does not necessarily generate followership but realism. At the strategic level the company may, however, decide to take on a price leadership role, although this is inherently a high-risk proposition since by construction the base price is the price above which the company risks losing a major supply share at the account. Price leadership actions intended to raise prices by 10 percent must thus go hand-in-hand with supporting actions that discourage competitors from undercutting. (This is a complex and legally sensitive subject beyond the scope of this paper.)

Generate Win-Wins: Identify, Create and Share Value, but don't Give it all Away

Even if the base price is competitively set in the sense defined above, it is not sufficient to have a discount structure that offers discounts for customer performances (and, possibly, extra charges for additional services requested by the client) beyond those described in the base offering.

It must be the case that the discount offered does not exceed the incremental savings that the customer performance generates to the supplier. Conversely, the extra charges for the additional services must exceed the incremental cost of these services. What we often observe for companies in “super-pleasing mode” is that they tend to offer numerous “services” at little or no extra charge to please their clients only to find out at the end of the year that little margin was in fact generated.

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While clients often appreciate this extra attention they often want to pay less (often nothing) for the extra service than the incremental cost of offering these services. A good example in many industries is technical service, which is often offered for free. Two sources of margin decline emerge as a result: (a) obviously, every specific technical service intervention costs the supplier money (the incremental cost of the intervention) and (b) clients will abuse the technical service precisely because it is free, and call on tech service as soon as a potential problem arises. The effect is thus to increase the volume of tech service that is provided at a loss.

To guarantee that no money is lost in the transaction means that clients should at least be charged an amount that exceeds the incremental cost (not the fully allocated cost) of offering these services and less than the monetary value that these clients attach to these services. Only if the monetary value attached by the client to the service exceeds the incremental cost is there room for margin improvement for both parties (win-wins). If this is not the case, then the client should not be offered the service. The incremental cost can and should be calculated. The value to the client is unknown (it can, of course, be approximated by a close understanding of the client's economics, but this is not always the case).

Conversely, when clients offer a performance/service to the supplier (e.g., by improving their forecast accuracy of how much of the product they will actually buy from month to month) then the supplier should be willing to grant a discount that is at most equal to the incremental cost savings generated by the client offering this particular service (such as planning, storage and logistical costs savings from the improved accuracy) and at least equal to the incremental cost to the client of providing this service to the supplier. If this incremental cost to the client is

smaller than the cost savings to the supplier then there is an opportunity for margin improvement for both parties (again win-wins). In this case, however, it is the incremental cost to the client that is unknown, whereas the costs savings to the supplier can and should be calculated.

In both of the above cases (services provided by the supplier to the client and services provided by the client to the supplier) there is thus always one unknown. How can one then extract maximum value from offering services to (e.g. vendor-managed inventory or technical service) or receiving services from the client (e.g. forecast accuracy)?

By charging the incremental cost of the service in the case of services provided by the supplier and, conversely, by giving a discount equal to the cost savings to the supplier for services provided by the client? Not really. In both of these cases, all the value created goes to the client and none to the supplier.

The fact of the matter is that one will never know either the true willingness-to-pay for extra services to the client or the incremental cost for the client of offering a service/ feature to us.

By charging incremental cost plus a mark-up then or, conversely (for services provided by the client), offering a discount equal to our cost savings minus a “mark-down” over these savings? Again this arbitrary rule is suboptimal as it may lead to situations where opportunities for mutual margin improvement are not capitalised on. For services provided to the client by the supplier, for instance, potential win-win gains are not capitalised on when the incremental cost of the service is less than the value to the client of the service but the incremental cost plus the arbitrary mark-up exceeds the true but unknown value to the client. There is a potential gain for both parties that does not materialise because the mark-up is too high.

The fact of the matter is that one will never know either the true willingness-to-pay for extra services to the client or the incremental cost for the client of offering a service/feature to us. This is even the case for very “monetary” services (like the extension of payment terms) as the client may value these extended payment terms more than they cost the supplier (reflecting the differing cost of money between the two parties). Given this, are we then not nitpicking when we say that our mark-up (or mark-down) may be too high (or too low)? The answer is: we can do better than using a mark-up, and the negotiation techniques proposed below guarantee that win-win opportunities are maximally capitalised on.

To maximise these chances it is essential to split the negotiation into two stages. In the first stage, the supplier should not attempt to set up a pricing structure for services provided to or by him, but should identify the offering that creates the maximum total value (the largest total win-wins) for both parties. In the second stage, pure price negotiation over that best offering takes place. The larger the extra highest total value offering created in the first stage, the larger the incremental profit (the part of the extra value going to the seller) generated to the seller (for a given pure price negotiating skill of the seller) in the second stage. To keep it simple, if two parties negotiate on price over an offering that generates an extra total (yet unknown) value for sellers and buyers of € 100,000, as opposed to an offering that generates an extra (equally unknown) € 50,000 of total value, then if on average the seller's price negotiation skills are such that he manages to capture 40 percent (or any other percentage) of that extra value, he will capture more incremental value (profit) if he negotiates over the first than the second offering.

In our model here we will focus on the first stage, as the second stage consists of pure “splitting the pie” price negotiations. The question then arises of how this first stage really works in practice. In this stage, the supplier needs to identify the key services - and their levels - that the buyer values more than they cost to generate, and those services that the buyer can generate for the seller that are valued more by the seller than they cost the buyer.

Each of these features and services has different levels. For example, rush ordering, a service offered by the seller, could either not be offered (level 1), could be offered within 48 hours of placing the order (level 2) or could be offered within 24 hours of placing the order (level 3). Forecast accuracy, a service offered by the buyer, could either not be offered (level 1), could be offered at 75 percent accuracy (level 2) or could be offered at 90 percent accuracy (level 3), with level 3 having a bigger total cost

saving to the buyer than level 2 or level 1. The same holds for the other features and services. With five possible features or services, each with three different levels, one has $3^5 = 243$ different levels of combinations of services, each with different incremental costs and benefits across both parties.

Use Tools for Value Identification and Creation

To maximise the chances of identifying those offerings that create the maximum total value, the supplier should go through the following process:

1. Of the 243 different combinations, select four reasonably different offerings (combinations of levels for the five different features or services);

2. Identify the incremental cost differences (due to cost savings or extra costs from the service) generated by these offerings;

3. Propose offerings to the client that are margin-neutral for yourself, the supplier;

4. Ask the client to rank these in decreasing order of preference.

Step 1 is in principle easy. One offering, package A has a combination of levels for each attribute. Another, package B, has a different combination of attribute levels. Package B is represented in the left part of the figure below. Go through a similar exercise for packages C and D.

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To actually identify reasonable packages in step 1 of the process and the sum of incremental cost differences in step 2, the sales force is very much helped by electronic negotiation tools, as illustrated in the figure below. This represents an example, taken from the chemical industry, of a tool that salespeople use in negotiation. The walk-away and target prices in this example are fed by the base price mentioned above, which is adapted as competitor and market intelligence is updated in line with the new pricing rules. They are not communicated to the customer.

Exhibit 2 **Operational Dashboard (Example)**

Package selection criteria

Payment terms
Alternative 1: 60 days and sconto 1%

Consignment stock
Alternative 3: 95% safety

Rush ordering
Standard offering: Not offered

Order cancellation
According to schedule 2

Forecast Accuracy
Alternative 1: Target level of 75%

Results for Product offering X

Walk away price €/kg	Target price €/kg
3.1	3.7

Delta price of offering over package A €/kg
1.2

Step 2 requires cost analysis that is fed into the system and that allows the tool in figure 2 to calculate immediately the sum of incremental cost differences between the packages. As in the above figure package B is demonstrated, the system calculates that this package generates an extra cost of € 1.2 more per kg than package A (this is the sum of the extra cost savings from the client's services to the supplier and the extra costs of offering services to the client, expressed per kg.)

To define margin-neutral packages in step 3, the sales person initially proposes package A. Then he selects package B, explains the feature level combinations that it represents and provides the information that it would cost the client a delta price (this could be a negative number) over package A, without ever mentioning any total price of either package (this is the object of the price negotiation in phase 2). In the dashboard, we notice that the represented package B would cost the client € 1.2 more than package A. The same reasoning holds for packages C and D.

In step 4, the sales person asks the client to rank these in order of decreasing preference. At this stage only relative prices are mentioned to the client, relative to package A. It is possible that the client will prefer package B over C and then again over D. It is also possible that the client will try to play strategically and say he doesn't like any. In that case the sales person should ask which package the client dislikes the least. There is no strategic reason to lie

in this case.
By going through this exercise and only in phase 2 negotiating over the most preferred package (from phase 1) it is guaranteed that one negotiates over the package that has the highest total incremental value creation potential and thus the highest margin improvement potential to the seller as well. This is so by construction, even if the buyer is a pure price buyer. In that case, the negotiation will reveal that he prefers the no-frills package in phase 1 and so price negotiation will be held over the no-frills offer in phase 2. What is avoided here is that the buyer gets all the services, even the ones that are valued less than they cost and in addition at a low price. By how much the extra value created will eventually accrue to the seller depends on the price negotiation skills of the seller. These are likely not to be different across packages so that the largest opportunity for value and profit creation is not in the price negotiation per se, but in the identification of the largest extra value created for both parties.

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Implementing Pricing and Sales Excellence in B2B Markets

To summarise, we believe that the following elements are essential for generating pricing and sales excellence in B2B markets:

- Build the foundation: align top management on realistic winning pricing rules based upon realistic assumptions about competitors' objectives and reactions;
- Set up tailored competitive intelligence systems to increase the realism of the assumptions about competitors;
- Translate the pricing rules fully into simple guidelines that are fed to the sales force;
- Provide easy-to-use electronic tools that help the sales force to identify and create value/win-wins;
- Define roles and responsibilities and align incentives for the pricing process to be structured and effective and for the tools to be updated dynamically;
- Test the tools at a number of accounts in order to increase the confidence of the sales people in the effectiveness of the tools;
- Train the sales people at using the tools, ideally with “real” purchasers from within the organisation, in order to increase the level of realism in the negotiation.

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