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# HIGHER PRICES = FEWER CUSTOMERS?

**How businesses are ducking the natural laws of supply and demand.**

It is said that in some industries a 10% improvement in profits can be achieved from just a 1% increase in price. But the natural laws of supply and demand tell us that under normal conditions the more we charge the less customers will buy. Accepting this 'law' ignores the strong 'price blurring' influence of brands and perhaps even more critically, customers' differing attitude towards price.

The management of customer discounts, often the single most significant influence on revenue and profit, is often completely delegated to agents at the point of sale with little co-ordinated analysis or control.

An approach proven to be effective, by progressive consumer service businesses, as well, of course, in business to business markets, provides a new lever in generating significant revenue and profit growth.

## PRICE OPTIMISATION

It is well understood that there is a relationship between price and demand. It is also known that after reducing price beyond a certain point, the increased demand is insufficient to generate greater revenues overall. Conversely, in some markets increasing price can stimulate more sales through a perception of prestige and cache… sadly such opportunities are all too rare for the average brand.

However, price optimisation through differential price setting or discounting has been implemented with great effect in many consumer industries, especially when applied at an individual customer level. Interestingly, it has hardly been explored in most business and industrial categories where the opportunities for revenue growth are equally, perhaps even more, profound.

Based on the published accounts of some of Australia's business-to-business material suppliers for example, a 1% price rise, without a reduction in volume, would deliver an increased operating profit of between 5% and 15%.

Given this, it is surprising that a third of all possible revenue is typically lost by discounts, rebates and other concessions usually offered by the sales rep at the point of sale, without much analysis or control. By far the largest reduction in revenue is typically through price discounts negotiated every 6 or 12 months with customers.

## CUSTOMER LEVEL PRICING

Despite this typical and often simplistic discounting behaviour, many companies are adopting new methods of setting net prices based not just on value, but also on unit volume, frequency of transaction and perhaps range of products / services purchased. Fewer companies have a good enough understanding of price sensitivity at an individual customer level to use this in the price offered to each customer. While charging apparently similar customers different rates might challenge some brand's values or in some cases be contrary to the concept of loyalty rewards, differential discounting is one of the greatest remaining levers in enhancing margins and overall business performance in mature and competitive markets.

In reality, in most categories each customer buys a slightly different proposition, when the product composition, its purchase channel, payment method and servicing or support can be 'tailored'….and with it their price. It is these same factors, as well as the length of time they have bought your product and perhaps their estimated wallet size which can be most influential in determining their sensitivity to price.

The insurance industry uses demand-based pricing at the customer level, in full knowledge that in this category different customers are prepared to pay different amounts for the same product or service. Customers will also have varying awareness of competitor offerings and the ability (or appetite) to switch brands or suppliers. Some customers are purely price chasers, others are not and it *is* possible to distinguish which customers are which. By knowing this dynamic for each customer, companies can increase margins without sacrificing demand and overall market share.

## CASE EXAMPLE

In a recent assignment in the materials industry, this new process has been applied. The process involved building statistical models which predicted the likelihood each customer would stop buying at each discount level. The models were based on a detailed analysis of the historical relationship between the supplier and its customers, taking into account a very broad range of factors which might influence demand and purchase behaviour. The factors investigated ranged from the product types and quantities purchased, the frequency of order, the method of delivery, the location of the customer and even their distance from the nearest competitor outlet.

The supplier used the model findings to determine the optimal price for each customer. They revised their discounting strategy for each, to optimise their revenue overall. If the price was too high, the additional revenue collected is offset by a higher likelihood that the customer would stop buying. If the price was too low, the increased likelihood the customer would make a purchase is offset by the lower revenue collectable. At the optimal price these two forces balance to give the highest expected revenue with a predicted response from customers across their buying behaviour, allowing for a balance to be achieved across value realisation as well as retention and market share maintenance. Importantly, other strategic and cultural considerations were also catered for in implementing such changes. For example, great care was given to the way the sale force was introduced to the perceived reduction in delegated authority to set prices, by initially simply formalising their current client practices, then gradually evolving 'rate recommendations'.

By applying demand-based pricing techniques companies are able to create a new means of enhanced margin delivery. While re-engineering prices, even for some of the most loyal or longest established customers will not come without some disruption, the dramatically increased returns are too attractive to ignore.

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