Optimus et Ultima

In pricing and sales negotiations, the vast majority of people are haunted by the "ghost of prices past." This is because the only method for truly determining if a price point is a market competitive price occurs at the transactional level, and this analysis requires real time knowledge of market conditions, product state, margin erosion, M&A activity, and at least 142 other measurable variables. So how can you know for certain that your price is competitive? Author Raymond Augustin is a recognized thought leader, specializing in pricing strategy. He has an active interest in the research of the psychology of price and pricing motivations. He can be reached at raymond.augustin@miami.edu.

by Raymond P. Augustin

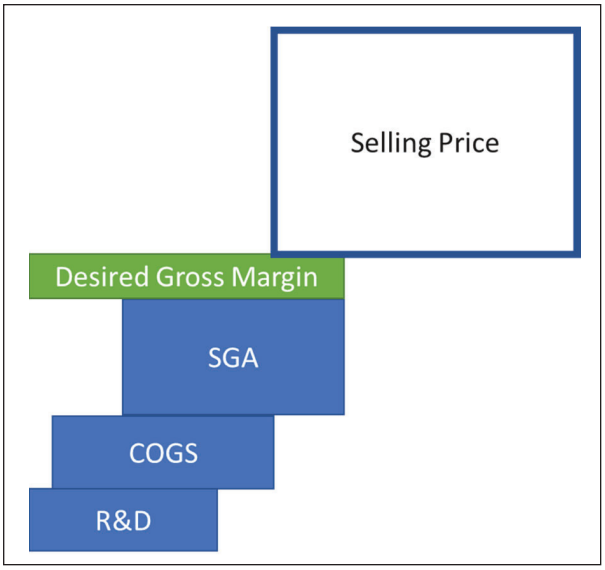
You have just received the best and final offer for your new solution. It's been a long process to get to this point, from the initial RFP to the funnel of analytics and eventually to selection, not to mention the internal battles and the negotiation ballet with vendors. You are now ready to move forward and get this contract executed. But something is holding you back. You have a slight nagging feeling because you are not sure that you have secured the best deal. Maybe this is because you have memories of prior purchases that you found out later were not all they were cracked up to be. You are not alone!

"The vast majority of people are haunted by the ghost of prices past."[1] Or it could be that you are not sure if you were being forced to choose between a description of options versus the options themselves. Maybe you were reading Thaler's work and agreed with him when he wrote that "In the absence of market values, selling prices are typically twice as much as buying prices [above and beyond any strategic exaggeration for the sole purpose of establishing a bargaining position]."[2]

Now the question that plagues you is whether you have a price at market value. How the heck would you know? Do you compare to some third party? Or to some proxy that is similar to something you bought recently (as in comparables for real estate)? Your salesperson helped you develop a Return on Investment calculation (ROI) – but all the ROIs you have ever been given are positive. You start to realize that the question should not be is there an ROI, but rather **what is the true ROI and how much better would it be with real market competitive pricing**?

Then again, this comes in at or maybe just under your budget, which surprisingly a lot of the proposals you review seem to do. This fact makes you begin to ponder: are you and your team that good at developing accurate line item budgets or are the prices that you are being quoted pushing as high up to your (supposedly private) budget as possible? Are you sure you know which came before the other?

Figure 1



You also know better than to rest on your laurels having secured what seems to be a huge discount. From the days of mail order catalogs, suppliers have been publishing multiple rates for the same items. This practice continues today, albeit with some updated variations. You can't, for example, compare everything in some of the big box stores to the open market because they have custom stock keeping units (SKUs). You may have to resort to laboriously comparing descriptions which are artfully written to appear different but say the same thing. Foregone gains are less painful than perceived losses. This perception manifests strongly in people's judgments about fair behavior. Kahneman, Knetsch and Thaler (1986)[3] present survey evidence supporting this proposition. **A quirky irrationality of our behavior is how we are 'convinced' it is completely fair (more attractive) to have a better discount than a lower reference price.**

Sellers and their agents know that the way to maximum revenue is by framing. It is so ubiquitous that we almost stop noticing it, like the invisible gorilla[4]. If you see a price that was originally $179.99 marked down to $99.99 you still think you have gotten a great deal despite the fact that it really should have been priced at $49.99 originally.

Another method is anchoring, which provides you with a single point from which to make your comparison. Anchoring happens early in the discussion (in real estate – it happens before the discussion). The selling agent has nothing to lose by anchoring at as high a price point as they can. From then on, whether you want to or not, you will be doing some mental math comparing your price to the totally made up anchor. Chances are that if you feel you got a 'great deal' you will be telling others about your negotiation prowess based on that anchor.

What then is the correct market competitive price? After all, the vendor is trying to make a profit and you do want them to continue to stay in business. So, you may think that the prices you are quoted have been built up from the COGS (cost of goods sold), as shown in Figure 1.

In reality, smart companies price their

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product top down, based on what the customer is willing to pay (WTP), as seen in Figure 2.

Figure 3 shows what it looks like when you put them on the same dimensional grid.

Each organization has various pricing methodologies, fiscal years, and even compensation plans, which are all complicated further as you work through the product or service lifecycle. From a manufacturer standpoint, you must consider where the product is in its natural lifecycle. Then, distributors need to be factored into the equation. Then, the resellers come into play – VAR (Value-Added Reseller) or alternatives such as agents – who will be representing both competing products and competing solutions. Then there is the impact of foreign exchange, both real and forecasted, depending on where the item originates and is sold.

How can an organization manage procurement with this type of information asymmetry?

There are a several options that businesses consider:

- Hire specialized staff
- Outsource
- Retainer
- Cost plus
- MFN (Most Favored Nation) Pricing/ Negotiate higher discount across the board

Each of these approaches have their benefits, but the disadvantages of each usually outweigh the positives. Hiring specialized staff is expensive. From a utilization perspective, it has a direct impact on your expense budget and – just like outsourcing via a retainer model – you have no controls to ensure that you are indeed securing the best price. If you go the route of the outsourced with a cost-plus model – group purchasing organizations tend to use this – then there is an inherent conflict of interest. Lastly, it is naïve to think that MFN Pricing or demanding an automatic higher standard discount can provide you with a guarantee of best price due to the multiple SKUs strategy. This is the process where sellers try to befuddle the consumer by creating different part numbers or stock keeping units with the same description or even slightly but not materially different descriptions.

As shown in Figure 4, Shephard's Table[5] is a good example of how it's possible to make the same thing look different. (These two tables are exactly the same, and if it's going to keep you up nights, go to https://michaelbach.de/ot/sze-ShepardTables/index.html to calm your addled nerves.)

The only true way to ensure a market competitive price – for any transaction – is at **the transaction level**. Each one *sui generis* and each one not a predictor of future, nor dependent on past purchases. That requires real time knowledge of market conditions, product state, margin erosion, M&A activity, and at least 142 other measurable variables to understand what market competitive pricing should be. ❖

Figure 2

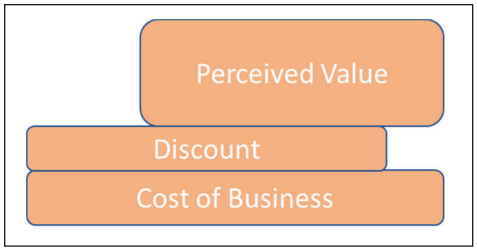


Figure 3

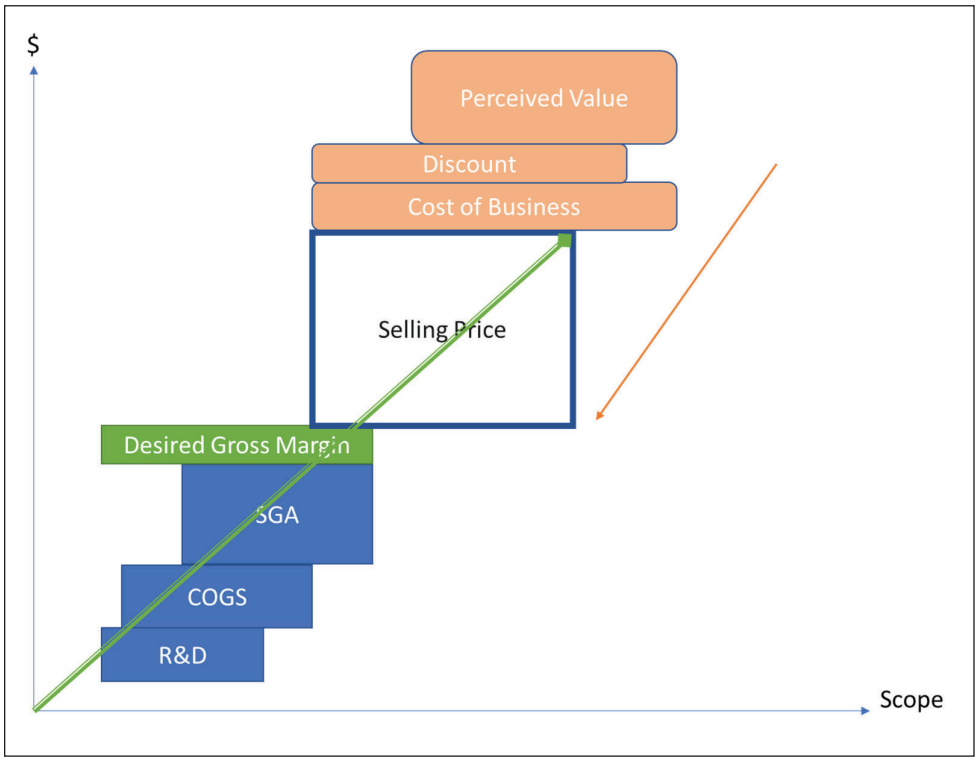
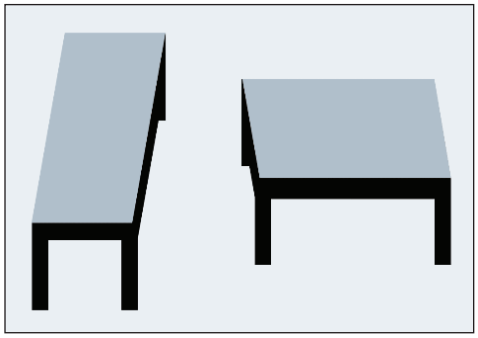


Figure 4



Endnotes

1. Poundstone, William (2010). Priceless : The Myth of Fair Value (and How to take Advantage of It)
2. Kahneman, Daniel, Jack L. Knetsch and Richard Thaler, "Fairness As a Constraing on Profit Seeking: Entitlements in the Market." – *American Economic Review*, 1986, 728-41
3. Ibid
4. Charbis, Christopher, Daniel Simmons, 2010. The Invisible Gorilla
5. Shepard, Roger (1990). Mind Sights