This relatively straightforward analysis allows us to identify where our product or service lies in the spectrum of price/value compared to the competition.

So value is subjective, different for each individual customer, and changes over time as needs and perceived benefits change. However, customer value is not too difficult to measure, although it is a little subjective. It simply requires a good understanding of your customers and markets.

Customer value is made up of a product or service's reference value (the price of alternatives) plus its differentiation value (the premium that our differentiated product or service commands through superior features and benefits). Differentiation value comprises four elements:

- **Cost drivers:** the ways in which your product or service offers the buyer cost savings over and above the reference product or service; demonstrated performance, savings, reliability, faster servicing and so on are all cost drivers
- **Revenue drivers:** the ways in which your product or services can help the buyer increase revenues – for example, through superior technology, customer support or brand strength
- **Psychological drivers:** the intangible elements of your product or service that add value for the buyer – including brand image and reputation, and also the risk that a buyer takes in purchasing from you
- **Negative drivers:** where your product or service performs less well than the reference product or service in any areas, this will decrease the differentiated value of your offering

In each market segment that you serve, there will only be three or four key drivers of differentiation value. The key to measuring customer value is to identify those few drivers of value, and to compare your organisation's performance against them with that of your competitors. This comparison will allow you to make a judgement of where in the range of prices in the market place your product or service should lie. This comparison will also help identify ways in which you can best improve the customer value of your products and services.

This may best be illustrated with an example.

A business with around 150 employees manufactures heating elements for industrial applications. One key market for the business is laboratories, where the heating elements are used in equipment that keeps cultures and samples at constant temperature. In the UK, this market comprises NHS laboratories and commercial labs. Work with internal experts and managers in NHS labs reveals the following key drivers of value:

- Speed of response – NHS labs have a high workload and cannot afford to have equipment out of action for a long period
- Product life/reliability – NHS managers budget for equipment and components on a cost per year basis
- Understanding of needs – NHS managers appreciate tapping into the knowledge of experienced representatives who can advise on the most efficient use of the equipment
- Order quantity – NHS laboratories want the flexibility to order in small batches – ideally singly – as they do not have space to hold stock

The company worked through a series of steps to compare its value offering with the competition – see Table 1. This relatively straightforward analysis allows us to identify where our product or service lies in the spectrum of price/value compared to the competition. It also highlights areas for improvement that will enhance customer value and hence price.

Before finalising your price, there are a number of other factors to bear in mind, which may impact on the price you decide to charge.

Buyer's risk

One of the main intangible – psychological – factors in a buyer's decision-making process is that of risk. Your business needs to be fully aware of the risks that customers face in purchasing from you. These risks include:[2]

- Performance risk – that your product or service will not provide the benefit for which it was purchased
- Financial risk – the monetary loss if the product or service fails
- Time loss risk – the time lost if you product or service fails
- Opportunity risk – the risk of choosing one product or service over another
- Social risk – the risk that the purchase will not satisfy the individual's self-image or gain the approval of others
- Physical risk – the risk that the product will cause harm, including legal harm

You should develop an action plan to minimise your customers' risk and, thus, enhance the value of your products and services. Tactics to reduce the buyer's risk include guarantees, insurance backing, brand reputation, good service back-up, testimonials from other customers, hire-purchase or cost per usage schemes, rather than upfront purchase, and trial usage. The sales slogan: 'Nobody ever got fired for choosing IBM', remains an example of a risk reduction strategy imitated by many companies.

Psychological value drivers

Even in business-to-business transactions, people buy emotionally and justify intellectually. The difficulty with measuring customer value is that there are many intangible elements of your product or service that add value for the buyer. These psychological value drivers are generally related to your company's brand image – for example, a track record of reliability, on-time delivery, a reputation for quality, good service back-up, a prestige image and so on. Buyer's risk is another psychological driver, dealt with above.

Value drivers	Company A	Company B	Company C	Our product/service	Comments
Speed of response	1 week	1 week	Next day	2 days	Our response is good but not best in class.
Product life	1 year	1 year	2 years	2 years	We offer class-leading quality and reliability.
Understanding of needs	Low	Low	Adequate	Good	The quality of our support is highly praised.
Order quantity	Min 10 units	Single piece	Min 5 units	Single piece	We meet the customer's need for small order batches.
Psychological drivers	Our ordering, customer service and quality departments are perceived not to talk to each other. Company C scores well for friendly service and good internal communication.				
Buyer's risk	There is no perceived risk to the customer in purchasing from us. Company A is new to this market and relatively inexperienced = high buyer risk. Company C is the longest established in the market with the most well-known brand.				
Minimum order quantity	10	1	5	1	
Price/unit	£10.00	£12.50	£15.00	£12.50	
Commentary:					
How do we compare?	At present our customer value greatly exceeds Company A and B. In understanding of needs and order quantity, we offer better value than Company C, but our relatively poor internal communications and slower speed of response are seen as negative value drivers.				
Where should we fit on the pricing spectrum?	If we can improve our speed of response, our internal communications and market awareness, we could match the price of Company C, whilst still improving market share.				
Other elements in the pricing decision					
The customer experience and other intangible drivers	The customer enjoys dealing with our representatives, who have excellent product knowledge. However, the customer's experience of our internal communications is poor, with departments perceived as not speaking to each other. This must be a priority for improvement.				
Strategic issues	We propose a neutral pricing policy, rather than a skimming price, to emphasise our value and quality compared to the competition.				
Pricing policies and fences	We must develop a clear pricing policy, with fences, that separates the value offering to the NHS from the premium offering we aim to offer commercial labs. To this end, we will develop a new advanced product with new electronics and a premium price for the commercial market. We will also implement an NHS-only price list for the standard product.				
Communicating the price-value proposition	Our communication strategy will focus on the superior economic benefits – quality, service, flexibility and speed of response – of our offering.				
Pricing decision	We will work to shorten our order lead-time, by improving internal processes, in order to allow next day delivery; and we will improve customer communication by offering a single point of contact. We will make these improvements within four months so that our new express NHS service can be priced at £14.00 per piece, emphasising quality, value, speed of response and in-depth expertise in the market.				
Target price	£14.00				

Value stream: NHS laboratory device heaters

Table 1

Psychological drivers are extremely important in customer value and can significantly boost the value, and therefore price, of your products and services. One approach that can be useful in surfacing intangible value drivers is that of the customer experience. Customer value is not just about the features and benefits of your product or service, it also encompasses the entire set of experiences that your organisation causes its customers to have. Thus, every time a customer interacts with your organisation, he or she gains an impression of your business, and these customer experiences combine to produce the image that your business projects to its customers. Every time a customer has contact with your sales staff, customer services or order entry, delivery or maintenance staff, engineers or quality assurance, or any other interaction, an impression is left behind – positive, negative or neutral. Over time, these impressions build into an image of the business, its reputation in the market.

Your challenge is to understand the customer's experience of your business and improve it in a way that maximises customer value.

Strategic issues

Your company's business strategy will also impact on its pricing. There are two strategic factors we need to consider before finalising the price:

- Skim pricing, penetration pricing or neutral pricing
- Placing the product or service within the product range

These are fairly detailed topics in themselves and we can only summarise the factors we need to consider in this article – see References and other marketing texts for further details.

Skim pricing, penetration pricing or neutral pricing

Skim pricing targets early adopters and other price-insensitive customers who desire premium products and services and a certainly exclusivity, in return for prices that reflect the high value they receive. Skim pricing requires a significant investment to communicate that value to customers.

Penetration pricing offers an exceptional price-value combination in order to attract a large market share. This strategy can only be effective in the long term where you have a significant cost advantage, or are using it as a loss leader tactic.

Neutral pricing pitches the product or service in the pricing spectrum, neither near the top nor the bottom, and emphasises value drivers other than price to attract customers.

Placing the product or service within the product range

Some customers are concerned with maximising the benefits they receive, and are prepared to pay premium prices for the best product or service. Other customers search the market for all alternatives to ensure they pay no more than they need to. Others can afford no more than the minimum necessary to meet their basic needs, and are willing to trade-off services and make other sacrifices to achieve that end.

Generally, therefore, it is desirable to have a range of products or services to meet the needs of different market segments – for example a basic product, a standard product, and a premium package. The basic product may be a loss leader, with a penetration pricing strategy to attract custom to the range. Once acquired, customers can then be sold on the greater benefits of products or services further up the range. The premium product may be priced using a price skimming strategy, offering the most benefits to top-end buyers, including last-minute rush orders.

Your pricing decision should fit each product or service into a range of offerings with different price-value propositions designed to target different key customers and different market segments.

Price sensitivity

Often a buyer's price sensitivity does not depend on anything immediately observable or on factors the customer freely reveals. It depends, instead, on how well informed about alternatives the customer is, and on the personal values the customer places on the differentiating attributes of the seller's offer. Nagle and Hogan[2] identify 10 factors that influence a buyer's price sensitivity:

- The price relative to perceived substitutes
- The perceived unique attributes of the product or service
- The perceived prestige or higher quality of the product or service
- The cost of switching to alternatives
- The difficulty of comparison with alternatives
- The importance of the end-benefit of the product or service to the buyer's business
- The relative size of the expenditure involved
- Whether the cost is shared with others – for example, reimbursed or funded externally
- The buyer's willingness to hold inventory and thus buy in bulk
- The perceived fairness of the price

Analysing the price sensitivity of your key customers and market segments in relation to these factors will have a significant impact on the price you charge.

Pricing policies and price fences

'Large business customers can afford professional actors – better known as professional purchasing agents – who have mastered the art of acting price sensitive even when they are not.'[2]

Maintaining a clear and fair pricing policy covering all customers and markets removes the incentive that buyers have to try to batter price reductions out of the supplier, because the buyer sees that the policy is fairly maintained across all purchasers. Pricing policies can also drive customer behaviour to reduce the cost to serve them, including encouraging buyers to make regular orders, to make a complete commitment to the supplier, for managing inventories, for paying on time and for reducing the seller's costs.

Price fences are the criteria, defined in the pricing policy, that are used to separate different market segments. They result in different prices being charged to different customers or markets for different levels of value. Pricing for customer value will only work where there are clear and consistent price fences. Implementing a fair and consistent pricing policy that everyone – customers and sales staff – sticks to requires a strong and visible commitment from management.

Salespeople also need to be motivated to adhere to the agreed pricing policies and apply the price fences. This requires training and, usually, a change in internal policies, such as sales commissions, and performance measures that reward driving profitability rather than revenue.

With a consistent approach and a good cross-functional team, you can begin to put together a robust and highly customer-focused pricing strategy that will improve customer value and customer satisfaction, at the same time as increasing your profitability.

One last thing needs to be borne in mind: for your pricing policy to stick, a buyer must be motivated to listen to your value proposition, and must be persuaded by it: 'Unless customers actually recognise the value that you create and ask them to pay for, value-based pricing will fail.'[2]

About the author

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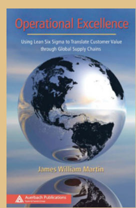

Operational Excellence: Using Lean Six Sigma to Translate Customer Value Through Global Supply Chain (Series on Resource Management) (Hardcover)
Author: James William Marti
Publisher: Auerbach Publications
ISBN: 9781420062502
Members: £56.99; Non-members: £59.99

Abstract:

Presenting a valuable array of tools, methods, and concepts, Operational Excellence is a practical source of information for improving an organization's manufacturing or service operations. It covers a wide range of topics-from translating a customer's voice to the design of a product-that detail the implementation of effective operational systems. In particular, the text focuses on adapting strategies for competitive organizations; translating customer needs and value expectations into products and services; the planning, management, and control of operations; the collection, analysis, and sharing of information; and the management, integration, and control of a global supply chain.

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