Pricing Strategically in the Complexity Avalanche

An Issue Primer for Technology Services Leaders

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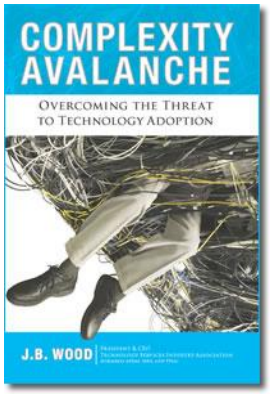
In October 2009 J.B. Wood, CEO of the Technology Services Industry Association, challenged the 800 participants at Technology Services World to think more strategically about the mega-forces driving growth and opportunities for services in technology industries. This paper outlines strategic price management issues that technology services leaders should keep in mind to maintain financial performance while navigating the turbulence. The author examines why value based pricing is instrumental to successful change, how the role of services pricing will dramatically increase, how to defend maintenance prices and what steps will lead to optimized prices for value added services.

Pricing Strategically in the *Complexity Avalanche*

An Issue Primer for Technology Services Leaders

Background



In October 2009 J.B. Wood, CEO of the Technology Services Industry Association, challenged the 800 participants at Technology Services World to think more strategically about the mega-forces driving growth and opportunities for services in technology industries. His thesis is codified in a book he published and distributed at the conference entitled *Complexity Avalanche*. Here are the core tenets of that thesis.[1]

- *Technology companies are already suffering from a growing consumption gap caused by the complexity avalanche they have unleashed on their customers. This gap is negatively affecting the sales of products and services across most every industry sector.*
- *Developing an effective service approach to the problem could be a good stand-alone business, and would drive more frequent and larger product repurchases along with a host of other financial benefits.*
- *Today's existing professional services function has the right goal of moving customers successfully along the product adoption life cycle. It also has the right skill sets. But it stops short of end-user-adoption (EUA) and is a very expensive financial model.*
- *Today's customer services function is exactly the right operating model but has the wrong customer mission and lacks many of the right skill sets.*

What the technology industry needs is a way to deliver the next generation of adoption services using the customer service delivery model.

[1] J.B. Wood, Complexity Avalanche: Overcoming the Threat to Technology Adoption, Point B, Inc., 2009, Page 69

Value Based Pricing to the Rescue

But even with the commitment to pick up the gauntlet, the path to more effective service approaches is not without hurdles. Services leaders at a prominent software company, for example, are stymied. They have made a sizable investment to understand end user adoption, and have outlined an effective, low cost delivery model. Still the projected financial performance of these new services is disappointing. They will never get investment dollars for their service innovation initiative unless projected margins improve. Moreover, demand for the firm's other fee based services are below expectations. So they have two questions:

- How can we stimulate demand for fee based services?
- How can we realistically improve the projected financial performance of our new value added services?

The answer to each question is value based pricing. Taking cost out of the service delivery model is only half the equation. The other half is being paid a price that generates adequate margins to justify investment. The two pricing models most commonly used in the service community – cost based pricing and market (aka competitor) based pricing – fall short.

Taking cost out of the service delivery model is only half the equation. The other half is being paid a price that generates adequate margins to justify investment. Here cost based and market based pricing fall short.

In the recent Market Rates Study of leading technology professional services practices, for example, of the 19 responding firms not one identified themselves as a value pricer.[2] To add insult to injury, in a 2005 SSPA research study of maintenance pricing practices, not one of the 114 enterprise vendors surveyed used ROI models to demonstrate the value of maintenance and

[2] TSIA Research, 2009 TPSA Market Rates Study

support services.[3] This despite the fact that ROI models are used routinely on the product side of the house.

Cost based pricing and market based pricing are the norms in technology services. When cost based pricing is used, firms develop a service offering, calculate the costs of delivery and then think about what price to charge to achieve a margin target. When market based pricing is used, firms look at comparable offerings in the market and price similarly. In both cases, companies forego revenue opportunities that are sometimes massive. A value based pricing approach often recommends prices to be 2X to 20X the level of either the cost based or market based approaches, and firms succeed at capturing them!

There are other shortcomings of cost based pricing, especially related to value added services. In the short run when proserve organizations deliver value added services, cost plus pricing means that low value implementation services and high value end user adoption services are priced off the same rate card. Since customers will force prices down to the lowest common denominator, it becomes nearly impossible to capture rate premiums for higher value services.

In the longer run, when value added services can be delivered more cost effectively, cost based pricing poses two problems. 1) It alienates customers because value to them and cost to the company have little to do with one another, therefore limiting market penetration. 2) And whatever margin is attached to costs, it is unlikely to match the potential achievable margins available from some customers for whom value can be enormous. In one exceptional case, a service organization routinely captures 40% of measurable value created for customers. Since most of its process is automated, margins on these services rival maintenance margins.

[3] SSPA, Defending Support and Maintenance Prices, an SSPA Industry Committee White Paper, 2005

Pricing Strategically

So what does pricing strategically mean? In the book, Wood refers to a question posed by the CIO of Computer Sciences Corporation. "I know how to improve operating efficiencies in services, but how do I make strategic investments there?"[4] Strategic pricing provides an answer to this question as well. Strategy is fundamentally about resource allocation. The answer to the question is to invest in services where value is high, permitting high prices and high margins.

This answer may appear trite, but in this context we are not talking about the term value as it is bandied about in business circles with the definition changing from conversation to conversation and with no ability to measure or quantify. Rather I am using the term value as defined by leading value researchers Anderson and Narus.[5]

"Value in business markets is the worth in monetary terms of the technical, economic, service and social benefits a customer receives in exchange for the price it pays for a market offering."

So the answer to the CIO's question is to invest in those services that have the greatest measurable economic impact on the business model of the buyer. These services will appeal most strongly to the customer and, in turn, permit you to charge a value based price. Indeed, value based pricing is ultimately about being paid fairly for delivering high business impact.

How should service leaders make strategic investments in services? Invest in those services that have the greatest economic impact on the business model of the buyer.

[4] J.B. Wood, Complexity Avalanche: Overcoming the Threat to Technology Adoption, Point B, Inc., 2009, Page 164

[5] James C. Anderson and James A. Narus, Business Market Management: Understanding, Creating and Delivering Value, 2nd ed., Pearson Prentice Hall, 2004

And business impact is the name of the game. Demonstrating business impact can be instrumental in making services value tangible. After developing an economic value model for a firm selling broadband telecommunication services, the CIO remarked that "It's a license for printing money." After the firm closed a sizable sale with the State of Wisconsin, the state purchasing agent remarked "Yours was the only vendor that demonstrated why this investment makes sense for our state."

Pricing strategically is about changing the question from an internal orientation where costs are the driver to an external orientation where customer value is the driver. The question changes from "What price do I need to cover my costs and achieve my revenue objectives?" to "What price is the customer willing to pay for the services, and what costs should I incur to deliver them?" The difference is subtle, but the business consequences can be profound.

Cost based pricing needlessly exposes the firm to two risks. The first risk is that the firm builds a service operation with a cost structure that the customer cannot afford. So the service business collapses of its own weight. The second risk occurs because of the margin target orientation. Instead of exploring the pricing upside, the firm settles for a target margin return, forever losing potential value it could have captured.

Alternatively pricing strategically leads the firm to scale the service offering to meet customer demand and positions the firm for higher margins.

The outcome of market based pricing may even be worse. If you indeed have unique value to your customers, then pricing similar to the competition leads directly to needless price competition. Your higher value prompts your competitor to drop price in order to stay in the game. Whammo! You started a price war and didn't even know it. In truth, Pogo was right: "We have discovered the enemy, and he is us". Experience across a wide variety of industries confirms that the most price competition is unintentional and unnecessary. Further, most of the harm resulting from price competition is self inflicted.

Market (aka competitor) based pricing can lead directly to needless price competition.

Pricing strategically has direct implications for the services engineering process as well. Cost based pricing puts pricing at the end of the process. Pricing strategically puts pricing at the front of the services engineering process. At the front it drives the firm to eliminate unnecessary costs early in the development process and focuses development on service attributes the customer is willing to pay for -- a wicked good combination for creating competitive advantage.

Finally, pricing strategically simplifies the complexity. It drives attention of the customer, sales organization, and development team away from features and functions (complex) and toward how those features and functions combine to deliver improved business performance (simple).

The Changing Role of Services Pricing

Over the upcoming decade, the role of services pricing will dramatically change in several ways. Let's take a software business as an example.

With a variable cost of virtually zero, the goal of software pricing is to maximize revenues. In these fixed cost businesses, maximum revenue translates to maximum margin. Maintenance simply piggybacks on software, and prices are a percentage of the software price. No thought whatsoever is given to the underlying economics of the services business. Of course, with 70% maintenance margins who cares? Nobody looks too closely at the pricing model. Just keep discounting under control, and enjoy the ride. Other service functions have often been operated in many cases as cost centers, again with the objective of maximizing product revenues.

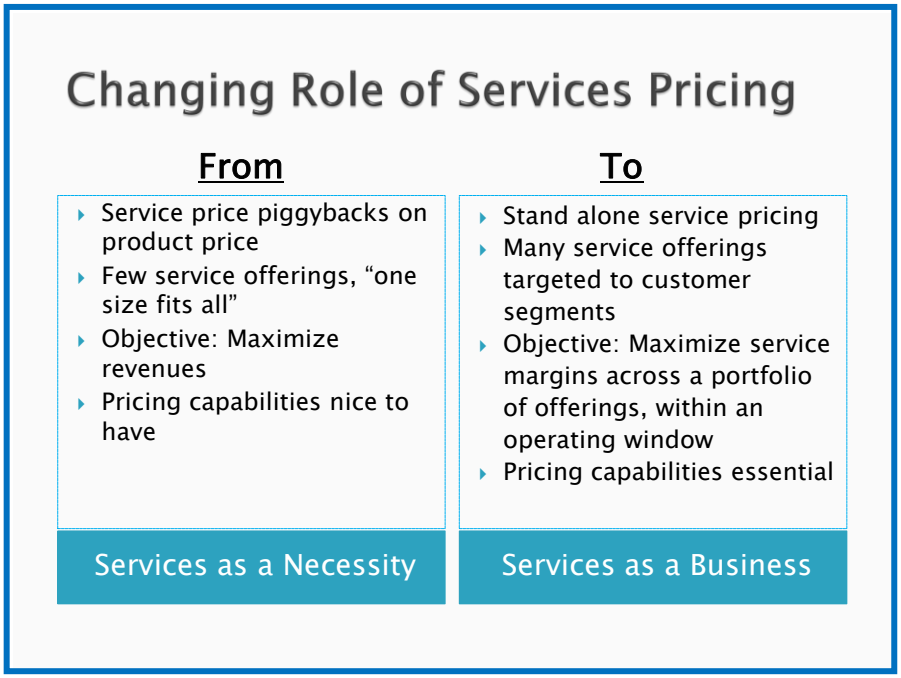
In a services business, the goal of maximizing revenues leads to higher costs and lower margins.

The underlying economics of a service business, however, are different than those of the example software business. As a result, the role of pricing changes. Unlike the software company example, where costs are largely fixed, service business costs are largely variable. Moreover, unlike software where unlimited copies can be printed, service operations have a limited capacity, and costs can grow rapidly as the limits of capacity are reached. Ask the leader of any services group what happens when demand is high, pushing the limits of the team. In this kind of environment, the goal of maximizing revenues leads to higher costs and lower margins. In one services case, economic modeling demonstrated that maximizing revenues led to a 33% decrease in margins.

The goal of pricing for services, therefore, is not to maximize revenues, but rather to maximize margins given a certain scale of operation. This is more closely akin to pricing in process industries like chemicals, where the goal is to maximize margins for a given level of production capacity.

As technology companies begin to offer value added services, the complexity of the pricing problem increases. Some customers will want fewer services and others will want more. Instead of a single price point – "maintenance" – there will be multiple service offerings and price points. In the current environment, the simple definition of

pricing success is to capture as high a percentage of the license price as possible. In the not to distant future, the business objective will be to maximize margin across a portfolio of service offerings consumed by a variety of customers.



Finally, as companies transition from services-as-a-necessity to services-as-a-business, pricing moves from an afterthought to an essential skill set for survival. Many services organizations will find that skill set sorely lacking. Investment in pricing capabilities will therefore be required to sustain financial performance.

In sum, the role of pricing in services will rise, driven by changing business economics, deterioration of the maintenance model and increased offering complexity. These changes will drive service organizations to beef up pricing capabilities to meet the challenges.

Defending Maintenance

The maintenance model of services revenues has served the technology industry well since its inception. It is the cash cow of many tech businesses. However a significant threat to maintenance prices is emerging: the potential collapse of software prices.

After all, 20% of zero is zero. With the emergence of cloud computing, entrance of new competitors having little overhead and the establishment of new services exclusive competitors, it may not be a question of whether but when. In the context of the *Complexity Avalanche* and evident mounting price pressure[6], the operative question is: How can tech firms defend the maintenance revenue stream long enough to profitably navigate the transition to value added services?

With the underlying basis for value at risk of collapsing, i.e. software prices, the obvious response is to find a new basis. Of course that basis should be value delivered. For the past 20 years or more, software customers have consistently been willing to pay roughly 20% of the license price for maintenance services, year in and year out. That is great news indicating high delivered value. Yet, according to the 2005 SSPA study, that value has not been measured.

As new delivery vehicles, like cloud computing emerge, there is a very real risk that unmeasured value will simply be lost. If technology companies want to protect their maintenance revenue streams over the long run, then a top priority must be to quantify delivered value. That quantification can, in turn, be used to justify prices of maintenance services independent of software or hardware prices.

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Beyond quantification of value delivered, the solution in part will be found in embracing the digitization of value rather than resisting it. A significant challenge of maintenance is that it is an undifferentiated mass both on the cost side and the value

[6] TSIA Research, 2009 Maintenance Pricing Practices Study

side. By trimming maintenance component services that provide customers with little value and investing in services that provide customers with high value, maintenance prices can be defended. This presumes the firm has done the recommended value quantification work, so the impact of individual services on the customer's business model can be assessed. If done, the focus on higher value component services creates competitive advantage and increases switching costs, strengthening the firm's negotiating position.

In at least two ways, though, preserving the maintenance model of services may be a trap. Experience across many industries has shown that services easily lose their differentiated value when bundled. It has to do with the intangibility of services. Products retain their individuality in bundles, e.g. it is easy to differentiate between fries and a burger even when served as a Happy Meal. In contrast, tell me what are the individual services in your auto insurance policy? Beyond one or two services most of us couldn't list them; that despite the fact that we pay 200X the price for insurance than a Happy Meal. Then in times of natural disaster it is no surprise that so many people discover that their insurance didn't cover the flood or hail or wind or other damage. Services lose differentiation in bundles.

"Experience across many industries has shown that services easily lose their differentiated value when bundled. So to capture maximum value in services, unbundling has proven an effective pricing tactic."

So in order to capture maximum value in services, unbundling has proven an effective pricing tactic. Itemizing services more clearly communicates value, and providing customers with more options generally increases customer spend. Unbundling is especially important for new value added services. The last thing you want to do is develop something truly valuable for your customers and then bury it in a pile of other services under the label "maintenance".

Another trap of the maintenance model is competitive vulnerability. A favorite competitive strategy since the time of Sun Tzu has been to narrowly define the field of battle in order to gain relative competitive strength. Working across a variety of industries, time and again niche competitors attack the highest margin elements of an incumbent's undifferentiated offering. Continuing the insurance industry example, there has been a flurry of activity in the auto insurance industry recently led by Progressive and Geico. "Name your own price", "choose the policy that is right for you", and "do it for less money". It is a powerful combination. Note recently that industry powerhouses like Allstate and State Farm have been forced to follow suit.

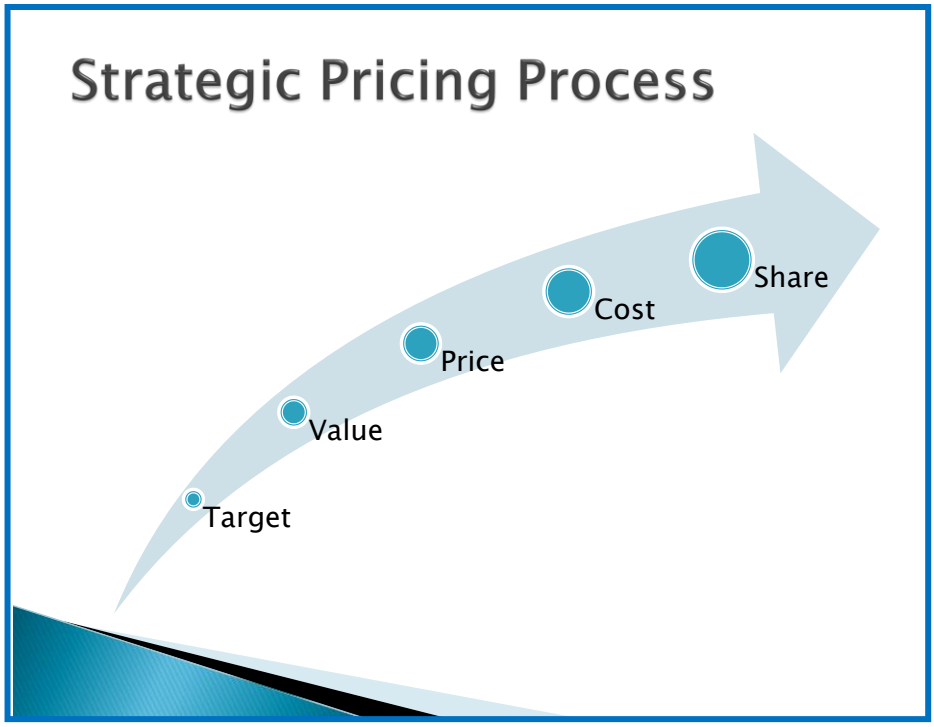
Value Added Services

If the key to the future is value added services, driven by services science, then the key to making the most from the effort is value based pricing, driven by pricing science. And just as service science is anchored into the organization through the service engineering process, so value based pricing is anchored through the strategic pricing process. In a world where the key to success is the "application of the technology to address the unique business opportunities of your customer", where the buyer is a business buyer and where the objective is business results, value based pricing simply fits the bill.

If the key to the future is value added services, driven by services science, then the key to making the most from the effort is value based pricing, driven by pricing science.

The strategic pricing process can be summarized in six steps. Identify the target customer or segment. Quantify the value to the customer of solving their problem. Determine the price the customer would be willing to pay to solve the problem.

Determine the service operation and cost structure needed to deliver the expected value. Determine the market share objective that would maximize margins given the operating window of the service operation.



The strategic pricing process will help companies identify targeted customer opportunities that have the highest payback, while managing costs from the outset. The combination enables faster market entry, higher cash flow, and reduced time to breakeven. Moreover, value based pricing will help the service business maintain margins overall even if traditional maintenance margins fall.

In my experience firms who employ the strategic pricing process in offering development find it easier to pick winners from losers, and they are more inclined to make the necessary investments across the board that assure launch success.

Closing Thoughts

Finally, value based pricing is simply fair. It is fair to customers who pay for value received. It is fair for the services organization because they are paid for improving their customers' business condition. It is fair for shareholders because it is focused squarely on improving business margins.

Value based pricing anchored by the strategic pricing process is a powerful framework for preserving the financial performance of technology businesses while navigating the turbulence of the *Complexity Avalanche*. It is a perfect complement for capturing the value created by increasing user adoption. It simplifies complexity. It enlightens the path for preserving maintenance revenues. It provides a framework for optimizing service business margins while enhancing the services engineering process.

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Value and Pricing Partners, LLC provides consulting, education and coaching services to the technology services community.

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