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Which Price is Right?

It is an urgent question: How can we increase profits if we can't raise prices? The answer demands revolutionary thinking -- new insights about strategy and human behavior, turbocharged with software, mathematics, and rapid-fire experimentation. Is your company ready to master the new era of pricing? Are you prepared to pay the price of failure?

by Charles Fishman
photographs by Holly Lindem
from FC issue 68, page 92
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Airline tickets cost 40% less than they did 25 years ago. A two-liter bottle of Diet Coke often has the same price tag as it did in 1985. Light-bulbs, laptops, heck, even the "cost" of a mortgage -- all are at historic lows. It's been a good 20 years to be a consumer.

But for companies, the pressure is on. Most companies are desperate to raise prices. And virtually every company has the same lament: We can't. Customers won't stand for it. Competitors will undercut us. And technology will disrupt us -- again. Jack Welch saw it back in 1996, when he famously complained, "There is no pricing power at all." The environment is even tougher today.

Anyone who sells anything knows that price is the pivot of business, the ultimate leverage. If you can raise prices -- even a bit -- you can increase profits dramatically. If you can't raise prices, you feel like your business is struggling, regardless of what is happening with cost, quality, or service.

Meanwhile, anyone who buys anything knows that almost nothing has a single price anymore. Want to know the price of something? Well, you get back a series of questions: Who are you? How long have you been a customer? How much are you buying? How good are you at unblinking negotiation? Did you bring your frequent-shopper card?

So I set out on a mission: to enter the hidden world of prices and pricers. I wanted to talk candidly with the smartest experts, the savviest executives, and the most nimble tacticians about the most urgent subject in business today: pricing. I sensed trouble when the first person I called to interview said after a few minutes, "Wait. I hear typing. I always get nervous when I hear typing." Next came a woman from American Airlines. She kept repeating the official position: "Absolutely not. We just don't discuss prices." Finally, she pleaded, "If I talk about prices, I could go to jail." The spokeswoman for a telecom company said, "We're not going to talk about prices, and the fact that we're not going to talk about it is off the record. You can't use the fact that we won't talk about prices in a story."

But it was not until I traveled to Chicago, to a Professional Pricing Society conference, that I got a full picture of how sensitive the subject is. On my first day, I was asked to leave the trade-show exhibits -- the place where vendors beg for attention. A guard was posted at the door, in case I tried to slip in. On the second day, Eric Mitchell, president of the PPS, spotted me standing in the lobby outside the meeting rooms and scowled. I would approach someone and introduce myself, and Mitchell would tag along and stand with his arms crossed as I asked questions. Eventually, his dignity overcame his paranoia, and he assigned an aide to follow me. It didn't matter. Shortly, I was approached by a man who was large enough to play nose tackle for the Chicago Bears. Leval worked security for Marriott. He was nose tackle for the Chicago Bears. Leval worked security for Marriott. He was extremely polite, and he told me that I would be leaving the hotel. *Immediately*.

So there I was, standing in a biting breeze on Michigan Avenue, wondering what it is about prices that makes otherwise reasonable businesspeople so paranoid. One factor is strategic secrecy: Prices are so important to business that most executives don't want to disclose what they know. But the bigger factor, I came to appreciate, is fear of embarrassment: Most executives are surprisingly in the dark when it comes to setting prices. They guess; they say a prayer; they cross their fingers. They are afraid to disclose what they *don't know*.

Kent Monroe, a professor at the University of Illinois at Urbana-Champaign, is one of the deans of pricing. He's been teaching the subject for nearly 37 years, and he knows that sloppy thinking about pricing is widespread across the U.S. economy. Both consumers and businesspeople assume that price has everything to do with cost. *Wrong*. "You have to know the cost so that you can understand the profitability implications of price," says Monroe, "but not for the purpose of setting price." Businesspeople assume that if they are in a competitive situation, and prices drop, they have to match. *Wrong*. "The natural tendency to match is foolish," he says. Executives who are devoted to using "data" in all kinds of other arenas think it's perfectly acceptable to set prices based on "history" or "experience" or "instinct." *Wrong again*.

Monroe tells a pricing story that shows how even the simplest situation can confound accepted wisdom about prices. "A company is making two versions of the same product," says Monroe. "One has a little more gold and foil on it, but they're essentially the same. One is $14.95; the other is $18.95." Not surprisingly, the $14.95 item is selling better. It's also the lower-profit product.

"Then a competitor comes in with a third product. Again, it's essentially the same thing, but a fancier version. And it's much higher priced: $34.95."

For our original company, asks Monroe, "what becomes the best-seller? Why, the $18.95 version, of course."

It's a small story, but it's true. In fact, you can *feel* how right Monroe is. "The point," he says, "is that economic theory says that can't happen. But it does."

The neat curves and crisp laws of supply and demand, elasticity, and rational behavior that everyone learns in microeconomics class don't work in the real world.

Business is at the start of a new era of pricing. This era is being shaped by a new set of insights into business strategy and human behavior, and these insights are turbocharged with software, mathematics, and rapid experimentation. The result is what might be called "scientific pricing." There is even a blossoming industry of a dozen companies that offer scientific-pricing services.

Changes in pricing will alter every part of the economy. The way that business gets done will change, and companies will flourish or be crushed based in part on their ability to grasp and master the new science of pricing. Among those already using the new techniques are Best Buy, DHL, Ford Motor Co., the Home Depot, JC Penney, Safeway, Saks, Staples, UPS, and Winn-Dixie. General Electric, perhaps taking Jack Welch's warnings to heart, is not only working with at least two different pricing companies -- it has also invested in one.

PRICE CHECK (I): BEFORE THE BAR CODE

The oldest records of prices ever found are clay tablets with pictographic symbols found in a town known as Uruk, in what was ancient Sumer and what is now southern Iraq. These price records are from 3300 BC -- they've survived 5,300 years. The documents -- records of payment for barley and wheat, for sheep, and for beer -- are really receipts. "Uruk was a large city, at a minimum 40,000 people," says UCLA professor Robert Englund, one of the few experts on the Uruk documents. "So some of the quantities are very high -- hundreds of thousands of pounds of barley, for instance."

But here's the really remarkable thing. The earliest Uruk tablets aren't just the oldest pricing records ever found. They are the oldest examples of human *writing* yet discovered. In other words, when humans first took stylus to wet clay, the first thing that they were compelled to record was . . . prices.

INSIDE A PERMANENT PRICE WAR: "YOU'RE ONLY AS SMART AS YOUR DUMBEST COMPETITOR"

If there are pioneers in the world of scientific pricing, they are the airlines. In the 25 years since deregulation, the airlines have honed an obsession with prices -- their own and each other's -- that is legendary. We all live with the seemingly bizarre inconsistencies that result, such as two people on the same plane, sitting across the aisle from each other, one of whom paid $290 to fly from New York to Miami, one of whom paid $1,290. We also benefit from the pricing obsession: With just a little bit of planning, you can fly for the same price today that you did in 1980.

The airlines know full well that we are puzzled by the frantic pricing and repricing that they do -- puzzled, that is, when we aren't infuriated. Jim Compton, senior vice president of pricing and revenue management at Continental Airlines, not only wasn't scared of going to jail if he talked about