Preface

It is remarkable how much the pricing of a company's products and services affects the profitability of the company in either direction: High (realized) prices can mean high total profits, and low prices can mean low total profits. From an Economics 101 perspective, there exists a perfect price at which profits are maximized, and any price lower than that point hurts not only profits but potentially revenues as well. However, in a business-to-business (B2B) selling context, there are two challenges in achieving such a price. These apply to the list price and to the price realized in individual transactions, respectively.

First, for a company with thousands, or even tens of thousands of products, it is inconceivable that its list prices are the best possible for all its products. This is especially the case in a dynamic market with continually changing competitive and customer situations. Perfect information regarding attributes and prices of all competing products is rarely available to the customer or to the company.

Second, even if a company is able to set its list prices such that they maximize its profits, each transaction has its own negotiated price or discount off the list price. Sales personnel have incentives that typically depend on the amount of sales they generate, not on the realized prices or profits. Buyers' agents have incentives that typically depend on the discounts they are able to extract off the list prices. Both sides can agree on transactions with large discounts for large sales amounts. The actual transaction price is then quite a bit lower than the list price because both sides focus on the revenue. However, such a transaction might not add to the company's profits and might even contribute to losses.

Therefore, the absence of any realistic control over transaction prices means that the company cannot realize "optimal" prices even if it can determine what these are. This absence of control can hurt in other ways too. For instance, when raw material prices go up, the company increases list prices but finds that in practice the realized prices remain the same, and so profits actually go down.

Even when there are operational controls in the company by way of price checks, requests by sales personnel to get prices approved within the company may take so long that the customer gets impatient and takes her business elsewhere. Such controls impede sales, the lifeblood of the company. As a result sales personnel, in their need to make and grow sales, have to devise ways to go around these controls. Nevertheless, circumventing price checks means that sometimes the price in a transaction is too low relative to guidelines, effectively diluting profit. Alternatively, the price may be too high relative to guidelines, hurting sales in the long term because the customer may find out and curtail his purchase in the belief that the company is opportunistic.

Improving and controlling the realized prices over individual transactions and contracts is the domain of pricing operations. If a company can improve manufacturing and service operations, why can't it improve its pricing operations? Substandard operations, whether marketing-, pricing-, or sales-related, can lead a company to distress even when there are good marketing and pricing strategies in place.

The goal for improving pricing operations is to prevent the dilution of list prices in individual transactions and contracts, assuming of course that the company has (list) priced the products correctly in the market relative to the competition and demand. Moreover, pricing operations ensure that realized prices are as close as possible to guidelines vis-à-vis list prices consistently over time and across customers. For instance, operations would ensure that volume discounts are applied consistently across transactions.

This is no different than manufacturing (or services operations) seeking to ensure that the product (or service) does not deviate from the design each time the product is made (or the service is rendered). Just as companies gain a reputation for good quality for manufactured goods or services, a company that controls its transaction prices will gain its customers' trust for superior sales and pricing practices. These customers will not suspect the company of opportunistic or sloppy practices.

There are many ways to improve manufacturing and service operations—Total Quality Management, Statistical Process Control, and Lean Manufacturing to name a few—to adapt to pricing operations. Which of these should a company follow to improve pricing operations?

To select a particular approach, one must realize that on one hand, every decade or so there is a new movement promising to rid the business world of inefficiency, which eventually becomes a fad. Companies spend much effort doing enterprise-wide implementation. Executives and consultants tell stories in business conferences while the business press writes magazine articles about stories reporting success or at least promising it. Then slowly but surely, stories of excess start circulating, foretelling the demise of the fad but paving the way for another one.

On the other hand, some ideas stay around despite the coming and going of various fads because they are core concepts and are quite useful when implemented. Such ideas include the use of statistics—inferring the state of a system or process from a sample—that permeates Statistical Quality Control, Total Quality Management and, now, Six Sigma. Another idea is incremental change or continuous improvement whether in these approaches or in Lean Manufacturing based on the Toyota Production System. This is in contrast to the radical change in Business Process Reengineering that had some successes but also birthed many disasters and unnecessary upheavals.

When we set out to write this book, our goal was not to capitalize on the current popularity of Six Sigma, but to capitalize on the ideas behind Six Sigma that predate this methodology. These ideas will survive Six Sigma when some other methodology replaces it in popularity. Therefore, when reading this book, please keep in mind that we are not cheerleaders for Six Sigma or any other movement for that matter. We are fully behind fact-based analysis and for achieving major improvements to profits through the incremental changes that underlie Six Sigma.

In regard to "incremental" changes as part of continuous improvement, what has been surprising in our own experience is that such changes in price improvements have had huge positive impacts on profitability. We might be doing Six Sigma a disservice by advertising that it aims for and achieves only incremental changes. We should clarify that the small changes refer to the changes in the process in question, not to the magnitude of benefits received.

Finally, do we need to add to the plethora of Six-Sigma-related terms with another one, namely, Six Sigma Pricing? One could say that Six Sigma Pricing is simply the application of Six Sigma to the area of pricing, which it certainly is—you can carry out Six Sigma steps for improving a pricing process as in any nonpricing application as long as you can additionally navigate the minefield that is pricing.

This, however, is where there are challenges. Pricing processes have many stakeholders, each believing he or she has a lot at stake. This means you are treading constantly on eggshells despite top management support. Not all of these stakeholders will see a Six Sigma pricing project as a win-win situation even if it adds significantly to the company's bottom line. This makes such a project vulnerable to being undone at the first possible opportunity, something that does not usually happen with manufacturing or services projects.

There are other differences between applying Six Sigma to pricing operations and applying Six Sigma to manufacturing operations. For projects related to pricing operations, the most important customers are internal. Their requirements may not be well stated or not stated at all in comparison to manufacturing projects. Pricing processes, when they do exist formally, are notable mainly for the lack of any discipline or effort to follow them.

On the other hand, pricing projects may be saturated with data, especially in comparison to services projects. Additionally, relative to the effort that goes into the project, the benefits provided by pricing projects by way of increased profits is huge in comparison to those brought by manufacturing or services projects.

Therefore, there are significant differences between a "typical" manufacturing or services situation and one that involves pricing to justify our use of the term Six Sigma Pricing. Improving pricing operations using Six Sigma Pricing is the subject matter of this book.