Managing Cost Plus Pricing in a Crisis

In a very chaotic world, such as the one in which we currently find ourselves, cost-plus pricing is straight forward. Costing, however, can be rather complex, which makes managing dynamic cost-plus pricing very tricky. If your main pricing orientation is cost-based or cost-plus, you should consider the points presented here in order to survive current challenges. Stephan M. Liozu, Ph.D. is Chief Value Officer at Thales Group (www.thalesgroup.com), Research Fellow at Case Western Reserve University, and Founder of Value Innoruption Advisors (www.valueinnoruption.com). He has authored nine pricing books and is a frequent keynote speaker at industrial and digital conferences. He can be reached at sliozu@gmail.com.

by Stephan Liozu Ph.D.

Over the past few years, there has been a great deal of discussion and debate on the topic of cost-plus versus value-based pricing. While cost-plus pricing still gets negative press, some experts have made the point that there is a place and time for cost-plus pricing. Others, like me, argue that it is not a matter of one versus the other but rather more of a question of balance between the 3Cs: customer, cost, and competition. I have also proposed that a firm utilizing cost-plus pricing should first improve cost-plus before they invest heavily in value-based pricing. Value-based pricing requires customer intimacy and competitor knowledge which do not materialize overnight in a cost-plus driven organization.

All of this makes sense when times are good. With the current collapse of demand and supply in many industries, it is inevitable to anticipate renewed attention on cost excellence along profit and cash flow management. With prices of commodities dropping, material and commodity costs should also go down providing short-term relief for manufacturers and distributors. It is always the silver lining of an economic crisis. However, with the good news also comes the challenge of managing cost reduction and price changes, especially when customers have access to the same cost information along the value and supply chain. In a very chaotic world, cost-plus pricing is straight forward. Costing, however, can be rather complex. So, it makes managing dynamic cost-plus pricing for manufacturing companies very tricky. Cost transparency in general is never good news when things go south.

If your main pricing orientation, meaning the primary way you set your prices, is cost-based or cost-plus, you should consider the following points:

1) Your costs are going down. Are your prices going down? That is the evil about cost-plus. You have educated your customers on your cost-plus pricing methods, especially when costs go up. You also have turned your salespeople into cost-plus and commodity driven professionals. They are used to thinking in terms of costs and exchanging cost information with your customers. So, when costs go down, are you passing savings to your customers as a straight pass-through? If your costs go down by 20, 30 or 40%, how far down do you adjust your prices? How far do you let your salespeople go in price negotiations?

2) Your costs are based on standards. Are your cost-plus prices wrong? If you run your financial models using standard costs based on wrong cost estimations due to cost decreases, then your prices are wrong. You have two choices: 1) move to actual costing for a time and upload information into your IT systems with new cost information; or 2) spend hours calculating variance every day, week or month and adjust pricing accordingly. During times of cost volatility, doing cost-plus pricing is tough. It is hard to know what your true margins are in a dynamic way and to also really adjust prices to reflect cost savings pass-through.

3) Your costs are wrong. In large companies, different costing systems are utilized, and cost allocation mechanisms are not unified. In other companies, there is a lack of costing discipline and precision. It is, at times, due to the lack of expertise or the lack of resources necessary to reach cost excellence. Bottom line: if your costs are wrong, your prices are wrong, and you are giving away margins. Part of the short-term effort is to either get better at costing or move to real costing as soon as possible. In situations where a business survival is at risk, it is time to adapt and to think day-by-day and week-by-week.

4) Your costs are neither clear nor complete. Do you have the right accounting systems to price dynamically? Are you costing large and complex projects? Costs going down is one thing. Costs changing dynamically and moving in different directions requires the proper cost accounting systems that can handle this level of cost dynamism. Add to this potential intercompany pricing and formula-based pricing contracts, and you have chaos on your hands if you do pricing manually in Excel. Cost accounting software can take you halfway. Match this with the proper dynamic pricing software. If not, you are again leaving money on the table.

5) Your real material costs are changing every hour. Are you ready to reprice every hour? Most manufacturing companies update their price lists once a quarter at best. Most of them do that once or twice per year. When costs of commodities change every hour or every day, you might need to separate what is material cost versus what is processing and added-value. The result is dynamic pricing fluctuating with raw material costs combined with value-based pricing for your higher value activities. Without this, you are giving away the farm.

6) Your sales force might know your costs. Are they communicating too much information? You often hear the expression "Ok, I will give it to you at cost." This is a trap that most buyers want you to fall into. They want more information on your cost so that they can predict your cost-plus pricing and request the proper discounts. Are your sellers trained not to discuss cost in front of customers? Have you trained them in managing price concessions and discounting in the context of a global depression? This is typically an area

➢ CONTINUED, next page ➢

that is not covered in pricing. We train lots of people regarding implementing a pricing increase. We do not do the same on managing a price decrease.

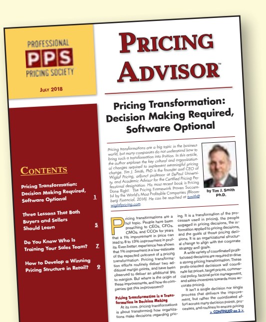
7) Your formula-based pricing is driving your pricing down. Formula-based pricing is a particularly good cost-based method if you want to avoid discussing pricing all the time. Once loaded in the proper ERP system, it applies pricing changes based on cost changes. Of course, you can make serious mistakes in your contracts when you define the formula. Are you including floor and ceilings? What happens if prices turn negative as we recently saw with oil prices? Have you thought of force majeure and exit clauses? Now is the time to revisit all your contracts using formula-based pricing and make sure they include all the above.

8) Your offers now include software and data. Most manufacturing companies are good at costing products and parts. They are not always exceptionally good at costing what is more intangible and dematerialized. That includes data, software, apps, and some services. Applying cost-plus to what might be extremely low cost for the manufacturer but high value to the customer is giving away great value for nothing. These costs are folded into the product costs and these items are given away for free. If an app costs $1,000 to produce and generates $10,000 of average customer value, how do you price it? Cost-plus pricing might lead to a price at $1,400 to $1,600. Value-based pricing would price it at $5,000 (50/50 rule).

The current crisis presents a good opportunity to think about how your pricing is managed and start improving on your pricing discipline. I am not saying that it is the right time to deploy value-based pricing when you have done cost-plus pricing for the past decade or more. I am saying it is the right time to think about these points and to move from chaotic and manual cost-plus pricing to a more data-driven and dynamic cost-plus pricing system. It is also the right time to invest in the proper pricing system to avoid pricing mistakes and delays and to match dynamic costs with dynamic prices.

The current crisis presents a good opportunity to think about how your pricing is managed and start improving on your pricing discipline.

Eventually, having discussions about the value of services, software, and very differentiated offerings is going to be a good idea. Right now, when you are in a fire fight, start paying attention to your costs and adapt your pricing quickly. Change the business rules and put safeguards in place. Be bold, join the pricing revolution. ❖



The Pricing Advisor™ is the monthly member newsletter of the Professional Pricing Society. If you have feedback regarding this newsletter or want to contribute an article, please email: editor@pricingsociety.com.

Editor: ....Rebekah Wortman, PPS Marketing Publications Editor

Publisher:.............. Kevin Mitchell, PPS President

For all other inquiries, including subscription and PPS membership information, please contact:

Professional Pricing Society
3535 Roswell Road, Suite 59
Marietta, GA 30062 USA
Tel: +1.770.509.9933
Website: PricingSociety.com
E-Mail: contactus@pricingsociety.com