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Getting The Price Right

Value Pricing in the Chemical Industry

New Thinking – Many companies in the chemical industry take an inefficient approach to setting their prices. Kai Pflug explains how companies can take on a cleverer tactic with better results.

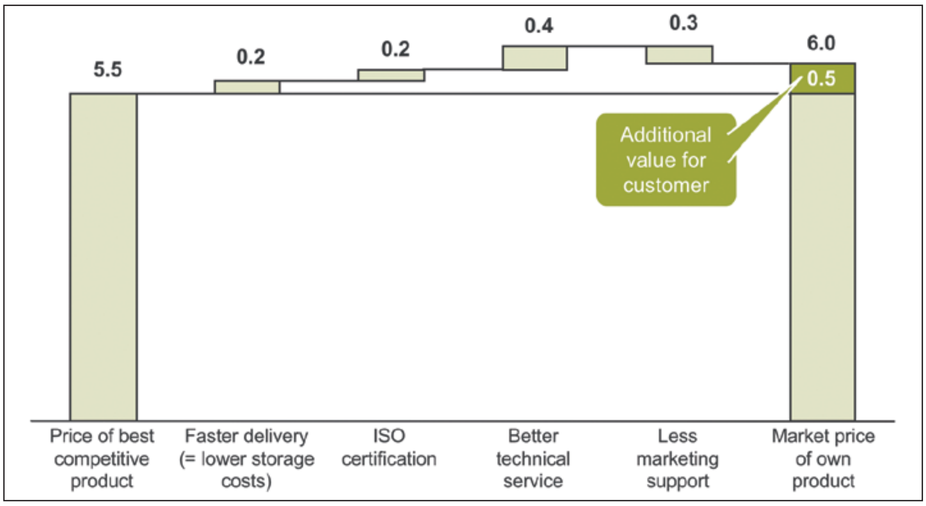

FIG. 1: Value pricing based on best competitive product

As in other industries, setting the right price is an extremely relevant factor affecting the profits of chemical companies. However, the high importance of pricing sometimes seems to be poorly understood within the chemical industry. While it would seem a somewhat strange idea for a producer of luxury accessories, brand-name cosmetics, new medicines or high-quality machinery to base their prices on production costs, this approach is still commonly employed by many chemical companies.

Value pricing has been offered to the chemical industry as a solution to this dilemma. In essence, the idea of this pricing concept is to quantify the value a chemical creates at the customer, and base the price charged on this value. Thus, it is indeed fundamentally different from cost-based pricing, and much more in line with modern pricing methods as employed in consumer industries.

However, in our own consulting work, we have lately experienced something of a backlash against the value pricing approach. This is understandable as the initial approaches to value pricing were less than realistic. Prices set by this method failed to take competitor's prices into account, as can be seen from these statements from various consulting companies:

"… price determination is still dissatisfying as it remains too strongly focused on costs and the competitive situation."

"… to move away from traditional methods of setting prices such as the cost-plus model or benchmarking of competitor's prices and begin to use the power of value pricing."

This thinking is fundamentally flawed. Of course the price of competitor's products has to have a strong influence on the price a chemical company can charge itself. If customers can create the same high value using different chemicals from different producers, why should they choose the most expensive one just because this still leaves them profitable?

On the other hand, taking competitor's prices into account does not prevent chemical companies from successfully utilizing the concept of value pricing. Rather, it just needs to be slightly adapted. The starting point for determining the price then is not the absolute value of the chemical created at the customer, but rather the price of the best competitive product. Based on this price, all differences in value are quantified to get to the maximum price for the own offering (fig. 1)

Of course, identifying and quantifying all differences between the own offering and that of the best competitor can be quite time-consuming and does require substantial market knowledge. In our experience, the following process has been found to be useful:

- Identification of a longlist of differences in value elements between own offering and competitor offering (see fig. 2 for typical areas in which differences may occur). This is best done in internal interviews (e.g., with staff from marketing and sales), though interviews with customers may also yield additional insights
- Prioritization of these differences (i.e., which of the differences are thought to have the biggest impact on the value of the own offering?), ideally in an internal workshop

Value element	Examples
Quality	• Quality consistency • Quality guarantees • Certification • …
Brand	• Brand image • Offer of Ingredient Branding • …
Marketing & Sales	• Responsiveness • Marketing & Sales support • …
Technical Service	• Basic technical support • On-site support • Samples, test batches • …
Product	• Product properties • Customized products • …
Packaging	• Package size • Customized packaging • …
Logistics	• Frequency of delivery • Order size • Order-to-delivery time • …
Payment	• Payment terms • Financing • …
Other	• Waste issues • …

FIG 2: Typical value elements

Pros	Cons
• No loss of margin • Highly differentiated price • Method encourages critical analysis of all aspects of a company's offerings • Consequently method facilitates design of good offerings ➔Particularly suitable for highly differentiated products	• Implementation somewhat time-consuming ➔ may initially be limited to larger products • Requires good knowledge of markets and customers • Requires good communication with customers to justify prices ➔Less suited for commodities (but check whether some differentiation can be created)

FIG 3: Pros and cons of value pricing

- Quantification of the differences in monetary terms. Depending on the importance of the product, the quantification may be restricted to the most important differences identified in the previous step. The quantification is often perceived to be problematic as not all relevant data may be available. However, it is generally possible to come up with a reasonable estimate based on internal knowledge, customer interviews and possibly the additional knowledge of an external consultant.

Often the key in understanding the value of the own material for the customer lies in understanding its role in the customer's production. This leads to questions such as

- Does the material speed up the customer's production process, increasing its capacity?
- Does the material improve the customer's products, allowing them to charge higher prices?
- Does the material allow the customer to save money in any of its functions, e.g., in production, QC, marketing and sales, etc.?
- Does the material lower the capital costs of the customer?

Some examples may illustrate the application of value pricing in the chemical industry:

- A polymer additive for drying nets used in paper production doubled the lifetime of the nets. This was used by the maker of the nets to increase prices by 30%. The chemical company producing the additive based their price on this additional profit
- The price of a dental product used by dentists in preparing tooth fillings was not based on the raw material costs but instead on the time savings the dentist had when using the product. A 30 second gain per application thus could be converted into a maximum price per application of about €1 (based on the costs of running the dental surgery)
- A maker of polymeric isocyanate raw materials used the lower monomer content of his products to justify higher prices. Customers accepted these higher prices, as using this raw material allowed them to produce for the EU market with its lower limits of monomeric content in polymers, and thus increased their profits
- Switching to just-in-time delivery allowed the customers of a hazardous chemical to substantially save on storage and hazard prevention costs. By charging higher prices for this type of delivery, the chemicals supplier shared the benefits of the customer
- By guaranteeing more stringent quality controls of its additives than a competitor, a chemical company saved their clients part of their own quality control work. This was successfully used as a justification for higher prices.

Figure 3 gives an overview of some of the advantages and disadvantages. In particular, it is worth pointing out that value pricing should be accompanied by good communication. It is necessary to clearly point out the additional value created for the customer, and to clarify that using the specific product results in a win-win situation in which both the customer and the chemical company get additional benefit.

Obviously, once the knowledge basis for value pricing has been established in a chemical company, it may also be utilized to actively modify offerings to customers. Once there is a solid estimate of how much a certain value element is worth to the customer, this worth may be compared to the cost of delivering the specific value element. If these costs exceed the value to the customer, there is a strong case to be made for dropping this element from the offering (e.g., delivery within 24 hours is expensive but creates only limited value to the customers and thus may not be offered any longer).

In summary, value pricing is a helpful tool in setting the right prices in the chemical industry. A solid understanding of the value attributed by the customer to each element of an offering allows setting a price that is neither too high nor substantially below what customers are willing to pay if they are aware of the benefits of using a product.

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