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Is innovation in pricing your next source of competitive advantage?

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Abstract Few companies treat innovation in pricing as seriously as product innovation or business model innovation. However, after interviews with 50 executives and the analysis of pricing practices of 70 companies worldwide, our research suggests that innovation in pricing may be a company's most powerful—and, in many cases, least explored—source of competitive advantage. Innovation in pricing brings new-to-the-industry approaches to pricing strategies, to pricing tactics, and to the organization of pricing with the objective of increasing customer satisfaction and company profits; too many companies today see pricing as a win/lose proposition between themselves and their customers. Innovation in pricing breaks this deadlock and shows how to increase profits and customer satisfaction conjointly. As a result of our research, we present a canvas laying out more than 20 possible avenues for innovation in pricing, offering to any organization—regardless of size, industry, or nationality—a few key ideas on how to increase both profits and customer satisfaction.

1. Introduction

Is product innovation a top priority for your company? If so, you are certainly not alone. Has your firm tinkered with business-model innovation? Great. Your competitors have done this already and customers may even expect it. But what about another advancement that is less recognized, yet still a crucial factor in product innovation: Could innovation in pricing be your next source of competitive advantage? Based on a series of interviews with CEOs and top management personnel—as well as analysis regarding pricing practices at leading companies in the U.S., Europe, and Asia (see Appendix)—we estimate that less than 5% of companies have applied innovation to their pricing strategy, tactics, or organization. Our research shows that companies that implement innovation to their pricing activities significantly outperform their competitors.

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Thus, chances are good that innovation in pricing is your next and most powerful source of competitive advantage.

Based on our research, we develop a framework to kick-start innovation in pricing. This roadmap provides a unique overview for understanding current global best practices of innovation in pricing and for guiding organizations to successfully implement it. The roadmap, which lays out more than 20 possible avenues for innovation in pricing, offers organizations—regardless of size, industry, or nationality—a few key ideas on innovation in pricing. Our research suggests that this is enough: many highly successful companies (e.g., Zipcar, Salesforce.com) have built their competitive advantage essentially around one, and only one, pricing innovation.

In this article, we first define innovation in pricing and discuss why it is too often neglected. Then we develop our roadmap for action. Following that, we delve into the essence of the framework by showing how the use of innovation in pricing strategy, tactics, and organization can lead to superior profits and increased customer satisfaction.

2. What is innovation in pricing?

Most companies unfortunately view pricing as antagonistic: a win-lose relationship with customers in that what one party gains the other loses, or so goes the weakly held assumption. Our research shows that innovation in pricing helps to break this vicious cycle. Such innovation brings new-to-the-industry approaches to pricing strategies, to pricing tactics, and to the organization of pricing with the objective of increasing customer satisfaction and company profits. As we illustrate via examples proffered, the joint increase of company profitability and customer satisfaction constitutes the hallmark of innovation in pricing.

The experience of General Electric (GE) highlights the importance of innovation in pricing. Historically, the company sold aircraft engines to airlines at or below cost in an attempt to recover profits through intransparent maintenance contracts. Customer satisfaction was low: service contracts were expensive and capital outlays were high. GE struggled to bridge the gap between its own capital outlays and cash inflows. Innovation in pricing enables the company to overcome both problems. Instead of selling jet engines, GE now sells what it calls "Power by the Hour"; that is, usage rights to jet engines, which include maintenance and spare parts. Customers pay only when the aircraft is flying, and thus earn money. In contrast to maintenance contracts, GE now has every incentive to ensure that the jet engines perform. As a result, profits—as well as customer satisfaction—increase dramatically. In a similar vein, the success of companies such as Salesforce.com and Zipcar is not based on product innovation but rather rests solidly on innovative approaches to pricing. Instead of selling software, Salesforce.com licenses usage rights to customers who appreciate the advantage of tying payments to usage intensity. Contrast this with traditional software pricing whereby customers pay a fixed fee regardless of the benefits experienced. Similarly, Zipcar's success in the car rental industry is not due to better vehicles or improved customer service but lies predominantly with the company's pricing schemes, which give customers the option to pay for rental cars on a much more flexible basis: by the minute.

Innovation in pricing is thus already a source of competitive advantage for a small number of leading companies. It is less about numbers and much more about the appropriate model that will enable a company to grow profitably while at the same time provide superior customer satisfaction. If innovation in pricing is such a powerful tool to drive profitability, why are so few companies embracing it?

3. Why innovation in pricing is not a priority

Our research suggests that product or service innovation is a top-management priority for close to 100% of companies. But only 5% of companies introduce new-to-the-industry pricing innovations; only one company from our interviews has implemented an innovative pricing strategy. Like GE, this business-to-business (B2B) equipment company has shifted from selling products to charging customers a given fee that reflects the enhanced productivity realized and includes service, maintenance, and performance guarantees. This new approach propels the company from an also-ran to an industry leader in terms of customer satisfaction, growth, and profitability.

As interesting as this single case may be, it is an exception. The typical answer we received from companies surveyed was "No, we have not introduced any innovation in pricing." Many executives who are true pioneers in fields such as product innovation, marketing, finance, and talent development seem to hold the following weakly held conviction: "Pricing did not change that much over the past decades, so why should it change now?" This