

# Pricing Strategically in the Complexity Avalanche

An Issue Primer for Technology Services Leaders

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Value and Pricing Partners, LLC

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In October 2009 J.B. Wood, CEO of the Technology Services Industry Association, challenged the 800 participants at Technology Services World to think more strategically about the mega-forces driving growth and opportunities for services in technology industries. This paper outlines strategic price management issues that technology services leaders should keep in mind to maintain financial performance while navigating the turbulence. The author examines why value based pricing is instrumental to successful change, the dramatically changing role of services pricing, how to defend maintenance, and pricing for value added services.

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*Commitment to Profitable Growth*



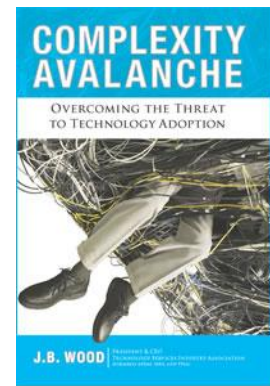
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# Pricing Strategically in the *Complexity Avalanche*

## An Issue Primer for Technology Services Leaders

### Background

In October 2009 J.B. Wood, CEO of the Technology Services Industry Association, challenged the 800 participants at Technology Services World to think more strategically about the mega-forces driving growth and opportunities for services in technology industries. His thesis is codified in a book he published and distributed at the conference entitled *Complexity Avalanche*. Here are the core tenets of that thesis.<sup>1</sup>



- *Technology companies are already suffering from a growing consumption gap caused by the complexity avalanche they have unleashed on their customers. This gap is negatively affecting the sales of products and services across most every industry sector.*
- *Developing an effective service approach to the problem could be a good stand-alone business, and would drive more frequent and larger product repurchases along with a host of other financial benefits.*
- *Today's existing professional services function has the right goal of moving customers successfully along the product adoption life cycle. It also has the right skill sets. But it stops short of end-user-adoption (EUA) and is a very expensive financial model.*
- *Today's customer services function is exactly the right operating model but has the wrong customer mission and lacks many of the right skill sets.*

*What the technology industry needs is a way to deliver the next generation of adoption services using the customer service delivery model.*

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<sup>1</sup> J.B. Wood, *Complexity Avalanche: Overcoming the Threat to Technology Adoption*, Point B, Inc., 2009, Page 69

## Value Pricing to the Rescue

But even with the commitment to pick up the gauntlet, the path to more effective service approaches is not without hurdles. Services leaders at a prominent software company, for example, are stymied. They have made a sizable investment to understand end user adoption, and have outlined an effective, low cost delivery model. Still the projected financial performance of these new services is disappointing. They will never get investment dollars for their service innovation initiative unless projected margins improve. Moreover, demand for the firm's other fee based services are below expectations. So they have two questions:

- How can we stimulate demand for fee based services?
- How can we realistically improve the projected financial performance of our new value added services?

The answer to each question is value based pricing. Taking cost out of the service delivery model is only half the equation. The other half is being paid a price that generates adequate margins to justify investment. Here cost based pricing, the pricing model most widely used in the services community, falls short.

In the recent Market Rates Study of leading technology professional services practices, for example, of the 19 responding firms not one identified themselves as a value pricer.<sup>2</sup> As another example, many tech firms employ ROI or TCO models at the time of the product sale. But how many service organizations use economic value models in selling or pricing their service

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<sup>2</sup> TSIA Research, 2009 TPSA Market Rates Study

offerings? According to a 2005 SSPA research study, of the 114 enterprise vendors not one used ROI models to demonstrate the value of maintenance and support services.<sup>3</sup> Cost based pricing is the rule, where firms develop a service offering, calculate the costs of delivery and then think about what price to charge to achieve a margin target.

In the short run when professional services deliver value added services, cost plus pricing means that low value implementation services and high value end user adoption services are priced off the same rate card. Since customers will force prices down to the lowest common denominator, it becomes nearly impossible to capture rate premiums for higher value services.

In the longer run, when value added services can be delivered more cost effectively, cost based pricing poses two problems. 1) It alienates customers because value to them and cost to the company have little to do with one another, therefore limiting market penetration. 2) Whatever margin is attached to costs, it is unlikely to match the potential achievable margins available from some customers for whom value can be enormous. In one exceptional case, a service organization routinely captures 40% of measurable value created for customers. Since most of its process is automated, margins on these services rival maintenance margins.

## Pricing Strategically

So what does pricing strategically mean? In the book, Wood refers to a question posed by the CIO of Computer Sciences Corporation. "I know how to improve operating efficiencies in services, but how do I make strategic investments there?"<sup>4</sup> Strategic pricing provides an answer to this question as well. Strategy is fundamentally about resource allocation. The answer to the question is to invest in services where value is high, permitting high prices and high margins.

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<sup>3</sup> SSPA, Defending Support and Maintenance Prices, an SSPA Industry Committee White Paper, 2005

<sup>4</sup> J.B. Wood, Complexity Avalanche: Overcoming the Threat to Technology Adoption, Point B, Inc., 2009, Page 164

This answer may appear trite, but in this context we are not talking about the term value as it is bandied about in business circles with the definition changing from conversation to conversation and with no ability to measure or quantify. Rather I am using the term value as defined by leading value researchers Anderson and Narus.<sup>5</sup> *“Value in business markets is the worth in monetary terms of the technical, economic, service and social benefits a customer receives in exchange for the price it pays for a market offering.”*

So the answer to the CIO’s question is to invest in those services that have the greatest measurable economic impact on the business of the buyer. Value based pricing, in turn, is about being paid fairly for delivering that business impact.

And business impact is the name of the game. Demonstrating business impact can be instrumental in making services value tangible. After developing an economic value model for a firm selling broadband telecommunication services, the CIO remarked that “It’s a license for printing money.” After the firm closed a sizable sale with the State of Wisconsin, the state purchasing agent remarked “Yours was the only vendor that demonstrated why this investment makes sense for our state.”

Pricing strategically is about changing the question from an internal orientation where costs are the driver to an external orientation where customer value is the driver. The question changes from “What price do I need to cover my costs and achieve my revenue objectives?” to “What price is the customer willing to pay for the services, and what costs should I incur to deliver them?” The difference is subtle, but the business consequences can be profound.

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<sup>5</sup> James C. Anderson and James A. Narus, *Business Market Management: Understanding, Creating and Delivering Value*, 2<sup>nd</sup> ed., Pearson Prentice Hall, 2004

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Cost based pricing needlessly exposes the firm to two risks. The first risk is that the firm builds a service operation with a cost structure that the customer cannot afford. So the service business collapses of its own weight. The second risk occurs because of the margin target orientation. Instead of exploring the pricing upside, the firm settles for a target margin return, forever losing potential value it could have captured. Alternatively pricing strategically leads the firm to scale the service offering to meet customer demand and positions the firm for higher margins.

Pricing strategically has direct implications for the services engineering process as well. Cost based pricing puts pricing at the end of the process. Pricing strategically puts pricing at the front of the services engineering process. At the front it drives the firm to eliminate unnecessary costs early in the development process and focuses development on service attributes the customer is willing to pay for -- a wicked good combination for creating competitive advantage.

*Pricing strategically drives out unnecessary costs early in the services engineering process and focuses development on service attributes the customer is willing to pay for.*

Finally, pricing strategically simplifies the complexity. It drives attention of the customer, sales organization, and development team away from features and functions (complex) and toward how those features and functions combine to deliver improved business performance (simple).

## The Changing Role of Services Pricing

If the maintenance model of services indeed breaks down, then the role of services pricing will dramatically change in several ways. Let's take a software business as an example.

With a variable cost of virtually zero, the goal of software pricing is to maximize revenues. In these fixed cost businesses, maximum revenue translates to maximum margin. Maintenance simply piggybacks on software, and prices are a percentage of the software price. No thought whatsoever is given to the underlying economics of the services business. Of course, with 70% plus maintenance margins who cares? Nobody looks too closely at the pricing model. Just keep discounting under control, and enjoy the ride. Other service functions have often been operated in many cases as cost centers, again with the objective of maximizing product revenues.

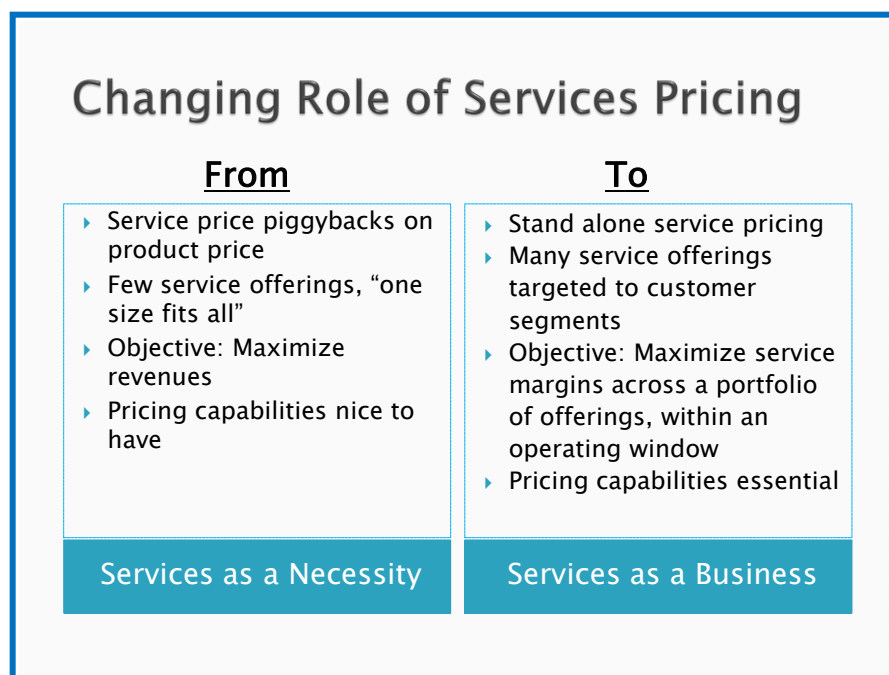
The underlying economics of a service business, however, are different than those of the example software business, so the role of pricing changes. Unlike the software company example, where costs are largely fixed, service business costs are largely variable. Moreover, unlike software where unlimited copies can be printed, service operations have a limited capacity, and costs can grow rapidly as the limits of capacity are reached. Ask the leader of any services group what happens when demand is high, pushing the limits of the team. In this kind of environment, the goal of maximizing revenues leads to higher costs and lower

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margins. In one services case, economic modeling demonstrated that maximizing revenues led to a 33% decrease in margins.

The goal of pricing for services, therefore, is not to maximize revenues, but rather to maximize margins given a certain scale of operation. This is more closely akin to pricing in process industries like chemicals, where the goal is to maximize margins for a given level of production capacity.

To add insult to injury, if the existing maintenance model deteriorates, the complexity of the pricing problem increases. The maintenance model will be replaced by a portfolio of service offerings plus value added services. Some customers will want fewer services and others will want more. Instead of a single price point – “maintenance” – there will be multiple service offerings and price points. In the current environment, the simple definition of pricing success is to capture as high a percentage of the license price as possible. In the digitized future, the business objective will be to maximize margin across a portfolio of service offerings consumed by a variety of customers.



Finally, as companies transition from services-as-a-necessity to services-as-a-business, pricing moves from an afterthought to an essential skill set for survival. Many services organizations will find that skill set sorely lacking. Investment in pricing capabilities will therefore be required to sustain financial performance.

In sum, the role of pricing in services will rise, driven by changing business economics, deterioration of the maintenance model and increased offering complexity. These changes will drive service organizations to beef up pricing capabilities to meet the challenges.

## Defending Maintenance

The maintenance model of services revenues has served the technology industry well since its inception. It is the cash cow of many tech businesses. In the context of the *Complexity Avalanche* and evident mounting price pressure<sup>6</sup>, the operative question is: How can tech firms defend the maintenance revenue stream long enough to enable the transition to value added services?

The 2005 SSPA Industry Committee Whitepaper mentioned above provides a solid foundation for thinking about defending support and maintenance prices.<sup>7</sup> There are several additional factors I would suggest here.

The first is to focus on a better objective. In most conversations I participate in on this topic, the presumed objective is either to defend maintenance prices or to defend maintenance revenues. From a pricing perspective, both these objectives are red herrings. A better goal is to sustain or improve maintenance margins.

*“Hit your margin target and all sins will be forgiven.”*

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<sup>6</sup> TSIA Research, 2009 Maintenance Pricing Practices Study

<sup>7</sup> SSPA, Defending Support and Maintenance Prices, an SSPA Industry Committee White Paper, 2005

As one IT exec put it: “Hit your margin target and all sins will be forgiven.”

The forces driving change described in *Complexity Avalanche* suggest increasing power of buyers, increasing use of price as a competitive weapon and increasing use of technology to automate service delivery. These forces will combine to put downward pressure on maintenance prices. The goal of sustaining either maintenance prices or maintenance revenues, therefore, may be untenable.

By focusing on maintenance margins instead, the firm can proactively pursue automation strategies that lower the end cost of maintenance for customers, improving their competitive position, while maintaining margins.

Beyond the right objective, the solution in part is found in embracing the digitization of value rather than resisting it. A significant challenge of maintenance is that it is an undifferentiated mass both on the cost side and the value side. By trimming maintenance component services that provide customers with little value and investing in services that provide customers with high value, maintenance margins can be defended, perhaps indefinitely. Over the long run, the focus on higher value component services creates competitive advantage and increases switching costs, strengthening the firm’s negotiating position.

In at least two ways, though, preserving the maintenance model of services may be a trap. Experience across many industries has shown that services easily lose their differentiated value when bundled. It has to do with the intangibility of services. Products retain their individuality in bundles, e.g. it is easy to differentiate between fries and a burger even when served as a Happy Meal. In contrast, tell me what are the individual services in your auto insurance policy? Beyond one or two

*“Experience across many industries has shown that services easily lose their differentiated value when bundled. So to capture maximum value in services, unbundling has proven an effective pricing tactic.”*

ancillary services most of us couldn't list them; that despite the fact that they are the most important components of the policies. Then in times of natural disaster it is no surprise that so many people discover that their insurance didn't cover the flood or hail or wind or other damage. Services lose differentiation in bundles.

So in order to capture maximum value in services, unbundling has proven an effective pricing tactic. Itemizing services more clearly communicates value. Providing customers with more options generally increases customer spend. Unbundling is especially important for new value added services. The last thing you want to do is develop something truly valuable for your customers and then bury it in a pile of other services under the label "maintenance".

Another trap of the maintenance model is competitive vulnerability. A favorite competitive strategy since the time of Sun Tzu has been to narrowly define the field of battle in order to gain relative competitive strength. Working across a variety of industries, time and again niche competitors attack the highest margin elements of an incumbent's undifferentiated offering. Continuing the insurance industry example, there has been a flurry of activity in the auto insurance industry recently led by Progressive and Geico. "Name your own price", "choose the policy that is right for you", and "do it for less money". It is a powerful combination. Note recently that industry powerhouses like Allstate and State Farm have been forced to follow suit.

### Value Added Services

If the key to the future is value added services, driven by services science, then the key to making the most from the effort is value based pricing, driven by pricing science. And just as service science is anchored into the organization through the service

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engineering process, so value based pricing is anchored through the strategic pricing process. In a world where the key to success is the “application of the technology to address the unique business opportunities of your customer”, where the buyer is a business buyer and where the objective is business results, value based pricing simply fits the bill.

The strategic pricing process can be summarized in six steps. Identify the target customer or segment. Quantify the value to the customer of solving their problem. Determine the price the customer would be willing to pay to solve the problem. Determine the service operation and cost structure needed to deliver the expected value. Determine the market share objective that would maximize margins given the operating window of the service operation.



The strategic pricing process will help companies identify targeted customer opportunities that have the highest payback, while managing costs from the outset. The combination enables faster market entry, higher cash flow, and reduced time to breakeven. Moreover, value based pricing will help the service business maintain margins overall even if traditional maintenance margins fall.

In my experience firms who employ the strategic pricing process in offering development find it easier to pick winners from losers, and they are more inclined to make the necessary investments across the board that assure launch success.

### Closing Thoughts

Finally, value based pricing is simply fair. It is fair to customers who pay for value received. It is fair for the services organization because they are paid for improving their customers' business condition. It is fair for shareholders because it is focused squarely on improving business margins.

Value based pricing anchored by the strategic pricing process is a powerful framework for preserving the financial performance of technology businesses while navigating the turbulence of the *Complexity Avalanche*. It is a perfect complement for capturing the value created by increasing user adoption. It simplifies complexity. It enlightens the path for preserving maintenance revenues. It provides a framework for optimizing service business margins while enhancing the services engineering process.

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*Value and Pricing Partners, LLC provides consulting, education and coaching services to the technology services community.*

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