Evening the Odds in Price Negotiation
How to understand the schemes of purchasing agents

BY DR. THOMAS T. NAGLE AND DR. GEORG MÜLLER

Price negotiation is usually a David vs. Goliath confrontation. David, the sales rep, has much less influence over what his company sells than the purchasing agent has over what his company buys. Purchasing agents are better informed, since it is legal for them to compare prices and terms with other buyers, while it is illegal for sellers to do so. Finally, salespeople are usually paid for making sales, while purchasing agents are paid for saving money. Not surprisingly, Goliath, the purchasing agent, usually wins, in part because David, the sales rep, is often so disheartened that he expects to lose.

While the ideal solution to this problem is to replace price negotiation with a non-negotiable price menu, that's not always feasible. Only a quality leader can lead a market to such a policy, and only companies that could survive calling a large buyer's bluff can afford the cost of the transition. Even then, the transition from negotiated to fixed prices usually takes some time. In the meantime, it's essential that salespeople be able to recognize and parry purchasers' deceptive tactics.

The following are some of the most common mistakes to avoid in price negotiation:

Discounting the price increase. We see many clients whose pricing strategies have suffered for years from the effects of poorly negotiated price increases. The seller in this case establishes an across-the-board price increase—say 6 percent—that is then presented to buyers. Those without power are forced to take it or leave it. Larger buyers, however, often make the case that since they deserve a volume discount, they should not have to bear the full increase. Consequently, they negotiate an increase of, say, 4 percent. The seller feels happy that at least some of the increase "stuck."

In fact, the seller got taken in by a bogus argument, and the cost of the mistake compounds as years go by. The large buyer who gets a 6 percent increase is already getting a discount on the increase relative to smaller buyers. For example, if the large buyer is currently paying $80 while everyone else is paying $100, a 6 percent increase for the large buyer is only $4.80 vs. $6 for everyone else. By demanding a discount on the increase, a purchasing agent is demanding that the seller pay twice for the same volume.

When buyers use this tactic repeatedly, their discounts quickly compound. One client saw its prices for volume buyers drop from over 70 percent to less than 50 percent of list price in only seven years. To compensate for this loss, the company began asking for higher increases to create room for erosion with large buyers. As a result, it lost progressively more of its medium and small customers, making it ever more reliant on and vulnerable to intimidation from its largest buyers.

When large buyers must have a concession, give it without undermining the integrity of the price increase. For example, rather than discounting the price increase, get a contract that delays its implementation for four months. The effective rate increase for the current year is discounted, but you begin the new year with the higher rate established and avoid compounding the discount into future years.

Discounting in return for "incremental volume." Sometimes buyers will offer a seller incremental volume in return for a price concession. This is in principle not a bad idea, even under a fixed-price policy. In practice, however, sellers often get taken. Here's how. First, a buyer who offers to purchase 10 percent more volume in return for a 2 percent price discount is actually getting a 22 percent price cut on the incremental volume! Here's how that works: Assume that the buyer is spending $1,000. He offers to purchase 10 percent more volume, which means he would be buying $100 worth of additional product at the pre-discounted price. If the buyer receives a 2 percent discount on that $1,100 worth of product, he gets $22 off, which is 22 percent off of the $100 of incremental volume.

If sellers actually calculated that incremental discount, many would never be willing to make such a large concession. Actually, the cost of the concession is usually far more than what the seller gives up in that year, since most sellers fail to segregate the extra discount from the base price, perhaps in the form of a year-end rebate. Consequently, the 2 percent price concession becomes incorporated into the basis for all future negotiations.

If you're going to give a discount for incremental business, focus the entire amount of the concession on the increment, or give it as a rebate. This has the added advantage of protecting you from duplicitous buyers who promise more business to get the discount, but never order the incremental volume. With the discount focused entirely on the increment, they don't get the savings until they deliver the volume, and the lower price doesn't get incorporated into the buyers' expected price level.[1]

Letting past behavior set future expectations. Expectations drive behavior and nowhere more so than when setting prices. A customer's decision to buy something at the offered price, or not, depends upon more than the trade-off between benefits and price. It also depends on customers' expectations, and their experience answering this question: how might our behavior influence the prices we have to pay? For example, a retail consumer may believe that a new fall fashion is well worth the price asked for it in September, but still not buy it if she expects the store following its past behavior will have a 20 percent off sale within the next month. A policy of regular predictable discounting has trained many retail consumers to wait for the sales price. As a result, sales at regular prices are less than they would otherwise be, increasing the amount of inventory that ultimately will be sold at the lower sale price.

The same dynamic plays out—only more so—when businesses sell products and services to other businesses. Professional buyers have learned to hold their purchases until the last couple of weeks of each quarter when sales managers are often willing to discount more deeply to achieve their quarterly goals. Sellers in these situations see the increasing portion of their sales made when prices are discounted as a sign that customers are becoming more

[1]Thomas T. Nagle, "Evening the Odds In Price Negotiation," *Across the Board*, March 1999, 56-58.

price sensitive in their brand choice. In fact, they are only responding to incentives for how to get a better deal on what they were otherwise willing to buy at a higher price.[2]

Valuing the differentiators. Companies that focus on volume rather than value in their price negotiations often get suckered into pricing only the commodity aspects of their product and giving away the valuable aspects. For example, we have seen many clients give their largest customers priority in scheduling and delivery. A sharp negotiator never gives away something that is scarce and valuable. A client in the transportation business found itself losing its high-margin customers because of its inability to guarantee delivery, while its lower-margin, but higher-volume, customers got priority. After this company put a price on expedited service, the high-volume customers that truly needed priority were forced to compete by paying a service premium. Those who refused to pay the premium opened up opportunities for this company to win back more service-sensitive customers. As a result, the company increased both its total revenue and its revenue per shipment.

The key to getting paid for value is to recognize—and force customers to recognize—when something is not an apples-to-apples comparison. A challenge that many companies face is the customer who claims to have found a better deal elsewhere. Instead of considering why the customer did not immediately switch their business to take advantage of the better deal, many companies panic and assume that the competitive offer is (i) real; (ii) an apples-to-apples comparison; and (iii) delivered with the same level of service, speed, and after-sale support. Without testing the details of the competitive offer, companies risk training their customers to find “low-ball offers” that are used to negotiate better pricing from their preferred supplier. We recently worked with a client whose customer service team had the authority to “match competition” and was evaluated based on customer satisfaction levels and how quickly they could complete phone calls. Needless to say, customers quickly found out that phantom competitive bids would be graciously and quickly matched by customer service reps who were eager to please.

Contracts with one-sided obligations. Some of the most costly mistakes are made by companies that sell products with highly seasonal demand and limited capacity to serve that demand at peaks. Smart buyers negotiate, and naive sellers accept, contracts based on annual purchase volumes. With no constraint on when they must purchase, smart buyers usually find that they can get better deals elsewhere for off-peak purchases, at a time when everyone has capacity and is eager for incremental volume. Then, when supplies are tight during the peak season, they purchase all their contract obligation.

Why is this so bad? Because, when supplies are short, it's often possible to sell at higher-than-contract prices. Suppliers under contract, however, must serve their contract customers first. The contract becomes nothing more than a one-sided constraint on the seller not to raise prices when the market value of the product is greatest. Not surprisingly, in these cases, the high-service suppliers, with whom everyone signs contracts at slight "premium" prices, often end up using their capacity less effectively and therefore remain less profitable than many of their lower-service rivals who take whatever prices they can get.

When we find a client with this problem, we help them design a peak/off-peak pricing strategy. Fixed-price contracts, which some sellers prefer, contain contingencies that limit the peak-period quantities that buyers can purchase at the contract price to some multiple of what they purchase during off-peak months. They also get priority for additional amounts, but only at the higher spot prices that non-contract buyers must pay.

Fixing the price/performance ratio. The idea that price should be proportionate to performance is so commonly accepted that challenging it usually requires extensive buyer education. Still, it should be challenged, since the rewards are large and the logic behind it flawed. The problem lies in allowing your product or service to be positioned strictly on relative performance, rather than on relative value. If offered the choice between two cancer treatments, one of which was 40 percent more effective than the other, would you refuse to pay more than a 40 percent premium for the superior drug? Unless taking 40 percent more of the cheaper drug could produce the same result, a price much greater than the proportional performance difference is obviously justified by the value of the lives saved and the related healthcare costs avoided.

Now, consider some less dramatic examples. If you could buy advertising that reached all of your potential customers in an area, would you pay no more than twice as much for it than for advertising that reached only half of your potential market? That's exactly what many large advertisers argue, claiming that they should pay no higher "cost per thousand" for a large publication than for a small one. Similarly, some technology buyers argue that a chip or a switch that operates twice as fast should cost no more than twice as much. In both cases, however, negotiators are focusing on performance rather than on value.

[2]Section adapted from: Thomas Nagle and Joe Zale, “Stop Reacting to Buyer’s Price Expectations; Manage Them,” Deloitte Development LLC., 2014.

We helped a large newspaper overcome this problem by showing management how to estimate the impact of advertising and to quantify that impact for buyers. By calculating how much gross margin various advertisers would forgo if unable to reach a segment of their potential customer base, we demonstrated that the value to them of the incremental "reach" from ads in the newspaper was many times the incremental rate. Moreover, we calculated what it would cost advertisers to reach the same number of potential customers by using alternative ad media. Taking into account the duplication that would occur and the need to prepare and coordinate different campaigns, the cost was still many times more. Similarly, by quantifying the value of greater reliability in terms of avoided warranty costs and added value to the end customer, a high-tech company convinced its buyers that a disproportionate premium was justified.

In each of these cases, the seller's disadvantage in price negotiation may be a devious purchasing agent—or simply a buyer who understands no better than the seller the true value of the product being purchased. In either case, when you understand your product's value and communicate that value to buyers, you create buyers who know the value of what you are offering them and who know that you know. The net result is a lot more leverage in price negotiation and, likely more profitability.

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Dr. Thomas Nagle is a senior advisor of Deloitte Consulting LLP and a member of the Pricing and Profitability Management service offering within the U.S. Strategy service line Monitor Deloitte. Dr. Nagle has been consulting on pricing for nearly three decades and personally developed many of the analytical tools for strategic pricing. He has extensive experience helping corporate clients develop and implement profitable pricing and value communication strategies, most notably for industrials, medical products, and information and is especially passionate about helping clients build marketing strategies and sales capabilities that drive growth in profits, not just sales.

Dr. Nagle founded the Strategic Pricing Group (now part of Monitor Deloitte) in 1987 soon after publication of the first edition of *The Strategy and Tactics of Pricing*. The book, translated into nine languages, remains a top-seller on pricing and a widely-adopted text on pricing at business schools. The fifth edition, co-authored with Joseph Zale, was published in 2010.

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