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# Common Cents: Managing the Perils of Retail Pricing

Price execution principles still apply with price optimization

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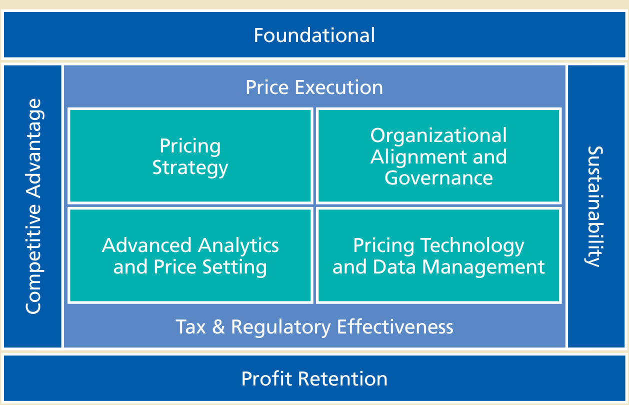
Retailers today face fierce competition, rising costs, eroding customer sentiment and mounting investor pressure. Pricing is one frequently pursued response that stands above the rest in terms of return on investment (ROI) and measurability.

> "Mind the pence, and the pounds will take care of themselves."
>
> – Old English Proverb

Pricing is a critical lever for most retailers and is uniquely tied to both top-line growth and margin generation. Recently, retailers have focused on price optimization software in order to amplify the earning power of their pricing processes. While extremely powerful in application, price optimization software only delivers benefits when executed properly. Retailers can arm themselves with the best management team, advanced software and a stream of data-driven decisions, but these strengths can evaporate if store employees fail to execute the company plan or if corporate data is improperly architected for the system. In reality, the "perfect" price is useless if it never reaches the eyes of a customer. Too often execution errors plague retail environments, thereby thwarting potential pricing benefits. The bleak question confronting retail leaders faced with an unexpectedly low ROI in their pricing program thus becomes: "Now what?"

**Figure A: Core Pricing Competencies**




Source: Deloitte Consulting LLP

Pricing effectiveness requires retailers to close the gap between strategy and reality. Six competencies, as illustrated in Figure A, rest at the core of pricing excellence. Achieving execution proficiency, the keystone of any pricing program, requires a holistic approach that considers core operational concepts in addition to innovative strategy and scientific techniques. An optimized price that fails to be executed in stores is a defect of the pricing process. Advanced analytics that apply elements of neural networks, Six Sigma, statistical process control, and behavioral demand modeling can help curb pricing defects. Nevertheless, to be successful a retail organization must leverage the science of pricing to support – not replace – accountability and the fundamental principles of retail execution. Given today's challenging environment, price execution represents an opportunity to improve the bottom line while positioning stores for future growth.

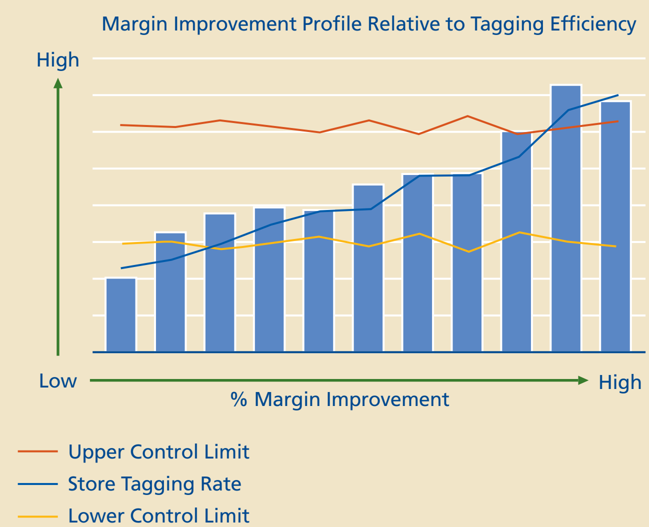
# Critical Steps to Realizing Anticipated Benefits

The optimal price of a product depends upon an organization's goals. Sometimes the goal is to maximize promotional revenue; in other situations it may be to maximize clearance margin while not significantly impacting unit volume. Whatever the goal may be, successful price optimization undoubtedly rests on successful execution. In Deloitte's experience, price execution errors can originate within both the corporate and store hierarchies. That is, a pricing defect can originate and compound during any one of the many critical steps including price tag execution, point-of-sale price overrides, data integration, as well as policy alignment and implementation. Therefore, an effective price execution initiative requires a cross-functional approach to realizing the correct prices in stores.

# Price Tag Execution: Find and Tackle the Defects

When was the last time your organization audited tagging compliance in stores? What was the compliance rate? The answer is of critical importance since the ability to discern pricing benefits is predicated upon a retailer's ability to efficiently tag prices, as illustrated in Figure B. As a retailer's tagging efficiency improves, their ability to positively impact the anticipated margin improvements should improve as well.

**Figure B: Execution Can Drive Profitability**




Source: Deloitte Consulting LLP

While not a complex or revolutionary process, store audits are usually inexpensive and insightful; the results of which can quickly reveal whether defects exist within the price tag process. Tagging defects can drain margin from stores and prevent price strategy from extracting the projected benefits. Worse yet, consistently low tagging compliance may result in greater issues including lawsuits from the attorney general's office, lost vendor development funding and declining customer loyalty.

The most comprehensive tagging compliance audits randomly select a sample of stores across multiple markets and price zones to determine the percentage of products that were tagged at the intended price. Large store-to-store variances often indicate broader execution defects, while tightly clustered dispersions usually indicate systematic defects across multiple stores. Plotted over time in the form of a p-chart (a statistical tool that relies on the fact that only two outcomes are possible: the right tag or the wrong tag), audit information can supply the data points needed to monitor if tagging has deviated beyond standard operating variability.

There is often no quick fix for tagging compliance issues – and no substitute for an end-to-end assessment. Retailers should start by monitoring the procedures over the course of a week. This process should provide an understanding of the current practices as well as insights into the reality of store execution. Next, companies should break the routine. The complexities and relationships behind successful price execution requires cross-functional and cross-operational (e.g., corporate and store personnel) process owners to gather and discuss tagging defects with a focus on three key metrics: severity, frequency, and ability to detect. The higher these defects are, the higher the priority should be to address them. All process owners should also provide their current practices, requirements, and challenges related to executing a tag within a store. The resulting process matrix (Figure C) should provide a framework for addressing the root cause of tagging defects.

# Price Override Behavior: Controllable vs. Non-Controllable

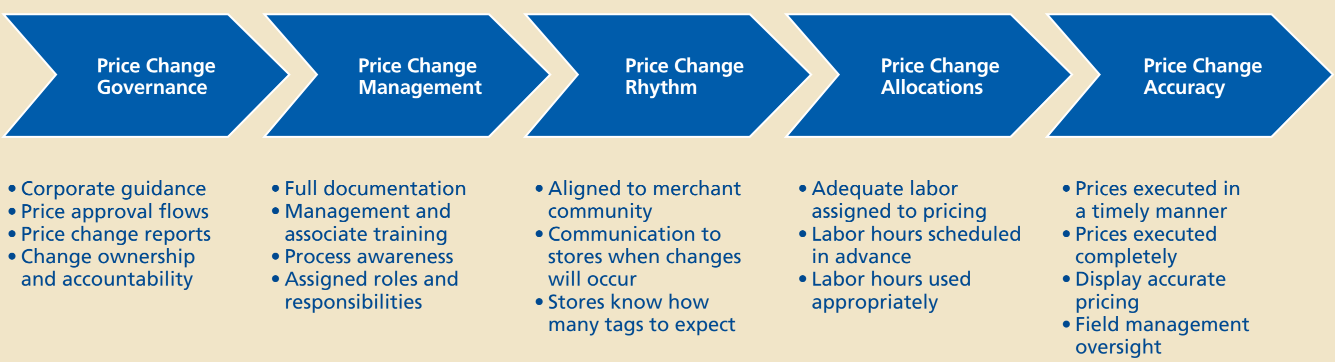
A retailer's prices carry a key message to its customers. Yet that message can be obscured by price overrides. A coupon applied when the customer was not aware of a special promotion, an inaccurately keyed item code, or a product on the wrong shelf can all muddle the pricing message and confuse the customer. Three short, but often unanswered questions reflect the complexities of price overrides:

- What is the organization's current price override rate?
- Is the company's override trend increasing or decreasing?
- What do price overrides cost the organization in a given year?

The questions become even more complex when applied to the category or market level. Uncertainty may arise when employees turn or do not turn to price overrides to close a sale. Some workers may view the idea of a few dollars off of a few sales each week as ultimately benefiting store financials. In your organization, would this decision be controllable and acceptable within the current pricing policy? Or, does a decentralized decision made by an associate represent a break from the company's strategic policy? Unfortunately, repeated abuse of pricing overrides can lead to price leaks totaling millions of dollars per year. Price override rates in excess of an industry's benchmark rate may indicate that significant defects exist within the company's processes.

A detailed data mining process and assessment of scan price behavior across stores can reveal whether defects exist within the current price override processes. Multivariate analysis coupled with Monte Carlo scenario simulation (algorithms that run constrained models hundreds or thousands of times to understand overall sensitivity) can illustrate the

**Figure C: Price Change Process Review**




Source: Deloitte Consulting LLP

factors influencing store behavior and depict the potential aggregated impact on company financials.

Broadly speaking, a price execution defect with respect to price overrides can be defined as an unacceptable percentage of transactions impacted by an override during a week, quarter or similarly relevant time period. To determine the magnitude of the issue, retailers can employ a cascading series of data, processes, and root cause analyses.

A cause-and-effect matrix can help a team identify the interplay of financial and marketing pressures exerted on store associates that encourage overrides. This tool yields a framework for a deep-dive analysis into the process. Another tool, a fish-bone diagram, can be leveraged to formally drill through the reasons why a problem is occurring. The process of creating the diagram also raises awareness about common problems across departments and the operating nuances of each department.

Fortunately, almost all transactional data is imbedded with information related to the time period and conditions in which a sale occurred. The challenge is to unlock the knowledge in support of business decisions. To do this, advanced analytics are needed. A time-lag neural network is a sophisticated mathematical model that has the ability to iteratively loop through historical data and discern patterns in a seemingly chaotic series of transactions. This science can deliver the forecasting and sensitivity analysis needed to make the right decision with respect to override source and frequency.

While many tools exist, the goal of price optimization is always the same: foster a collaborative environment focused on meeting the business objectives. As retail companies begin to address the price override process through data gathering and analysis, certain interrelated issues should be addressed. At the core of controlling override usage is governance, for without policy, there is little means to define acceptable behavior. Once a sales force is aligned to a policy, focus can progress to price override analytics. The results of this analysis can frame the context for realizing the price that is set at the register.

## Case Study: Curbing Promotional Price Overrides

A home improvement and hardware retailer observed severely inconsistent average selling prices for products across its stores. To solve the problem, a process improvement approach was instituted by the project team:

- **Define:** A pricing defect was defined as a scan price that rings beyond +/-1% of the intended price.
- **Identify:** Historical data was collected for a six-month period along with new data for two weeks to track a store-level price override rate.
- **Analyze:** An in-depth statistical analysis revealed high correlations between product promotions and the company's special "low price guarantee." Deeper root-cause investigations by a select team unveiled discrepancies in the way a "low price guarantee" was honored. Some stores matched competitive prices only during the promotional week while others matched for varying amounts of additional time.
- **Improve:** A new policy was authored that defined the price match guarantee as the week of the promotion only. Additional verbiage was added to the mailings and the online store.
- **Control:** Scan prices were tracked over a six-week period following the execution of the policy changes.

Within three months, scan price realization improved by 1,700 basis points. In addition, revenue and unit sales metrics remained within expected performance ranges. Once the promotional price realization issue was resolved, the retailer refocused on managing the right price through scientific tools.

**Figure D: Price Override Process Review**


Source: Deloitte Consulting LLP


## Data Integrity: From Start to Finish

The lack of data integrity can very quickly derail a pricing initiative. Far too often, organizations are primed to implement price optimization software — the contracts are signed, the business case is positioned — yet software implementation is delayed because of data integrity issues that end up costing the company money. The pressure is on.

At times it's not about price optimization, but instead the organization is using targeted analytics geared toward improving profitability through pricing. Sometimes a change has been made to pricing and the company is entering the scorecarding, or measurement, phase. Regardless of the exact scenario, organizations frequently move too quickly without respecting the importance of data integrity relative to the momentum of a pricing initiative.

In hindsight, data issues frequently become obvious. The Information Technology (IT) department may have been contacted to pull and package the data for the pricing initiative, but often no one from the business unit provided the necessary quality assurance. More importantly, incorrect methods may have been employed to validate the definition and source of each data element. In either case, IT provides the fields requested, but the true meaning and derivation of the data were not validated. Therefore, to help minimize the errors up front and enable a smooth transfer of data, retailers should ask themselves the following questions:

- Does the organization use a consistent cost field across the various business units?
- Is the cost field the same as that used to calculate merchandising and store personnel incentive rewards?
- Does an item's price represent the price before overrides or after?
- How are bulk orders and bulk discounts entered?
- Are returns included? Are employee-discounted sales included?
- What channels (Web, phone, catalog, store, etc.) are represented by the data?
- After what period of time does competitive data become irrelevant?
- Are price or price zones appropriately coordinated and aligned to the competitive data?
- How do industry and company accounting regulations shape revenue allocation?

The fact remains that no data set is perfect and uncertainty is expected. Nevertheless, by considering these questions upfront, retailers can apply their data most effectively in support of pricing initiatives. The more retailers integrate their IT and business functions when validating data, the more likely the organization will feel comfortable that integrity needs have been met. Furthermore, the organization will likely benefit from creating a consistent process and open channels of communication between various groups regarding data availability and transfer.

## In Conclusion

Investing in price execution capabilities can often reap profitable rewards for retail organizations. Developing price recommendations to meet business objectives is only the start of the price improvement process. Like other business processes, pricing can only provide its maximum return when coupled with an organization that is capable of tactically executing its strategy. By focusing on process defects using an advanced analytical framework, retailers can help promote a sustainable pricing process. Furthermore, the proper application of the science of business to common challenges can lay the foundation for future price improvement. For this reason, the ability to proficiently execute can enable a retailer to surmount the perils of pricing.

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