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Vartan Vartanian, President, Industrial Market, Regional Sales & Service of SKF, Sweden

Creating and Communicating Customer Value:

How companies can set premium prices that customers are willing to pay

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The SKF mission is to equip customers with the knowledge they need to improve their profitability. SKF is a leading global supplier in the areas of bearings, seals, mechatronics, services, and lubrication systems. The Group's service offer includes technical support, maintenance services, engineering consultancy, and training. SKF is represented in more than 130 countries and has 15,000 distributor locations worldwide. The Group's annual sales were SEK 66,216 million, and the number of employees was 46,039 in 2011. www.skf.com.

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ABSTRACT

Correctly pricing and selling the value one creates is at the heart of business in the twenty-first century. If a supplier creates incremental value, then it must be communicated and demonstrated in such a way that the buyer realizes the value and is willing to pay for it. If value can be quantified into measurable dollars and cents, and if it can be shown when and where it will have an impact on the customer's bottom line (B2B or B2C), customers will be more willing and better able to pay for it. A supplier's marketing must change from vague brand promises to tangible value created. Companies that can innovate, create, and communicate value in ways that customers can understand enjoy greater customer retention, higher margins and sales, and happier customers. In cases where procurement has no evidence of lowest total cost of ownership (TCO), customers have no choice but to focus on the one measurable differentiator: lowest unit price.

Key Words: Total Cost of Ownership, TCO, Value Pricing

Introduction

How does one get paid for value created? This question has been asked by every premium player in every market around the world. If a supplier creates value, and if that value requires investments, then it must find a way to obtain an equitable return on that investment, or the wheels of innovation will stop.

Successful companies allocate money to develop processes and cultures, and have the right people focused on finding innovation and on bringing that value to the market. The companies that are best in class in value-selling realize a 60 percent higher customer-retention rate, a 17.9 percent difference in year-over-year growth in company gross profits, and larger deal sizes (Aberdeen, 2011).

So why is it that so many companies still adopt a market-share or cost-driven strategy rather than value-based pricing? Companies that employ a good value-based pricing strategy are 20 percent more profitable than those with weak execution on value pricing, and are 35 percent better off than those that follow a cost- or share-driven strategy (Monitor Group, 2011).

Since the financial benefits of value creation and pricing are well known, why do so many companies fail to achieve the results they seek after they have done the work to create something that is of value?

Either they do not truly create customer value, and therefore cannot value-price for it; or they have not allocated the necessary resources to convert the value created into something that a customer is able and willing to pay for. Companies that choose a low-priced, commodity approach to their offerings will always be at the mercy of the next competitor to offer an “almost as good product at a lower unit price.” For those that do invest and create customer value, it is time to do the work to capture that value.

We will delve into a case study of an industrial firm in a tough market. This firm has found a way to convert the value of its premium performance products and technical knowledge and to communicate it to customers so that they are willing and able to pay for it.

Current Approach: Total Cost of Ownership (TCO)

When a company is able to understand where value is created throughout the asset lifecycle, it can price for part of the incremental value created. But first it must understand what costs and values are incurred and generated, and where, when, and by whom. In general, the concept of *total cost of ownership* (TCO) is the best model to use to find these factors.

The existing literature and market consensus is that total TCO is the “sum of purchase price plus all expenses incurred during the productive lifecycle of a product, minus its salvage or resale price” (Anderson & Narus, 2004). TCO is exclusively concerned with the cost side of customer value and thus neglects the value of customer-specific benefits (Anderson & Narus, 2004; Piscopo et al., 2008).

Future Approach: Total Cost of Ownership

Quantifying customer value along all relevant dimensions

To truly understand TCO, a supplier must ensure that all dimensions that affect the net profit generated for a customer are measured. The Gartner Group attempts to do this with a TCO variation called *total value of ownership*; however, the word “value” here refers to soft benefits such as ease of use, comfort level, or happiness of a user.” Although these soft values should be considered, a whole area of value creation has been missed: the revenue side. A true TCO analysis should explore all dimensions that affect the customer’s net profit. Therefore, a wider explanation of TCO—one that looks at the difference between the next best alternative of an

option, and that takes into account all increased or decreased revenue minus all increased and decreased costs over the life of an asset—allows one to determine which decisions are the most profitable.

Thus, suppliers that are able to help their customers increase revenue, expand margins, enter new markets, sell an “upgrade option,” and/or enter into longer customer relations create a benefit for the revenue side of their customer’s balance sheet that needs to be measured. A few real-life examples of an expanded TCO view follow.

The first example involves increased margin or sales for an original equipment manufacturer (OEM). When a supplier is able to help an OEM make a better piece of equipment, it can use that differentiated value either to sell more than its competitors or to value-price for it. However, if the supplier cannot help the OEM show its customer the value created, that value becomes “lost in translation” between the supplier, the OEM, and the product’s final customer. In such cases it is incumbent upon the supplier to work with the OEM’s product management, sales, and marketing teams to help them not only make a better application but also be able to sell that value to their customers.

A global OEM, after being pushed by field sales, decided that it needed to make a product that offered some customer features and benefits that were different than its competitors’ rather than trying to make a good-enough, cheap product that everyone in the market was focusing on. The OEM worked with an established partner and added not only high-quality branded components but also a solution that lengthened their application’s maintenance intervals relative to their competitors’, because the bearings did not have to be greased. In this case the value created for the OEM was the increased net margin they were able to obtain in the marketplace by having a differentiated product that they could show customers would have a

lower operating cost, would require less maintenance and less lubricant, and would cost less to dispose of. In taking an expanded TCO approach, the OEM was able to realize higher profits by creating and selling value. If it had taken the existing TCO approach, it would have viewed the price premium for these greased-for-life bearings as a “cost increase” and not taken into account the increased price premium for which its application could be sold in the marketplace. To do this the OEM was shown the value via TCO reduction that its customers would obtain and given the sales, marketing, tools, and training to be able to articulate that to its customers.

A second example is the well-known “Intel Inside” designation. Let’s assume that the Intel chip is better. Does it help the PC maker? Not really. It’s the person who buys and uses the computer—who now has a machine that uses less energy, is faster, or crashes less—who benefits. That value would have been lost inside the machine if Intel did not find a way to either pull customer demand or support their computer manufacturers with “Intel Inside” market communication to push this “value.” The marketing term *ingredient co-branding* describes this situation.

Let’s consider another example, in which a firm helps a user operate a piece of equipment that is more reliable, that runs at higher production speeds, or that generates less scrap waste. In the existing TCO analysis, no value is taken into account for the profitability that is generated by the better running machine. In one case, an operator was able to increase the throughput of his process by 1.5 percent, which yielded a net profit of over \$18,745,000 annually. The investment was justified only because the increased-profit side of the TCO model was included in the analysis.

What Do Customers Really Care About: Total Cost of Ownership and Net Profit, or Lowest Unit Price?

Before devoting the necessary time and investments to calculating the full TCO for a new product or customer, a supplier must first ask, “Do any of our customers still even care about value? Or in today’s world, is it always about the lowest price?” Sales teams continue to send market reports back indicating that they’ve lost deals because the supplier’s price was too high, and that the value it offers customers is not appreciated, so customers won’t pay for it. In too many instances, people transpose the terms “cost” and “price.” These are two completely different concepts. What customers want is the lowest total cost, since that will drive their profitability. However, if a company is unable to measure the values that it creates and how these either help increase revenue or reduce other costs, its customer will focus on unit price instead of total costs as they become conflated in the customer’s mind.

Customers and procurement professionals do seek value as measured by TCO. Respondents to a 2008 *Purchasing Magazine* survey reported a continued decline in the importance of purchase price, whereas the importance of TCO remained flat. Not surprisingly, a 2007 study sponsored by the International Association of Commercial and Contract Management (IACCM) found that customers rank TCO as being nearly two times as important as unit price (Strategic Account Management Association and International Association of Commercial and Contract Management, 2007). Procurement professionals and management teams are realizing that unit price is only a subcomponent of total cost, and that those price savings usually do not find their way to the company’s bottom line.

Where Costs and Benefits Exist in the Four Stages of an Asset Lifecycle

It is essential that a supplier know where the value and costs exist within the lifecycle of the asset that it is involved with—to know who obtains which benefit, and who is asked to make which investment. Sometimes an investment occurs in one stage and the benefit emerges elsewhere.

It all starts with the *design phase*. For example, an OEM works with its component suppliers and aggregates these components into a functioning asset that has utility. Here is where decisions about operating and disposal costs for the user are made, such as what material to use, what tolerances the machine should be made to, how long the product will last, how expensive it will be to operate, and so forth are made. These operating attributes are intended to be trade-offs between what the customer wants and what they will pay. This phase is where miscommunication sometimes occurs. The constant reports from the field that customers don't want something better or that they do not value something lead product designers to reduce costs, usually by substituting *similar products* that have a lower unit price. People become confused about whether the customer seeks the lowest price, or the lowest cost. As the aforementioned research shows, they seek the lowest costs. Thus the supplier must ensure that it can demonstrate how the performance of its product(s) will reduce customer costs and/or increase revenue. If it is unable to demonstrate this, then the term *lowest price* becomes the discussion point.

The operating costs incurred by and benefits to the user who buys this product from the OEM can be broken down into the following three stages.

The approach starts with a close look at the *acquisition process*, including receiving costs, payment terms, holding inventory, and unit price. When asked

whether they measure TCO, some procurement professionals will say yes. A follow-up question usually reveals that these are the indicators being measured. These are, of course, important measurements; however, in most cases they are just the tip of “The Priceberg.”



Next is the *operation phase*, during which the buyer uses what has been purchased, and in which the sometimes less visible costs below the water line come into play. Included here are factors such as how long the item lasts, how much energy it uses, and whether it can increase the throughput of what it is helping to produce, affect scrap rates, be easier and predictable to repair, and so forth.

Finally, the buyer needs to *dispose* of what has been purchased. Disposal can range from being almost free to very costly; the item may even have a residual value. For example, the cost to dispose of lubricants after their use can be as much as 2.5 times more than the cost to acquire them.

The breakdown of these costs into the different categories can vary as a result of many factors, but numerous studies show that the initial purchase price of an industrial application (such as a pump, fan, or gearbox) is 12 percent of its total cost (Accenture, 2009). Simply put, should you focus on reducing the acquisition price of an asset, when it is only 12% of its TCO, or on buying a better asset that has the lowest operating and disposal costs, that covers 88% of its TCO? The better asset that is more “expensive” up front might just have a lower TCO.

Lets take for example an industrial asset, such as a pump, that follows the Accenture Study and 12% of its cost is the acquisition price while 88% is its operating and disposal costs. These pumps could have the same ISO specification. It should be noted that ISO is a conformance measurement, and all things that have the same ISO specifications do not have the same performance. We will assume two options exist, a \$1200 initial purchase price pump with \$8800 in operating and disposal costs, or a TCO of \$10,000. Versus a better pump that costs \$1500 to buy but uses \$350 less energy, \$250 less lubricant, enables you to predict its failure meaning it can be repaired for \$235 less, saves one event of unplanned downtime which equates to 1 hour lost production at \$7500, and the pump lasts 20% longer . Its TCO is purchase price \$1500, + alternatives operating costs of \$8800, - Costs Saved of $(\$350 + 250 + 235 = \$835) +$ Revenue Increased $(\$7500 * 10\% \text{ operating margin} = \$750) +$ the \$1500 pump has a 20% longer life meaning it has to be replaced less often saving 20% of its initial purchase price $(20\% * \$1500 = \$300)$. By getting the supplier to help calculate the TCO the Low Price Product costs the company \$10,000 and the better product doesn't costs the \$1500 + \$8800 costs that are assumed or \$10300, it actually costs almost \$1900 less. $\$1500 + (\$8800 - \$835 - \$750 - \$300) =$

\$8415 or a \$1585 savings. In this case, like most, the 25% more expensive pump actually ends



up costing almost 16% less.

Looking at a far simpler example, what does the average person consider to be important when purchasing a car? Intuitively, once the specifications are chosen, such as a four-door family sedan, with automatic transmission, air conditioning, and a certain size engine, then one could assume the choice is made based on a unit-price comparison of the options that meet those criteria. However, the costs of owning a car do not end with the initial purchase. The operating costs such as fuel consumption, average cost to repair or service, financing, insurance, depreciation rates, and numerous other costs live well beyond the acquisition of the car. With this data, one might find that the car that initially appears to be expensive will actually provide the *lowest total cost*, and is therefore a better deal. In some cases the costs to insure different cars having the same features and specifications are very different. Since insurance is a mandatory cost, the cost differences should be included in a TCO analysis. Edmunds, a website for car buyers, has created their own TCO acronym, “true costs to own,” which allows customers to calculate the differences between cars <<http://www.edmunds.com/car-buying/true-cost-to-own-tco.html>>. The Accenture (2009) report shows that for light-duty trucks, the initial purchase price

is only 12% of its TCO, whereas for commercial aircraft it is 8%, and for Class 8 vehicles (large tractor trailers) it is 11%.

Because of the wealth of data that exist in the marketplace today, the ability to apply the concept to everyday purchases is now more feasible in the B-to-B and B-to-C worlds.

The Key Steps for Successful Value Pricing and Value Selling

The first step is to determine what is of value to one's customers, creating products and services that deliver that value, quantifying that value, pricing for the value created, and then communicating that value so that customers are willing to pay for it.

Sales and marketing should spend their time understanding where they affect a customer's profitability—rather than arguing with their own management that their products are priced too high, or finding numerous creative ways to discount in the marketplace.

Creating the right products and services in order to price for value

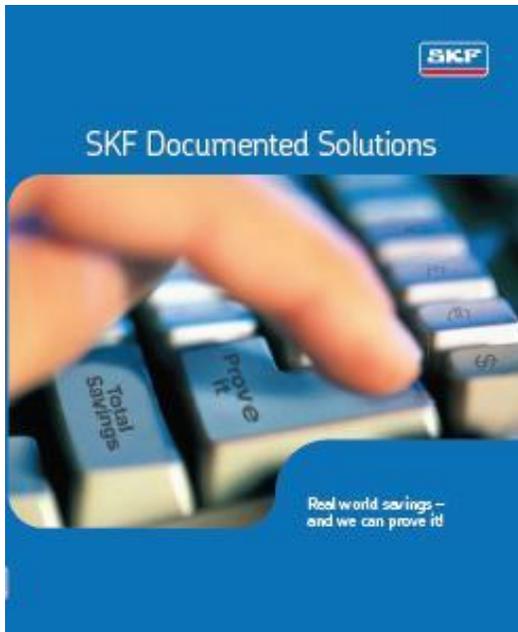
The journey must begin with creating products and services that have customer value. This value needs to be compared with the customer's next best alternative. A company's customers always have a choice, whether it is to do nothing, to buy someone else's (different) option, or to buy the company's offering. Value is not realized in the mind of the engineer who creates a product; it is realized only when the customer uses that product and obtains something they value. By "value" we mean something the customer is willing to pay for. Numerous tools exist for helping companies in this area, from voice-of-the-customer analysis to value-mapping to simple surveys and the like. Simply put, customers are not in the business of buying products or services; they are in the business of making money. A company's offer had better help them accomplish this in some way.

Quantifying that value

Once a company has a solution that offers the customer a benefit, it must quantify the benefit that the user or users will receive versus the investment it is asking them to make. The term *investment* is used to denote the price differential between the company and the next best alternative, otherwise known as the price premium. If the company's marketing uses buzzwords such as longer, more, less, faster, quicker, better, or a list of hundreds of more generic benefit statements, then these need to be quantified. How many companies will allow their employees to buy something they want? A business case needs to be created. The question is, by whom? Is it the job of the supplier, or the person wanting to buy the solution? Presumably the company knows more about how its solution creates value, and has an interest in supporting the buyer in justifying the investment in its solution. A recent study shows that 90 percent of buyers require a business case to change what they are doing and that 81 percent of them expect the supplier to deliver it (Alinean, 2011).

A tool that allows the sales force to sit down with a customer and run the expected business case is what is needed. The tool should not just guess at some "maybe" benefits. Best-in-class tools have the following characteristics.

- All inputs are changeable.
- Proof points are supported by references and technical reasoning.
- Ranges of expected numbers that help focus the discussion based on reference points.
- Database that shows where other users have obtained benefits, and what the impact was.
- Clearly understandable calculations. The goal is not to confuse one's customer into buying something. The logic and calculations should be obvious.



Now that the customer has a realistic business case, with the reasoning behind the case, references for the reasoning, support documentation, and an understanding of how the business cases was developed, a business discussion can occur. The premium value pricing can be seen as an investment. However, if the customer believes that the supplier is engaging in a value-pricing exercise (the more value he agrees to, the higher the price the supplier will charge), the supplier will encounter resistance. This exercise should be used to justify the supplier's price. We will later discuss how this value quantification helps in the initial pricing process.

All the customer can question now is whether the supplier will guarantee such performance, the probability that this will occur, whether the value created is aligned with the customer's goals, and the political question "Does the person investing in the solution belong to the department that will reap the benefit?" The supplier needs to have programs and answers for these reasonable questions.

At a 2010 Winning with Procurement conference, hosted by Huthwaite International in the UK, Paula Gildert, the head of R&D procurement at AstraZeneca, offered an interesting

summation: “Suppliers often don’t come to us with a business case. But it’s what we want. Sell your value in our numbers to get our attention. But if you can’t quantify your value – don’t be surprised at the failure of procurement to do so.”

Pricing for the value created

Once a supplier has created value, and has quantified that value in terms of a comparison with the next best alternative, it is time to price so that the supplier and the customer each gain an equitable return for the investments that will be made or have been made.

Since different customers, different segments, and different groups within the value chain all have different value created for them, it is important to start with who obtains what value and where in the asset life cycle. After a supplier runs numerous simulations, based on best available data, industry benchmarks it knows, and assumptions on improvements based on its test data, it can begin to obtain ranges of impacts for different customer segments. Whether it can support many different price points will then depend on its channels to markets and the type of product or service it is selling. For simplicity’s sake, a supplier would choose a price for its new offering based on the average incremental value created versus the next best alternative, where the value surplus that the buyer receives is enough incentive for them to try the new offering. This ratio will change based on the hardness of the value created and the time frame. If the value is immediately recognizable and very hard in measurement terms, the supplier can charge a higher proportion of this value. However, if the payback is longer term, the hardness of the value less visible, and the certainty less, the supplier would and should retain less of the value surplus.

When the value is created through the OEM, the supplier must calculate the incremental value that the user of the products received and then work backward to value-price. For example, if a supplier’s offering helps an OEM create a machine that lasts longer, uses less energy, and is

less expensive to repair, the supplier would need to calculate how much value it creates for the user of the machine and then price for that as well as help the OEM explain that value to their customers.

The Process

- Calculate ranges of customer value.
- Determine production cost.
- Determine whether there is enough profit to move forward. **If not, STOP.**
- Determine a sales price that maximizes one's profitability, with enough incentive for customer to move, versus next best alternative.
- Sales and marketing must work on increasing the understood customer value.
- Engineering, quality, processes focus on production efficiencies.



Pay for performance agreements, where suppliers are paid on their ability to increase the measurable value created versus the existing situation. A new book, *Vested Outsourcing, Five Rules That Will Transform Outsourcing*, based on research from, University of Tennessee, shows how and why companies that engage and reward their supply base around value created become the most profitable. (Vitasek, 2010)

Although value pricing is the usual and most visible way of capturing value, other options such as increased share of customer wallet, less discounting of overall business, longer

customer agreements, and even a consulting fee for finding the cost-savings ideas might be more palatable and easier for the customer than a price premium alone.

Communicating the price premium

The supplier may have found value that its customer cares about, and may have created it, measured its financial impact, and priced appropriately for it, but if it cannot communicate that value in a way that the customer understands and appreciates, the whole exercise is likely to fail to yield the desired results. Let's discuss two main points: the use of the word *value* and what the customer hears, and the use of industry and technical jargon-laden pieces.

“Value” has begun to acquire a negative connotation in the marketplace. First, the word is constantly overused. However, and more important, “value” has come to be associated with low-priced offerings. Think of the advertisements one hears about store brands, low-frills airlines, low-priced knockoffs . . . they all offer VALUE. The underlying message is that the only thing that creates value is a low acquisition price, that no other attribute creates a measurable or meaningful value. Even though that might be true for some of these product categories, it is not what I mean by value.

The word has also been used to encompass all the soft things we “enjoy” in a relationship. A value supplier is responsive, listens to its customers, and offers things it does not charge for. Basically, it creates *soft value*.

Finally is a term coined by Marco Bertini, an assistant professor of marketing at the London Business School, that I think sums up an issue I see in technical sales all the time. He calls it the “*the curse of knowledge*”: “When we know something, it is difficult for us to imagine not knowing it or to understand why others also don't know it. As a result, we often find it hard to communicate and collaborate effectively with others.” In technical industries, we see

communication material covered in industry language because we feel we are customizing our message. Even if a supplier's audience is a technical buyer, the supplier will need the commercial buyer's involvement. The supplier should not make the mistake of replying on the customer to translate its marketing message of longer, better, faster, more reliable, harder, or safer, into a business case for their company.

So let's not throw the word "value" around, unless we are willing to quantify it. It is more appropriate to speak of the financial impact that is created for the customer—and that impact must be expressed in dollars and cents, or euros, or . . .

The infographic is titled "The 360° Solution" and "SKF DOCUMENTED SOLUTIONS PROGRAM". The main heading is "Buying low-priced products and still not saving any money?".

What is the SKF Documented Solutions Program?
The SKF Documented Solutions Program uses powerful software to show you how much SKF products and services help you reduce your total cost. The software calculates Return on Investment (ROI) to justify your investment in a particular SKF solution.

Documented Solutions Proven
How can you trust the forecasted savings? Because you plug your numbers into the Documented Solutions software – for materials, labor, downtime, energy costs, inventory, lubrication, replacement costs and more.
You'll see actual, bottom-line results of solutions implemented in your industry and others, and learn what facilities with challenges similar to your own have achieved.
To set up a session to explore your potential for savings, call your SKF Authorized Distributor or SKF sales representative.

Investing in SKF® pays off big time... in no time.
For critical applications impacting production, investing in SKF® products is easy to justify – their high quality and performance help the application run more efficiently, and extend the machine's Mean Time Between Failure (Repair: MTBF/R).

But what about non-critical applications?
Is it good business to purchase lower cost, lower quality products for non-critical plant productivity equipment? And wouldn't SKF products have to help that equipment run far beyond its anticipated MTBF in order to justify choosing them?

Actually, no.
Even less critical equipment benefits from SKF knowledge. The minor savings from lower cost, lower quality products is overwhelmed by TCO savings. In fact, only a minor MTBF/R improvement supports your choice of SKF. It may sound hard to believe, but by plugging the numbers into SKF Documented Solutions software, we can prove it.

The bottom line?
For even the most non-critical applications, and even when SKF products cost three times more than the competition, a facility would only need those applications to run about three weeks longer to justify the additional investment.
See how we prove it with the SKF Documented Solutions example on the reverse side of this sheet.

Total cost of ownership

Brand X (Low price)	SKF
Product cost	Product cost
Ownership costs	Ownership costs
Total cost of ownership	Total cost of ownership

Substantial savings on ownership costs

Savings from lower price

SKF

Implications for innovation in pricing

As has been suggested before, the pricing discussion must be part of the whole new-market development process, and it should provide that sober second thought that challenges the

wild assumptions of engineers and product developers. Suppliers must keep asking “If value is really created versus the next best alternative, what can be charged for it?”

This discussion requires a true understanding of the TCO, including all profitability factors, and all costs and all revenues that have been created for each party along the value chain. If a supplier is trying to persuade an OEM to pay for value that will be realized by someone else in the value chain, then it must be able and willing to help the OEM communicate and capture part of that value. The theory of willingness to pay needs to be updated to a newer version—ability to pay—which will be based on the soundness of the supplier’s business case. At the extreme, a customer’s willingness to pay will be based on their ability to pay. If it’s a guarantee of performance and benefit, the buyer should be able to take the supplier’s business case to their bank and use it as collateral to secure the investment needed to buy the supplier’s solution. Willingness to pay increases as benefits are converted into hard, measurable currency, and ability to pay changes as the value created becomes a “currency” that can be traded internally for more funding or with a local bank.

Pricing professionals may need to offer customers many different ways to pay for the value created. A price premium supported by a business case that one’s sales force customizes and can clearly articulate is only one way. Pay-for-performance relationships, in which a premium is paid as value is created, is the next evolution for some capital goods that can have clear measurement impacts.

A supplier that invests to create better products or services must ensure that it can capture part of the value created. It must equip its sales teams with the necessary tools, knowledge, skills to present, and market communication collateral so that they can explain why its price premium is an investment. In closing, let’s consider a comment based on value-pricing research from

Marco Bertini, of the London Business School, “An interesting dynamic emerges when you compare the perceptions of most business customers and the reality. Lowest unit price is often assumed to be desirable. In fact, firms that are convinced to buy on value exhibit higher repeat purchase rates, which suggests they are far more satisfied” (SKF TCO Whitepaper, 2010). In using the term “convinced,” Bertini means convinced by a business case, not by smoke and mirrors.

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