70

RIEKHOF ON PRICING No 70

How to Succeed in Commodity Pricing?
Escaping the Commodity Trap.

How to Succeed in Commodity Pricing? Escaping the Commodity Trap.

"In our business, price is the decisive factor. We operate in a commodity market, and we have no chance of differentiation from competitors." I hear such statements repeatedly from my seminar participants. Of course, there are highly price-sensitive markets where this statement holds true 100%. However, not all companies have to accept this situation because there are indeed ways to escape the "commodity trap."

What is Commodity Pricing?

Commodities as a term typically designates raw materials such as coffee, cotton, copper, as well as electricity, petroleum, or hydrogen. These products are largely standardized and therefore interchangeable. Commodities are generally traded in larger quantities with regular transactions. This has implications for pricing.

How can companies with highly complex product ranges comprising, say, 20,000 or more individual products effectively map the differences in (perceived or indeed measured) price sensitivity? In our pricing projects, we work with a category model that I would like to present in this newsletter. Commodities are products that are largely standardized and, therefore, interchangeable.

This has implications for pricing

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Fig. 1: Raw materials are among the products that are largely standardized and therefore interchangeable. This has implications for pricing.

The peculiar characteristics of commodities make them well-suited for trading on stock exchanges.

When businesses believe that they are (almost) exclusively operating in a commodity market, it follows that price is viewed as the only effective or at least the dominant marketing tool. Some readers of my Pricing Newsletter may recall my thoughts on situation-based pricing, which I summarized in the LSDC matrix (see Riekhof on Pricing No. 10). For the B2B sector, these considerations can be represented in the corresponding CCIA matrix:

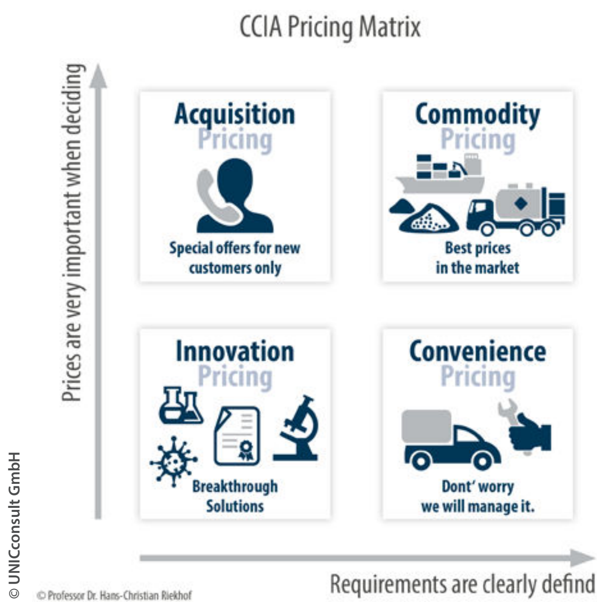

Fig. 2: Commodities in the CCIA Matrix.

Commodity Pricing mainly occurs when product and service requirements can be very clearly defined AND when price is an extremely important purchasing factor (due to interchangeability, high quantities or values, repetition, etc.). Ultimately, strategies of commodity pricing are often associated with tenders (see Riekhof on Pricing No. 61).

Commodity Pricing: Interchangeable Products and Suppliers with High Quantities

The salient features of commodity pricing include the interchangeability of products and, ultimately, suppliers – whereby price becomes the dominant factor. Which buyer succeeds on the stock exchange is a matter of price, not the customer-supplier relationship.

In commodity pricing, we are typically dealing with equivalent services and a lack of customer loyalty: services that tend to be uncomplicated and nondemanding do not allow for significant differentiation.

Commodity Pricing: Measuring Price Sensitivities of TOP Sellers

In the fundamentals of economics, we learn how to calculate the first and second derivatives of price-demand functions and how important the analysis of the relationship between price and the quantity sold is. However, what we do not learn in such precise detail are the conditions for practical applications: for example, where do the data come from that underlie the calculation of price-demand functions (see also Riekhof on Pricing No. 17).

My own empirical studies repeatedly show that very few companies use price-demand functions in pricing. Even in commodity pricing, this could be a helpful tool since it involves frequent transactions with large volumes at different prices. This tool could empirically demonstrate which products or product groups result in very large (or rather low) quantity effects due to price reductions. At the same time, differentiated analyses become possible, such as when different regions, time periods, distribution systems, or customer groups are compared in terms of price elasticity.

Fig. 3: Even if the product, fuel, is interchangeable, other reasons can determine whether one regularly visits a specific gas station.

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Theodore Levitt:
"There is no such thing as a commodity."

Marketing guru Theodore Levitt once said, "There is no such thing as a commodity. All things are differentiable." This is exactly where marketing tasks begin: creating differences that go beyond the physical properties of a product.

Even if the product, fuel, is interchangeable: other reasons can determine whether one regularly visits a specific gas station.

To illustrate this with an example: fuel with a defined octane rating is technically interchangeable, whether it's branded Aral, Shell, or Esso. Nevertheless, for many years, I exclusively refueled at Esso in Hamburg. Why? Because the owner of the Esso station was simply friendly, and we had known each other for many years. After his retirement, the service is now provided by student help; now I also refuel at Aral or Shell with the same satisfaction.

"Many companies perceive themselves to be in the commodity business. They should invest more time and energy to find out options to differentiate from their competitors, be it in terms of service, reliability, lead times or customer service. "

Prof. Dr. Hans-Christian Riekhof

Brand Preferences Even with Commodities?

Another example from the "anecdotal evidence" series: we conducted interviews with fleet operators for a manufacturer of German premium trucks some years ago to find out if premium brands are ultimately perceived as equivalent and therefore largely interchangeable. At the time, there were only very minor differences in terms of technical features, service, warranty provisions, and leasing rates. Therefore, the response of one entrepreneur as to why he had exclusively used Mercedes trucks in his fleet for decades was quite striking:

"My grandfather founded the company, and he only bought Mercedes. Why should I change the brand?"

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Fig. 4: Are premium brands perceived as equivalent and therefore largely interchangeable?

On the other hand, there is, of course, the phenomenon of brand parity, meaning that in certain segments, brands are perceived as largely interchangeable and equivalent: customers do not recognize a real difference. This applies more to the middle price range, while in the upper range of a brand segment, more distinct differences are perceived. Do you see a quality difference between Colgate and Pepsodent toothpaste?

Behavioral Economics and the Transactional Utility of a Purchase

If products are technically and economically completely interchangeable, this does not necessarily apply to the act of purchasing. Behavioral economics utilizes the concept of transactional utility: what is beneficial is not just the product itself but also the act of purchase or exchange.

Behavioral economists have found that consumers pay very different prices for the same brand of beer depending on the context, be it in the supermarket, at the gas station, at the beach bar, or in the hotel lobby. For the same brand of beer, mind you.

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Fig. 5: Consumers do pay different prices for a beer of a certain brand - depending on the context.

This finding is a small revolution for neoclassical economics but a matter of course for marketing and sales experts.

After all, I now know that refueling at Esso increased my transactional utility at the time, even though price and quality made no difference. And I usually rent my cars from Sixt - because of the transactional utility. But more on that in one of the next Pricing Newsletters.

Strategic Pricing: How to Escape the Commodity Trap?

The task of strategic pricing is to find areas where differentiation is possible with identical products and services. In the context of pricing projects, we often ask those involved where the competitive advantage of a company lies beyond (interchangeable) products. The answers are usually so varied that one would have to assume that those involved do not work in the same company. Keywords mentioned here include

- Service
- Customer care
- Accessibility
- Order processing
- Proximity
- Reliability
- (Quality) certificates
- Process validations.

In the case of these (perceived or actual) advantages, it is essential to inquire very precisely about what is meant by them and whether customers also share the company's perspective. Every sales organization is convinced that it delivers the best customer care in the region; therefore, a clear definition and the establishment of measurable criteria for "World Class Performance" in the relevant (!) business processes are required.

Measuring Transaction Processes: The CVQT Principle

Especially in customer care, it is possible to objectively compare how well business processes like order processing are digitalized, how transparent and traceable deliveries are, and what error rates are. In projects, we use the CVQT principle:

C **Cost: What are the process costs?**

V **Value: What value does the process create?**

Q **Quality: What documented error rates are there?**

T **Time: How long does the process take?**

Such quantification makes it easier to represent and measure the value contribution of services and processing.

To escape the commodity trap, you will need to find out what customers value, particularly in the area beyond (interchangeable) products. Relying on the statements of the customer care department may be insufficient.

On the other hand, if customers are dissatisfied and switch suppliers, it is often not because of the product but because of the accompanying services. These services apparently still make a difference. What customers actually value is an empirical question.

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