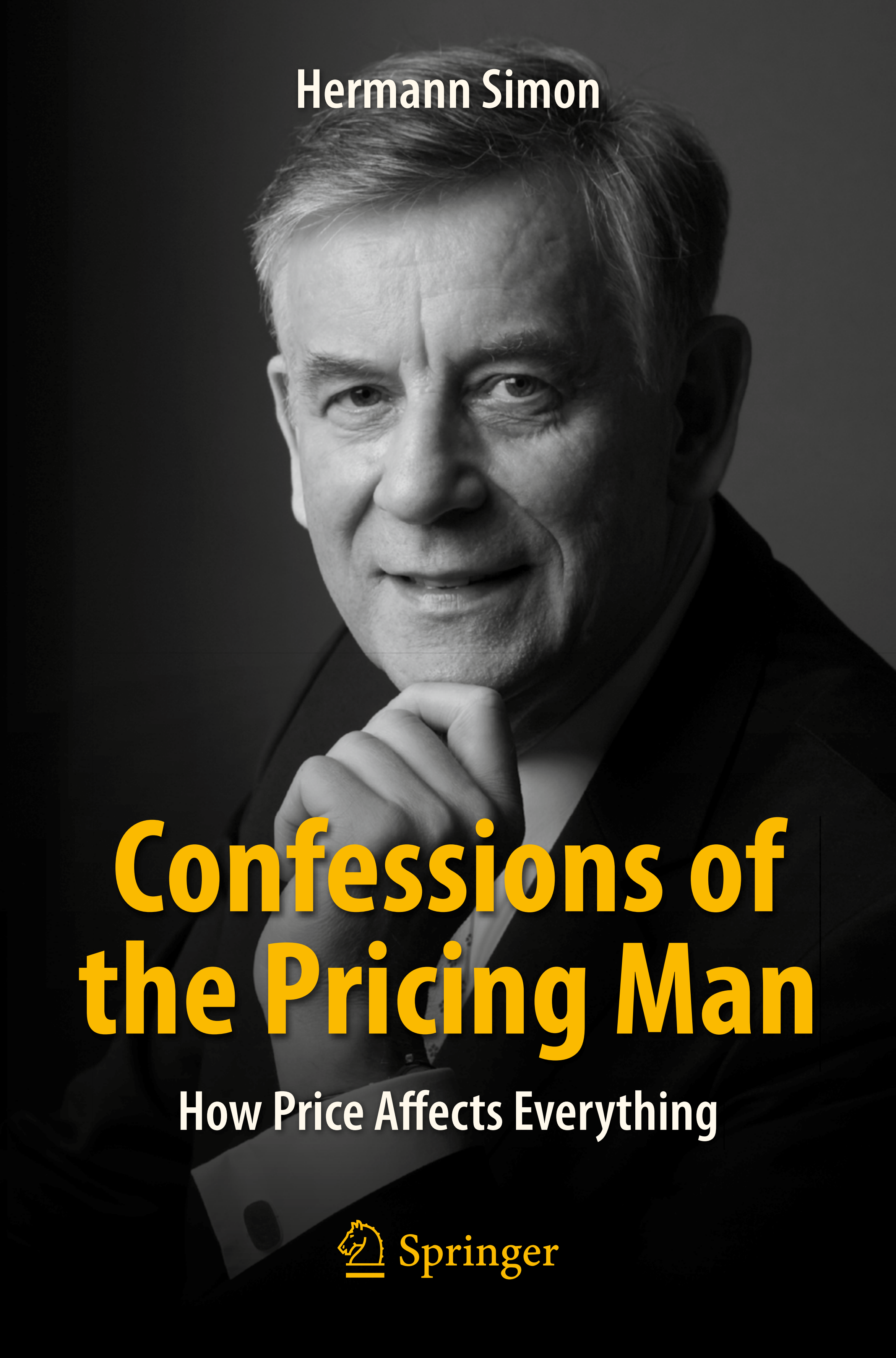

Hermann Simon

Confessions of the Pricing Man

How Price Affects Everything

Springer

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Hermann Simon
Simon-Kucher & Partners Strategy & Marketing Consultants

ISBN 978-3-319-20399-7 ISBN 978-3-319-20400-0 (eBook)
DOI 10.1007/978-3-319-20400-0

Library of Congress Control Number: 2015950470

Springer Cham Heidelberg New York Dordrecht London

Adapted from Original German Language Edition
Preisheiten: Alles, was Sie über Preise wissen müssen by Hermann Simon

Printed on acid-free paper

Copernicus is a brand of Springer
Springer International Publishing AG Switzerland is part of Springer Science+Business Media (www.springer.com)

Preface: Confessions

Prices are ubiquitous. We pay them and charge them many times a day, often agonizing over them, often giving them barely a second thought. Managers who understand the underlying dynamics of price can turn that knowledge into higher profits and a strong competitive advantage.

The challenge is that the game of "price" is becoming more and more complex. Intense competition, the maturing Internet, and increasing globalization are causing massive, disruptive changes in how consumers perceive values and prices, and thus how sellers need to set prices. Managers must remain vigilant and learn constantly.

When I started digging into the mysteries of prices and pricing more than 40 years ago, I could never have imagined that this fascinating area would evoke so much curiosity, intrigue, and innovation. Pricing became my vocation and my life's work. Over the span of four decades, my associates and I created a pioneering body of work which continues to guide price strategies and price setting for thousands of companies around the world. All this work has yielded an unrivaled store of accumulated experience, a treasure vault of practical pricing wisdom.

This book is your access key to that vault.

It will provide you the answers for everything you should know about the topic of price. These answers are just as relevant for executives, managers, sales professionals, and marketing experts as they are for consumers. I'll serve as your trusted guide as we look at the tricks, the tactics, and the "best" and "worst" of pricing practices. We will explore price from its rational and irrational sides, through the lens of revolutionary behavioral research. And occasionally we will do some simple math to make some points clearer.

Before we start our journey, though, I would like to introduce myself and make a few confessions.

My colleagues and I study consumer behavior in great depth in order to get to the best prices for the seller. I did that in my first life of 16 years as a business school professor and researcher. I continued to do so at the consulting firm Simon-Kucher & Partners, which I founded in 1985 together with two of my doctoral students. With 30 offices in all major countries and revenue in excess of $250 million, our firm today is the global leader in price consulting. We serve top managers and executives in all industries: health care, automotive, telecommunications, consumer goods, services, Internet, and industrial products. Simon-Kucher & Partners has provided the guidance and analysis behind many of the modern, sophisticated pricing strategies which confront the consumer or the industrial buyer. These customers are almost always unaware of who created these sophisticated price structures in the first place.

Through our recommendations, we have influenced prices of products and services with an aggregate revenue of $2.5 trillion. Only six countries in the world have a gross domestic product which is greater than this number.

Yes, I confess that there may not always be a level playing field between the seller and the consumer. This is less true for industrial buyers, the procurement specialists who are tough in negotiating prices. But generally I think that the game is fair. The reason lies in one word: value. Ultimately the customer is only willing to pay for the value he or she gets. The challenge for any seller is to find out what this perceived value is and then price the product or service accordingly. The customer stays loyal only if the exchanges with the seller cultivate a lasting sense of fairness. Customer satisfaction is the only way to maximize long-term profits.

Yes, I confess that we are occasionally confronted with ethical issues. Can you recommend to charge the highest possible price for a life-saving drug? Should a company ask the same price in poor countries as in rich countries? How far can a company go in exploiting a monopoly-like position? What is in conflict with antitrust and cartel laws and what is still allowed? These are difficult questions without clear-cut answers. Ultimately our clients have to decide. But we, as consultants, must still consider these legal and moral aspects.

Yes, I confess that I have been helping thousands of companies to use smart pricing to maximize their profits. Some people see "profit" as the ugly side of capitalism. "Maximize profit" is an inflammatory phrase which can send shivers down these people's spines. The simple truth is that profit is the cost of survival. Making a sustainable profit is a matter of "to be or not to be" for each and every private business, for without profit the business will fail. And price, whether you like it or not, is the most effective way to generate higher profits. We try to instill a true profit orientation in managers. But I am not a fan of short-term profit maximization. My mission is to support companies in optimizing their prices to achieve sustainable long-term profitability.

Finally, I confess that this book contains a comprehensive collection of my pricing endeavors, adventures, triumphs, and failures. I am still surprised almost every day as I see new, unconventional, and creative pricing ideas popping up. The confessions will continue.

I hope you have a lot of fun exploring the vast world of price, and wish you many "a-ha" moments along the way!

In the Fall of 2015

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Acknowledgements

For the adaptation of the original German text into English, I would like to thank Frank Luby and Elana Duffy of Present Tense, LLC. They not only translated and edited the text, but also contributed fresh research, encouraged me to add more anecdotes and "confessions," and challenged me on how to adapt the flow to make the book more appealing to an English-language audience.

For ideas, comments, critical reviews of portions of the text, and technical support, I would like to thank the following colleagues at Simon-Kucher & Partners:

In Bonn: Dr. Philip Biermann, Dr. Klaus Hilleke, Ingo Lier, Dr. Rainer Meckes, Kornelia Reifenberg, Dr. Georg Tacke, Dr. Georg Wübker
In Boston: Juan Rivera
In Frankfurt: Dr. Dirk Schmidt-Gallas
In Cologne: Dr. Gunnar Clausen, Dr. Martin Gehring, Dr. Karl-Heinz Sebastian, Dr. Ekkehard Stadie
In London: Mark Billige
In Madrid: Philip Daús
In Munich: Dr. Clemens Oberhammer
In Milan: Dr. Enrico Trevisan, Dr. Danilo Zatta
In New York: Michael Kuehn, Andre Weber
In Paris: Kai Bandilla
In San Francisco: Joshua Bloom, Matt Johnson Madhavan Ramanujam
In Sao Paulo: Manuel Osorio
In Tokyo: Dr. Jens Müller
In Vienna: Dr. Thomas Haller

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About the Author

Hermann Simon is Chairman of Simon-Kucher & Partners Strategy & Marketing Consultants, which has 30 offices in 24 countries. He is the world's leading authority on pricing.

Simon was a professor of business administration and marketing at the Universities of Mainz (1989–1995) and Bielefeld (1979–1989). He was also a visiting professor at Harvard Business School, Stanford, London Business School, INSEAD, Keio University in Tokyo, and the Massachusetts Institute of Technology. He studied economics and business administration at the Universities of Bonn and Cologne. He received his diploma (1973) and his doctorate (1976) from the University of Bonn. He has received numerous international awards and honorary doctorates, and is voted the most influential management thinker in German-speaking countries after the late Peter Drucker.

Simon founded Simon-Kucher & Partners in 1985 together with two of his doctoral students. After advising the firm for a decade, Hermann left his academic career in 1995 to assume the full-time role as CEO of Simon-Kucher & Partners, where he led the firm's international expansion. When he left that role in 2009, Simon-Kucher & Partners had become the world's largest pricing consulting practice, active in all major industries. The firm has consulted with more than 200 members of the Global Fortune 500, some in decades-long relationships.

Simon has published over 30 books in 26 languages, including the worldwide bestsellers *Power Pricing* (Free Press, 1997), *Manage for Profit*, *Not for Market Share* (Harvard Business School Press, 2006), *Hidden Champions* (Harvard Business School Press, 1996), and *Hidden Champions of the 21st Century* (Springer New York, 2009).

He has served on the editorial boards of numerous business journals, including the *International Journal of Research in Marketing*, *Management Science*, *Recherche et Applications en Marketing*, *Décisions Marketing*, *European Management Journal*, as well as several German journals. Since 1988 he has been a columnist for the business monthly *Manager Magazin*. He is also a board member of numerous foundations and corporations.

My First Painful Encounters with Prices 1

My first life lessons on the power, importance, and effects of price were emotional and left a permanent imprint. But they didn't come in the university classrooms or corporate boardrooms where I spent much of my adult life as a professor or a consultant.

No, the setting was one of the oldest forms of commerce known to mankind: a rural farmer's market.

I grew up on small livestock farm shortly after World War II. When our hogs were ready for slaughter, my father would bring them to the local wholesale market, where they would be auctioned off to butchers or traders. The sheer number of farmers who brought their hogs to market, matched by the large number of butchers and traders on the "buy" side, meant that no individual buyer or seller had a direct influence on the price of the hogs. We were at the mercy of the local cooperative, which cleared the transactions. They would tell my father the price he would receive, and thus determine how much money he could take home to our family.

The same applied to milk, which we would deliver to the local dairy. We had absolutely no influence on the price. The dairy, again part of a cooperative, told us what the price would be. The milk price would fluctuate based on supply and demand. In times of an oversupply, prices would plunge. We never had hard numbers on supply and demand, only the impressions we gained from observing the market itself. Who else delivered milk? How much did they have?

In every market my father went to, we were "price takers." We had to accept the set price, whether we liked it or not. It was an extremely uncomfortable position. As anyone with a similar experience will attest, money is tight on a farm; these sales were our only source of income.

I absorbed all these impressions as a young boy and I must admit, I didn't like them. Decades later, I would explain in interviews that these lessons taught me something which has guided me in running my own business and helping others

H. Simon, *Confessions of the Pricing Man*, DOI 10.1007/978-3-319-20400-0_1

improve theirs: never run a business in which you have no influence on the prices you charge.[1]

I won't claim I articulated those thoughts exactly that way in the 1950s as a young boy. But I have that same visceral feeling today whenever I think about the price of pork or buy a gallon of milk. I am rather certain that these childhood experiences shaped my opinions about how businesses operate. To this day, I don't think much of a business that doesn't make money.

Prices determine how much money you make. That much is clear. Yet how much influence can you exert on prices, so that money isn't tight and you don't need to live month to month or quarter to quarter? And if you have that influence, what is the best way to wield it? Out of my childhood experiences came a lifelong passion to get better answers to those two questions. I was hooked. Pricing would become my lifelong companion. But the journey from the small farm to global pricing expert was anything but straightforward.

Pricing Student: The Journey Begins

In college I was fascinated by lectures on pricing theories. They were mathematically elegant and often very complex. These challenging lessons gave me a solid set of ways to think about price problems, structure them, and solve them. They would become one more essential building block to my understanding of how pricing works.

But the farmer's son in me noticed something right away: the professors and their students rarely talked about how any of these theories applied to real life. At the time I had no idea that one could eventually apply these concepts to real-world problems. Only years later would I understand that the math also matters, and that it can provide companies a strong competitive edge when combined with other aspects of pricing.

Pricing became an emotional experience again when I met Professor Reinhard Selten, who would go on to win the Nobel Prize in Economics in 1994 for his work on game theory. Professor Selten conducted a pricing experiment in class with real money at stake. He offered a prize of $100. One "A" player and four "B" players could divide this money up among themselves if they could form a coalition that lasted at least 10 minutes.

Imagine now that you are the A player, which was my role. What would you do? What principles would you follow? What are your motivations? Keep those thoughts in mind as you read further. Toward the end of this chapter, I'll reveal how the experiment turned out. What I will say now, though, is that the results of this experiment cemented the word "value" in my vocabulary. They taught me first hand that pricing is about how people divide up value.

[1] "Hier ist meine Seele vergraben" (Here my soul is buried), interview with Hermann Simon *Welt am Sonntag*, November 9, 2008, p. 37.

Back in the 1970s, at the time I completed my master's degree in economics, no one in the business world thought of pricing as a discipline unto itself. That left me with only one practical option if I wanted to continue exploring my passion for pricing. I needed to stay in academia. The next major milestone came with my doctoral dissertation "Pricing Strategies for New Products." During my time as a teaching assistant I had the chance to work on several expert opinion papers which addressed questions about pricing policies. These papers gave me my first glimpse of how large companies priced their products. I do recall a strong feeling that their processes and policies had considerable room for improvement, but at that time I lacked specific solutions.

The next stop on my journey came in January 1979, during my time as a postdoc fellow at the Massachusetts Institute of Technology. Within a matter of a few days, I would meet three people who would not only influence my own career path, but who would also lay the groundwork for pricing to grow from an academic topic for a few passionate professors to a vital corporate function and a powerful marketing tool.

First I visited Professor Philip Kotler at Northwestern University. Kotler had become a marketing guru at a relatively young age, and I was eager to show him my research results on how a buyer's price sensitivity changes over the course of a product's life cycle. This is a topic all shoppers around the world experience nowadays, whether they are looking at high-tech gadgets in an online store or eyeing a basket of very ripe fruit at a local market: the value we perceive changes as the product ages. I wanted to know how that translated into opportunities for smart pricing.

In 1978 I had published a paper in *Management Science*, the leading journal at that time, which showed that one of Kotler's models on the dynamics of prices during a product's life cycle had implications which were nonsensical. My own empirical research on the dynamics of price elasticity over the product life cycle also contradicted the prevailing conventional wisdom.

Full of self-confidence, I told Professor Kotler that I wanted to conduct unconventional research into pricing. I wanted to go outside the realm of sophisticated functions and elegant theories and actually produce something that a manager or salesperson could understand and apply to his or her own business decisions.

He quickly burst my bubble.

"Most scientific marketing researchers want to uncover something that is relevant for day-to-day business," Kotler told me. "Few succeed."

I knew that Kotler was correct. Most of the science around pricing came from microeconomics. If pricing remained limited to the boundaries and shifts in microeconomics, its real-world relevance would be marginal at best.

Kotler did offer me one bit of encouragement, though. He knew someone who called himself a "price consultant," someone who apparently made a decent living by helping companies with pricing problems. The term "price consultant" sounds intuitive now, but it struck me as unimaginable when I first heard it. How did he do that? What did he recommend to his clients? I filed the term away and vowed to track down this "price consultant" after my trip and learn more about his work.

The same trip to Northwestern took me several miles south along Lake Michigan to the South Side campus of the University of Chicago, where I had appointments with assistant professors Robert J. Dolan and Thomas T. Nagle the next day.

I arrived in the evening and walked about four blocks through the biting cold and wind from the Illinois Central train station to the University guesthouse. When I met my hosts at the business school the next morning and told them that I walked in the night from the train station to the guesthouse, they were horrified.

"How could you be so careless!" they said. "This is a high crime area. You were really lucky you didn't get mugged."

Weather and crime risks aside, the University of Chicago was the place for me, as a quantitatively educated economist. It was something like visiting the Vatican. The business school had young professors who focused on the same research areas I did, namely Dolan and Nagle, at a time when so many new, exciting ideas started to percolate: empirical measurements of price elasticity and demand curves, nonlinear pricing, price bundling, dynamic modeling, the effect of price on the diffusion of new products, and many others. I stood out as a controversial figure, the unknown from Germany who had dared to attack the great Philip Kotler. Though Kotler himself took the criticisms in stride (the two of us remain friends to this day), many others viewed my comments as an insult. These feelings faded into the background though. As young professors focused on pricing research, we had plenty to discuss. Nagle left UChicago several years later and founded the Strategic Pricing Group, which concentrated on pricing training. He would also write *Strategies and Tactics of Pricing*, which would become one of the best-selling books on the topic. Nagle and I would usually meet when I visited Boston over the years.

Dolan and I, however, forged a lifelong friendship among ourselves and our families. He would later switch to Harvard Business School, where I was a Marvin-Bower-Fellow[2] for the 1988/1989 academic year. Dolan and I began an intensive cooperation and started publishing jointly, culminating in the book *Power Pricing* in 1996.[3]

A little later in 1979, I did indeed follow up on the referral Kotler gave me. I contacted Dan Nimer, the man who called himself a price consultant. He sent me some of his articles, and the differences between his publications and the theoretical papers I'd read and written in my academic career could not be more striking. The scientific papers on price in the academic world were long on theory but devoid of practical advice. Nimer's papers were the exact opposite, chock full of simple but useful insights. He had a very good intuitive feel for pricing tricks and tactics, without exploring or perhaps even knowing their theoretical underpinnings. For instance, he had recommended price bundling a couple of years before a Stanford professor presented the theory and showed why price bundling can be optimal.

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[2] Marvin Bower (1903–2003) is the co-founder of McKinsey & Company. He also was very interested in my pricing work.

[3] Dolan RJ, Simon H (1996) *Power pricing – how managing price transforms the bottom line.* Free Press, New York.

Nimer was the practice-oriented consultant who had a toolbox, before this toolbox was proven by academia. His enthusiasm for price consulting was contagious; it certainly infected me. And he was interested in what we young guys were doing. When people who are older, more experienced, and more famous than you are taking an interest in your work, it provides a tremendous motivation.

I would see Nimer on occasion in the ensuing years. Into his 90s, his enthusiasm did not wane. He still lectured on pricing and advised clients. In 2012, members of the pricing community honored this visionary of pricing with a voluminous book of almost 400 pages for his 90th birthday.[4] I had the honor to contribute a chapter titled "How Price Consulting is Coming of Age" to Nimer's anniversary publication.

All of these encounters and relationships made 1979 a watershed year in my understanding of pricing and its future. It would still take me six years, though, before I would find a way to weave all of these strands together—emotion, incentives, theory, math, value, and research—to offer companies the support I knew deep down inside that they needed. Between 1979 and 1985, I continued within academia to raise awareness about the importance of pricing and the fascinating areas of study within it.

Pricing Professor: Academia Was Still My Only Option

In the fall of 1979, I started teaching business administration at various universities and business schools. My research focused primarily on pricing. This culminated in the publication of my first book, *Preismanagement* in 1982. The English title *Price Management* under which I published a book in 1989[5] may seem very simple, but I thought long and hard about what to call the book. The idea of managing prices was not in the mainstream back then. If any terms had common usage, they were "price theory" or "price policy." The former dealt with the highly quantitative concepts I first encountered in my studies of economics. Prices must ultimately be quantitative. We express them in numbers. The latter term, "price policy," described what businesspeople actually did. It was highly qualitative, a sort of oral or written history passed on from one generation to the next at a company.

With the term "price management" I wanted to integrate these seemingly incompatible worlds in a way that would serve the managers, salespeople, and the finance teams that make price decisions every day. In other words, I tried to take the quantitative, theoretical concepts and make them accessible and useful so that these businesspeople could make better pricing decisions at their own companies.

During my tenure as a university professor, I regularly gave speeches and seminars on price management to businesspeople. I also sponsored numerous master's theses and dissertations on the topic. Many of these papers raised as many new questions as they answered. They combined with other research to expand and

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[4] Smith GE (ed) Visionary pricing: reflections and advances in honor of Dan Nimer. Emerald Publishing Group, Bingley.

[5] Simon H (1989) Price management. Elsevier, New York.

deepen the body of knowledge on price management. That helps explain why the second edition of the book *Price Management*, published in 1992, swelled to 740 pages. This growth in knowledge met a demand for more insights into pricing.

Pricing Consultant: We Take Theory into the Real World

Since 1975 I had been teaching in a 3-week management seminar for "high potentials" for Hoechst, a large chemical company and the world's largest pharmaceutical firm at the time. I extended my teaching activities to business schools around the world, through guest professorships at INSEAD, London Business School, Keio University (Tokyo), Stanford, and Harvard. And I started to advise companies. In the beginning it was a small side business and a nice change of pace from the academic grind. The time had now come to take the next step and take on the job title that Dan Nimer had coined in the 1970s. I dared to call myself a "price consultant."

My very first consulting project was for the chemical giant BASF. The BASF management told me that they needed to reconsider their market segmentation in the industrial paint business, and asked for our support. We also received projects from Hoechst, which became our biggest client in those early years. By 1985, I was well known in German and European industry and earned an appointment as director of the German Management Institute, which almost all large German companies belong to. Within a very short time, I got to know the top brass of German industry.

We soon realized that the only way to do all this work professionally was to form a consulting firm. So in 1985 I founded a firm together with my first two doctoral students, Eckhard Kucher and Karl-Heinz Sebastian. Similar to the motivation behind the book *Price Management*, we wanted to apply the methods and theories of academic research to actual business problems. Eckhard and Karl-Heinz ran the fledgling company, taking advantage of my industry connections before developing their own. With three additional employees, we achieved $400,000 in revenue in the first year. In 1989 the firm had 13 employees and $2.2 million in sales. The growth continued slowly but steadily, as we gained more and more confidence that we had tapped an unmet need for businesses.

As I said about Dan Nimer: when people who are older, more experienced, and more famous than you are taking an interest in your work, it provides a tremendous motivation. Around this time we received further support and inspiration from the world-renowned management thinker Peter Drucker. He and I had many interesting discussions about pricing, and he always encouraged me to pursue the goal of finding practical applications for pricing theory and research.

"I am impressed by your emphasis on pricing," he told me during a visit to his home in Claremont, California, adding that it is the "most neglected area of marketing." Drucker saw a clear link between pricing and profit and also sensed the same improvement potential I first noticed in my doctoral research.

Pricing intrigued Drucker from an economics and also from an ethical perspective. He understood profit to be the "cost of survival" and sufficiently high prices to be a "means for survival," two points which resonated deeply with me. In the 21st century, the word "profit" has become a magnet for protests and negative headlines. Drucker always tried to strike a clear ethical balance. He warned against the abuses of market power. He commented on price transparency, and advocated fair behavior. At the same time, he understood the importance of making money, and described it very eloquently in an opinion piece in *The Wall Street Journal* in 1975:

> It is not the business that earns a profit adequate to its genuine costs of capital, to the risks of tomorrow and to the needs of tomorrow's worker and pensioner, that 'rips off' society. It is the business that fails to do so.

"Pricing policy today is basically guess work," he told me in the early 2000s. "What you are doing is pioneering work. And I think that it will be quite some time before any of the competitors catch on."[6] Shortly before his death in 2005, he provided a testimonial for *Manage for Profit*, *not for Market Share*, a book which I co-wrote with two colleagues: "Market share and profitability have to be balanced and profitability has often been neglected. This book is therefore a greatly needed correction."[7]

By 1995, our little consulting firm had 35 employees and revenues of $7.9 million. At that point, I decided to stop serving two masters. I ended my academic career and devoted myself full time to the firm and its emphasis on price management. In 1995, I became the full-time CEO of Simon-Kucher & Partners and fulfilled that role until 2009. Since then I have served as the firm's chairman.

In 2015, Simon-Kucher & Partners achieves revenue of $235 million. At the end of 2015, the firm had more than 850 employees working out of 30 offices in 24 countries around the world. Simon-Kucher & Partners is now widely considered to be the global market leader in the specialized area of price consulting.

From that first visit to a farmer's market to my latest trip to give a speech in China, I have encountered prices in thousands of forms. This challenging lifelong journey to understand prices—where they come from, why they work, and how they work—has been immense fun at times, especially during those "Eureka" moments when my colleagues and I unlocked another secret with the real-world relevance which Professor Philip Kotler said was so elusive. You will read about many of those moments in this book. But I have also experienced frustration, confusion, and occasional helplessness. You will read about some of those moments as well.

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[6] Personal letter from Peter Drucker, July 7, 2003.

[7] Personal letter from Doris Drucker, the wife of Peter Drucker, on November 2, 2005. She wrote: "I am sorry to tell you that Peter is very ill. Before his collapse he dictated a letter to you. The secretary just brought it here for his signature." This note was followed by his testimonial for the book. He and I were scheduled to meet on November 12, 2005, at his house in Claremont, CA. The evening before the meeting, I called from Mexico City to confirm. Mrs. Drucker answered the phone and said, "Peter died this morning." I was shocked.

The biggest pricing triumphs came when we helped companies create and launch new pricing approaches that resulted in a big win for consumers and the company. In 1992, we introduced a discount card with an upfront fee for the huge German Railroad Corporation. Consumers loved it, because it made travel planning much simpler and provided unprecedented price transparency. The company loved it, because they would have a steady income stream from the card fees and earned higher revenue as more people saw the train as a practical, affordable option.

I was also proud that we helped Daimler implement a relatively high price when it launched the revolutionary Mercedes A-Class. Our teams have helped Porsche launch new models and have helped most major Internet companies use better pricing to turn their breakthrough ideas into sustainable, successful businesses.

A critical part of these triumphs is the ability to anticipate future trends and estimate their impact. In some industries, such as petroleum exploration, events may take years to unfold. A few times, though, the world changed in a matter of minutes. We developed new pricing for TUI, the world's largest tour operator, and we were on target to launch the system with them on October 1, 2001. The terrorist attacks on September 11 rendered every assumption, every analysis, and every recommendation behind that system obsolete. Nonetheless, it was comforting to receive an e-mail from TUI's top management a year later which explained that the work on the new pricing system was not for naught. They said that the company would have been much worse off if they had kept the previous system in place.

You might call Professor Selten's game the first pricing triumph I ever had, because it taught me about the importance of value, incentives, and communication. Unlike the experiences at the farmer's market, I had an opportunity to influence the amount of money I would take away from a negotiation. What were your thoughts about being Player A? When I had that role that afternoon long ago, the B players and I had a lot of back-and-forth negotiations before a coalition finally stood for the required 10 minutes. Two of the B players took home \$20, and I left with \$60, a lot of money for a student at that time, 20 % above the expected value.[8] Pricing is always a reflection of how people divide up value. This experiment was one of the highlights of my studies.

Naturally, I have experienced some flops as a pricing consultant, either because the client couldn't implement our price recommendation or because the price change did not yield the anticipated effects in the market. Fortunately these flops were few and far between. I have also had many intense discussions with clients who resisted our recommendations. In hindsight it is still hard to tell sometimes which party was right. A business team may have many viable options, but can choose only one. These decisions involve so many factors and face so many market dynamics that black-and-white certainty is rare.

Everyone creates and consumes value. We are constantly making decisions about whether something is worth our money, or trying to convince others to part with their money. That is the essence of pricing. Please join me in this book on a journey through that amazing world. Enjoy the confessions of the pricing man!

[8] Since the A player has double the weight of the B players the expected distribution is \$50 for the A player and \$25 for two B players. But any other outcome is possible. It depends all on the negotiations.