FORETHOUGHT

A Smarter Way to Sell Commodities

by Robert S. Lurie and Ajay K. Kohli

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A Smarter Way to Sell Commodities

How can you distinguish your commodity from the pack? Reduce customers' risk.

by Robert S. Lurie and Ajay K. Kohli

The mere word "commodity" strikes terror in the heart of most marketers. Whether it's coal, chickens, or memory chips, commodity sellers struggling to differentiate their products often resort to price cuts. And that, of course, means savvy buyers can play one seller against another to extract the greatest price concessions.

To be sure, conventional marketing approaches like bundling products or appending value-enhancing services such as training and consulting can distinguish commodities. But while these strategies may head off price wars, they can be so expensive that suppliers often don't recover their costs. What many commodities sellers don't appreciate is that their customers frequently *will* pay a premium to the supplier that understands and reduces their risks.

Segment by Risk

Consider the case of a company we'll call ContinentalGas, which sells gas pipeline capacity. Gas retailers and distributors purchase capacity to ship gas from distant wholesalers for distribution to local homes and businesses. These buyers, some of which operate across several cities, commonly enter into annual contracts for pipeline capacity, bargaining with various suppliers for the lowest cost. For years, ContinentalGas played the pricing game, eking out the narrowest of margins.

But then its managers had an important insight: They could segment their customers by their exposure to and tolerance for risk and offer customized risk-reduction packages – for a price. Their research showed that some gas retailers faced huge uncertainties in the volume of gas they would need in any given 24-hour period; others didn't. Some that sold gas in several cities worried about having too much gas in one and too little in another; others, operating in a single city, didn't. Some experienced marked fluctuations in the demand for gas from month to month; others didn't. Some required unvarying pipeline pressure; others didn't.

This kind of risk-based segmentation allowed ContinentalGas to create a portfolio of service offerings. To buyers with little risk exposure – those that operated in a single town, worried little about gas pressure, and had minor fluctuation in demand – it offered basic capacity at the standard price. But to other buyers, ContinentalGas offered to add value, at a premium price, by reducing or eliminating various types of risks. For example, ContinentalGas provided a guaranteed level of "excess" daily capacity above the standard baseline level to those buyers concerned about spikes in demand. The greater the daily maximum capacity it guaranteed, the higher the price on a per unit basis. Similarly, it guaranteed the pressure level for buyers anxious about fluctuations; the higher the pressure, the higher the price.

Minimize Uncertainty

This risk-based marketing strategy can be applied to any commodity, as long as the buyer stands to lose if there are variations in some element of it. A steak house chain, for instance, may pay a premium for consistently trimmed meat because eliminating variations in portion size reduces its risk of customer dissatisfaction. Or a hospital that buys commodity sutures may pay more to a supplier whose safety claims are backed by superior clinical trial data – in effect, paying extra for a lower risk.

Commodities sellers need to evaluate each customer's perception of risk and its true exposure. Naturally, customers are loath to volunteer the information needed for this analysis – and some may not even have it – so the approach requires careful research and skillful questioning. First, identify the elements of a commodity offering in which variation or uncertainty could generate risks for the buyer, such as variations in product specifications, supply, or demand. Second, estimate the probability that a given risk-associated negative outcome will happen. Third, estimate the loss the customer would incur if it does. For example, in the case of a gas retailer, what would it stand to lose if it couldn't meet spikes in demand? Finally, estimate the ability of the customer to withstand the loss. Some customers may be unaware of their risks, and others may believe their risks are lower than they actually are. Thus, a commodities seller needs to educate its customers about the real risks involved.

All things being equal, the greater the loss a customer stands to incur, and the less its ability to withstand that loss, the more a supplier can add value by reducing that customer's risk. And, of course, the more that customer may be willing to pay.

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