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MARKET RESEARCH IS A POWERFUL PRICING TOOL

Market research empowers buyers to obtain best value solutions for their organization.

By Thomas S. Wells, CFCM, Fellow

Market research, as defined in the *Federal Acquisition Regulation* (*FAR*), is "collecting and analyzing information about capabilities within the market to satisfy agency needs."[1]

This simple definition barely hints at the true power and value of well-conducted market research. Market research is essential to properly define requirements, plan an effective acquisition strategy, wisely evaluate competitive offers, award a quality contract, and successfully execute that contract.

Significant outcomes of market research effort include[2]:

- Identifying sources capable of satisfying the agency's requirements.
- Determining whether commercial or non-developmental items could be used to meet these requirements.
- Determining customary practices of firms engaged in producing, distributing, and supporting commercial products or services, such as type of contract, terms for warranties, buyer financing, maintenance, packaging, and marking.

- Ensuring maximum practicable use of recovered materials (see FAR subpart 23.4) and promoting energy conservation and efficiency.
- Determining whether consolidation or bundling (see FAR 7.107) is necessary and justified.
- Determining whether the acquisition should use one of the small business programs described in FAR Part 19.

Even this list of expected outcomes fails to expose the value of fully understanding the marketplace that exists to satisfy the agency's need.

When done properly, market research drives acquisition planning and the decision-making processes. Market research provides technical and business information about commercial technology and market capabilities that guide the buyer in determining the most suitable approach to acquiring, distributing, and supporting supplies and services.

In government acquisitions, decisions made during the pre-solicitation phase are critical in defining what the agency receives and how much it pays for the acquired product or service.

The greatest value of market research is realized when the buyer is willing to adjust the initially defined requirement to more closely align with the products or services regularly offered in the commercial market. By doing so, the buyer will increase competition and reduce purchase prices. These benefits can be even greater if the buyer is willing to tailor contract terms and conditions to align with those customary for the specific market.

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Strategic and Tactical Market Research

Strategic market research allows buying organizations to obtain a broad understanding of markets, technologies, supplier practices, market segmentation, business trends, industry value chain and cost drivers, and industry best practices.

Strategic market research is an ongoing process of surveillance not focused on the execution of a specific purchase requirement. This kind of research is appropriate when an agency is launching a strategic sourcing initiative or when the organization makes frequent purchases of certain products or services. It may also be appropriate when an organization has a specific mission focus, that aligns with specific markets such as information technology products, medical equipment, or construction services.

This strategic perspective provides a knowledge base that enables more rapid and effective tactical market research when required.

Tactical market research is accomplished in support of defining and executing a specific acquisition. FAR 10.001 requires that agencies conduct market research "appropriate to the circumstances" before:

- Developing new requirements documents for an acquisition
- Soliciting offers for acquisitions with an estimated value above the simplified acquisition threshold[3]
- Soliciting offers for acquisitions with an estimated value below the simplified acquisition threshold, when adequate information is not available, and the circumstances

justify its cost
- Soliciting offers for acquisitions that could lead to consolidation or bundling

Sources of Information

There are many sources that can be used to obtain market information. Primary source research may include:

- Interviews with:
  - Internal experts
  - Industry experts
  - Other agencies that acquire the same or similar requirements
  - Companies and suppliers
- Written or in-person exchanges using:
  - Requests for information
  - Sources-sought notices
  - Supplier surveys
  - Industry days
  - One-on-one meetings with suppliers
  - Site visits
  - Pre-solicitation conferences
  - Draft requests for proposal

Secondary research involves the review of information collected, published, or analyzed by other sources, such as:

- Company catalogs or brochures
- Government databases and tools
- Historical purchase or sales information
- Trade journals and professional or industry association reports
- Corporate 10Ks and annual reports
- Wall Street analyst reports
- Internet research including general news sources

Information About Prices

Many of the primary and secondary research sources provide information related to prices that were paid (historical) or are offered by suppliers (current). As previously noted, a major objective of market research is to effectively define the requirement by considering tradeoffs related to features, attributes, and contract terms that result in increased competition and lower purchase costs. For example:

- Increasing contractor performance costs will normally increase contract price.
- Lowering contractor performance costs will normally reduce contract price.
- Limiting competition will normally increase contract price.
- Facilitating competition will normally reduce contract price.
- Increasing contractor risk will normally increase contract price.
- Limiting contractor risk will normally decrease contract price.[4]

How Sellers Set Prices

Buyers should understand that sellers use a variety of methods to establish prices. Market research can help the buyer identify the pricing method being employed by sellers. With this understanding, buyers can more effectively evaluate and negotiate prices, as necessary, to determine whether the contract price is fair and reasonable.[5]

There are essentially two methods of setting prices, cost-based and market-based pricing, but a variety of strategies may be used.

Cost-based Pricing

The first general approach to setting prices is cost based. The strategies and specific methods related to this form of pricing include:

Cost-plus-profit pricing: This is the most sophisticated form of pricing and is the method used by most large businesses that specialize in selling to the government. This method requires cost estimating and accounting systems that allow a firm to reliably forecast costs and then track actual direct and indirect costs.

Prices are set by determining the direct material, labor, or other direct costs and allocating an appropriate share of the company's indirect costs (various overhead pools and general and administrative expenses). A desired profit margin is then added to the total estimated cost of the product or service.

A company must be able to forecast both direct and indirect costs for the accounting period based on an anticipated volume of sales. These forecasts are often reassessed during the accounting period to ensure that overhead costs are being adequately recouped.

Mark-up pricing: This simple method is more common among commercial firms and is used by most small businesses. The company still assesses its direct costs (labor, material, other) but then adds a markup factor that is intended to recoup all other costs and yield a reasonable profit by the end of the accounting period.

The Keystone pricing method[6] suggests retail merchants set selling prices by doubling what they paid their vendor, presumably a wholesale price. This pricing strategy was originally intended for brick-and-mortar stores. In these days of internet sales, not only is there greater competition but operating costs can be much lower.

Sellers can be more sophisticated by understanding their operating costs and setting a markup factor that ensures they recoup those costs while remaining competitive with other sellers. Rather than applying the Keystone 100% markup, they may decide to use a markup rate of 35% to 65%.

Unlike the complex cost estimating and accounting systems used with cost-plus-profit pricing, these markup factors tend to be rough estimates that provide for a reasonable profit margin. Different markup rates might be used for different products offered by the same seller given competitive market dynamics that differ by the product or service.

Margin pricing: Margin pricing is like markup pricing but considers the firm's total cost, projected sales revenue, and desired profit margin. Many commercial firms use this method because it matches their accounting reports, where costs and profit are reported as a percentage of sales.

In this case, the merchant projects the annual sales volume and the associated operating cost at that volume of sales. From this information, the cost per unit is determined. The desired margin is determined by the business leader(s) and becomes the targeted return on sales.

Margins are lower than markups because a margin is based on revenue and a markup is based on cost. For example, if the selling price is $100 and the product cost is $75, the margin is 25% ($25/$100), while the mark-up is 33% ($25/$75).

THERE ARE ESSENTIALLY TWO METHODS OF SETTING PRICES, COST-BASED AND MARKET-BASED PRICING, BUT A VARIETY OF STRATEGIES MAY BE USED.

Rate-of-return pricing: Rate-of-return pricing is a form of markup pricing in that profit dollars are added to the estimated product costs. However, profit dollars are calculated based on the financial investment made to design, develop, and market the product rather than the cost of producing the product.[7]

In this case, the desired return on that investment is allocated across the total number of units estimated to be sold during the accounting period. The unit selling price, therefore, includes the cost of producing the product plus profit intended to provide return-on-investment cost.

For example:

Investment made = $350,000

Desired return on investment = 30% ($350,000 x .30 = $105,000)

Product cost = $60 per unit

Estimated sales quantity = 4,000 units

Calculate desired unit profit = $105,000 / 4000 = $26.25

Calculate unit selling price = $60 + $26.25 = $86.25.

Market-based pricing

The second approach to setting prices is market-based pricing. The strategies and specific methods related to this form of pricing include:

Competitive pricing: Competitive pricing is based on the seller's own market research efforts. This is a necessary strategy if you are selling readily available products that are similar (or identical) to those offered by competitors.

Essentially, the price is set so that is appealing to consumers in the competitive marketplace. A smart seller will find ways to distinguish its product on something other than price by promoting unique features, quality, or other value, such as free shipping. The risk to the seller is that profit margins are often very small, so maintaining robust sales is key to economic survival.

A larger volume of sales also helps the seller receive lower prices from their suppliers, potentially enabling a larger profit.

Market penetration or promotional pricing: This is a variation of competitive pricing. In this case, the seller sets an initial price below the benchmark competitive price.

The goal here is to establish a business and try to get a lot of consumers used to buying the offered products. Once demand starts growing, the seller gradually increases its prices to a sustainable level, but may still offer discounts periodically, or only to repeat customers, to maintain customer loyalty.

This strategy may also involve "loss leader" items that are offered at below-cost prices with the hope that buyers will purchase related accessories or other products that are sold at a high price. A great example of this strategy is the low-priced ink-jet printer that can be purchased at nearly the same price as you will pay to buy the first set of replacement ink-jet cartridges.

Market share pricing: This strategy assumes that long-term profitability is based on capturing a significant share of market sales for the seller's product or service. The goal is to initially dominate the market using a market penetration strategy and then leverage the increased volume to drive down vendor and internal production costs.[8]

The low initial price can fall even lower as the seller's costs are reduced due to higher volumes and efficiency gains.

Value-based pricing: This method of demand-based pricing is a more risky and complicated method sometimes known as customer-based pricing. In this case, the seller uses knowledge of consumer demand and perceived value to determine the maximum price that customers might be willing to pay.

Products that are status symbols or that add some intrinsic value to the consumer will be priced higher when using this strategy.[9] Why do customers pay so much more for Apple products? It is because the perceived value of these products is a lot higher than competitor products.

Another great example of value-based pricing is airline ticket prices. When the travel demand is high (holidays and vacation season), the price is set very high. But during seasons when customers don't travel as much, the prices may drop significantly.

When a supplier adopts this strategy, offered products or services are typically priced quite high when compared to the actual cost incurred by the seller.

Market skimming: This demand-based pricing strategy is often employed for emergent products or technologies when initially released. Here, the supplier initially sets a higher price, knowing that some buyers will want to get the latest and greatest product right away.

The skimming strategy gets its name from "skimming" successive layers of cream, or customer segments, as prices are lowered over time.[10] Once the demand slows, the selling price is reduced. For example, game consoles like PlayStations and Xboxes are usually introduced for a high price, but prices fall once the initial excitement subsides.

This approach contrasts with the penetration pricing model, which focuses on initially offering lower-priced products to grab as much market share as possible.

Profit maximization: In profit-maximization pricing, the seller knows that demand will fall as prices increase and grow as prices decrease. A seller using this strategy carefully analyzes the market to find the combination of price per unit and quantity of sales that maximizes profit.[11]

This approach requires robust market research to continuously evaluate changes in sales and competitor pricing. The seller must thoroughly analyze and monitor the relationship between price and demand to effectively adhere to this strategy.

Current revenue pricing: In this case, the seller's emphasis is on maximizing short-term revenue rather than generating long-term revenue or profit. For these firms, a sure dollar today is much more important than the possibility of more dollars tomorrow.

Sellers who employ this strategy are typically concerned about long-term market uncertainty or the firm's future financial viability. To employ this strategy, the seller must determine the price/quantity combination that maximizes near-term revenue.[12]

Sellers that rely on this strategy may present more performance risk for the buyer, especially for long-lead items or services with longer periods of performance.

Strategy Implications for Buyers

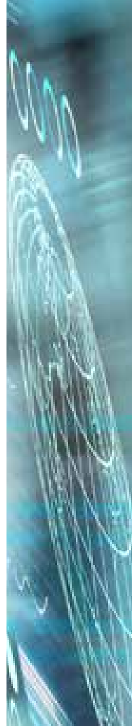
When evaluating supplier pricing strategies and price reasonableness, the buyer should consider the following factors:

- Competitive environment: Are there many sellers who offer similar products or services or are there only a few sellers? More sellers mean more competition and lower prices.
- Market share: Do one or more sellers dominate the market? Dominant sellers typically mean higher prices.
- Market buyers: Is the government a major or minor buyer of the products or services being offered? If a major buyer, the government may demand better prices.
- Type of market: What are the customary sales and pricing practices for sellers of the product or service? If you align with the market, better prices are likely.
- Market demand: How stable is buyer demand? Is demand increasing or declining? Are there any seasonal or cyclical variations evident? Buying at the right time, if possible, can provide savings.
- Market forces: Are there any conditions or trends that might drive prices higher or lower in the future? Buying at the right time, if possible, can provide savings.
- Seller size: Are the sellers primarily large businesses or are there many small businesses? Setting aside for small business, consistent with policy, is usually a beneficial strategy.
- Seller type: Are the sellers traditional government contractors or predominantly commercial providers? Are there both producers and distributors? Select a strategy that leverages the capabilities that the market offers.
- Seller tenure: Are the sellers well-established or relatively new to the market? Note that new sellers may offer better prices but consider the risk of unproven providers.
- Seller performance record: Does the seller have a positive record of performance? Are products or services delivered on time? Are there any known concerns with quality? Consider performance risk and tradeoffs with price.
- Seller viability: Are there any indications that the seller may be in financial distress? Consider performance risk and tradeoffs with price.
- Range of prices: Are seller prices tightly grouped or is there a wide range of seller prices in the market? Ensure that the competition is effective at including enough sellers to provide for reasonable prices.
- Price variability: How stable are market prices over time? Are there any seasonal or cyclical variations evident? Buying at the right time, if possible, can provide savings.
- Price sensitivity to competition: Do prices remain relatively stable for long periods, or do they change quickly or frequently in response to changes in competitor pricing? Ensure that the competition effectively leverages the market.
- Price sensitivity to quantity: Are lower prices available for larger quantity purchases? How does the anticipated quantity compare to the quantity purchased by other buyers? Seek a quantity discount, when warranted by the quantity required.
- Government pricing: Are there historic differences between the prices paid by the government versus other buyers? Can you determine why this difference exists? Adjust the requirement and strategy to get the right price.
- Promotional pricing: Will other items be purchased now, or in the future, resulting in an overall higher cost than other alternatives? Consider the total purchase cost.
- Life cycle cost: Are there differences in the cost of ownership between alternative products? What are commercial warranty terms and conditions? What are historical repair and maintenance costs? Consider the total purchase cost.
- Product differentiation: Are there

significant differences in attributes or quality among the products or services being offered? What is the apparent tradeoff between features and price? Carefully evaluate requirements and consider price-performance tradeoffs.

- Emergent products or technologies: Is the product new to the market or has it been around for a long time? Beware of price skimming. Buying at the right time, if possible, can provide savings.
- Product value: Is the higher price charged for a "prestige" product worth the premium you will pay? Carefully evaluate requirements and consider price-value tradeoffs.
- Product form: Are there any differences in how the product is sold, such as pre-assembled versus buyer assembled? Carefully evaluate requirements and consider price-value tradeoffs.
- Product or service location: Is the offered price sensitive to the geographical location where the product is produced or sold? Do shipping or transportation charges vary by location? Consider all costs when comparing prices.
- Product delivery: What are the typical lead times for the product or service as compared to the requirement? Evaluate how the offered price is affected by the requested delivery.

Discovering answers to these questions will help the buyer understand the seller's pricing strategy, select an appropriate acquisition strategy, equip the buyer to select the best source, and negotiate a fair and reasonable purchase price.



MARKET RESEARCH IS A POWERFUL TOOL THAT EMPOWERS BUYERS TO OBTAIN BEST VALUE SOLUTIONS FOR THEIR ORGANIZATION.

Conclusion

Market research is a powerful tool that empowers buyers to obtain best value solutions for their organizations. When you truly understand market dynamics and industry practices for the product or service you are buying, you can effectively tailor requirements and contract terms to align with the market.

Market research also enables buyers to understand the many factors that influence prices and to know, with confidence, that the price they ultimately pay is fair and reasonable. **CM**

Thomas S. Wells, CFCM, Fellow is a Vice President at Dayton Aerospace Inc. He is a Retired U. S. Air Force Senior Executive Service Leader with more than 40 years of experience in government contracting and acquisition program management. He is a member of the *Contract Management* Editorial Advisory Board and the NCMA Dayton Chapter.

ENDNOTES

1 FAR 2.101, Definitions
2 FAR 10.001(a)(3)
3 Normally $250,000, although higher thresholds exist for certain emergency procurements and for actions purchased and performed outside of the United States. See FAR 2.101, Definitions.
4 DOD Contract Pricing Reference Guide (CPRG), Volume 1, Price Analysis, Chapter 1.0, Market Research and Contract Pricing. https://www.dau.edu/pdfviewer?Guidebooks/CPRG/CPRG-Volume-1.pdf.
5 "Fair and reasonable" is a term of art in federal contracting. It is not defined by the *FAR* but is understood to mean the price is "fair" to both the buyer and the seller and does not exceed the price that a prudent and competent buyer would be willing to pay, given available data on market and economic conditions. DOD's CPRG Volume 1, I.2.1, *Pay a Fair and Reasonable Price*, provides lengthy discussion about the term's meaning and intent.
6 The term "keystone pricing" is believed to have originated in 19th century, when the jewelry trade magazine, Keystone, suggested store owners keep retail prices at double the wholesale price. Chaidaroglou, Alex., *Keystone Pricing Tactics That Every Retailer Must Know to Drive Sales*, 23 Dec 2022, https://altosight.com/keystone-pricing-tactics-examples/.
7 CPRG, Volume 1, I.1.3.3.
8 CPRG, Volume 1, I.1.4.2.
9 *Demand Based Pricing - A Detailed Explanation*, https://buildd.co/marketing/demand-based-pricing, accessed 28 Apr 2023.
10 Hayes, Adam, Price Skimming Definition: How It Works and Its Limitations, 22 May 2022, https://www.investopedia.com/terms/p/priceskimming.asp.
11 CPRG, Volume 1, I.1.4.1.
12 CPRG, Volume 1, I.1.4.4.

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