What Are Price Wars Good For? Absolutely Nothing.

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Corporate superstars like GE and Intel have demonstrated time and again that raising quality and slashing prices can translate into big profits. But is getting into a price war always the best strategy? Maybe not, according to a group of deep thinkers called game strategists. Led by Tom Nagle at the Strategic Pricing Group, a Boston consulting firm, and economists Adam Brandenberger of Harvard and Barry Nalebuff of Yale, this school believes that cutting prices to gain market share--as opposed to doing it because of a cost advantage--can often permanently hurt both profits and revenues.

'Pricing is a game,' says Nagle. The essence of a game, he explains, is that when a business person acts, other people, whether customers, suppliers, or competitors, respond. Therefore, it makes sense for a business to predict how everyone will respond so it can avoid future trouble. In seminars, Nagle runs a game to teach participants some of the negative consequences of unbridled price competition. The vast majority of participants learn the hard way, by figuratively bashing one another's brains out. 'Men,' says Nagle, 'are far more likely than women to compete.' You get more cooperators in Denver and Boise, he notes, and virtually none in New York City. When his firm gives a seminar at Management Centre Europe in Brussels, people from France occasionally cooperate with other Frenchmen, but rarely with someone from England.

What leads companies into such self-defeating price wars? Often, they make the mistake of measuring their success by market share rather than by profitability. But something more is at play. Michael Marn, a partner at McKinsey who heads its pricing practice worldwide, says that price wars are often caused by companies misreading or misunderstanding competitors. Marn tells of one McKinsey client, a company that dominated the market for adhesive labels nationwide. After a small competitor built a tiny factory in southern Florida with no prospects for further expansion, the company reacted with a nationwide price cut of 15% to 20% and, says Marn, 'gave away profitability for two years.' Typically, concludes Marn, price wars are 'overreactions to threats that either aren't there at all or are not as big as they seem.'

So how do you 'change the game,' to use Brandenberger's and Nalebuff's terminology, so that price competition won't get out of hand? One way is to make it less attractive to compete on price and hope that your competitors follow. Take airlines, where the high fixed costs and the almost zero marginal cost of adding another passenger are already a setup for a price war. In their book Co-opetition, Brandenberger and Nalebuff argue that frequent-flier programs reduced the airline industry's need to cut price to lure customers. That's because many people are willing to pay more for a ticket on their favorite airline so they won't miss out on their frequent-flier miles.

Another way to avoid a calamitous price war: make your competitor aware that a price war will hurt him as much as it hurts you. Recently, a company (call it Acme) heard that its competitor was trying to steal some business by offering a low price to one of its best customers. Instead of immediately cutting its prices, Acme visited three of its competitor's best clients and said they figured the client was paying x, the same price that the competitor had quoted to Acme's own customer. Within days, Acme's competitor had retracted its low-price offer to its client. Presumably, the competitor had received calls from three angry clients asking for the same special deal.

Game theorists also say it pays not to negotiate prices. Ten years ago in business-to-business selling, 80% of product was sold at list, and 20% was negotiated down from list. Now the percentages are reversed. Nagle decries this trend toward price negotiation. If you refuse to negotiate with your customers, he says, the question they will ask when seeing your price is 'Am I getting my money's worth?' When you start negotiating, and the word gets out, the game changes and your customers ask, 'How can I use various tricks to get the price down?'

The moral is clear: The only time you should negotiate is when the customer is an infrequent purchaser. A newspaper manager, for instance, made the mistake of offering his lowest ad rates to his biggest advertisers simply because they were his biggest. He ignored the fact that the paper was essential to these advertisers' continued profitability.

At times, game theory may lead you to make moves that seem counterintuitive and sometimes even downright scary. But fail to operate by these new realities, and you will surely end up paying a high price.