CHAPTER

14

Pricing Strategy for Business Markets

Understanding how customers define value is the essence of the pricing process. Pricing decisions complement the firm's overall marketing strategy. The diverse nature of the business market presents unique problems and opportunities for the price strategist. After reading this chapter, you will understand:

1. **a value-based approach for pricing.**
2. **the central elements of the pricing process.**
3. **how effective new-product prices are established and the need to periodically adjust the prices of existing products.**
4. **how to respond to a price attack by an aggressive competitor.**
5. **strategic approaches to competitive bidding.**

Customer value represents the cornerstone of business-to-business (B2B) marketing in the 21st century.[1] Thus, business marketers must pursue this unifying strategic goal: Be better than your very best competitors in providing customer value.[2] According to Richard D'Aveni:

> While the average competitor fights for niches along a common ratio of price and value ("You get what you pay for"), innovative firms can enter the market by providing better value to the customer ("You can get more than what you pay for"). These companies offer lower cost *and* higher quality. This shift in value is like lowering the stick while dancing the limbo. All the competitors have to do the same dance with tighter constraints on both cost and quality.[3]

The business marketing manager must blend the various components of the marketing mix into a value proposition that responds to the customer's requirements and provides a return consistent with the firm's objectives. Price must be carefully meshed with the firm's product, distribution, and communication strategies. Thomas Nagle points out, "If effective product development, promotion, and distribution sow the seeds of business success, effective pricing is the harvest. Although effective pricing can never compensate for poor execution of the first three elements, ineffective pricing can surely prevent these efforts from resulting in financial success. Regrettably, this is a common occurrence."[4]

This chapter is divided into five parts. The first defines the special meaning of customer value in a business marketing context. The second analyzes key determinants of the industrial pricing process and provides an operational approach to pricing decisions. The third examines pricing policies for new and existing products, emphasizing the need to actively manage a product throughout its life cycle. The fourth provides a framework to guide strategy when a competitor cuts prices. The final section examines an area of particular importance to the business marketer: competitive bidding.

The Meaning of Value in Business Markets

When members of a buying center select a product, they are buying a given level of product quality, technical service, and delivery reliability. Other elements may be important—the reputation of the supplier, a feeling of security, friendship, and other personal benefits flowing from the buyer-seller relationship. Value represents a trade-off between benefits and sacrifices. **Customer value**, then, represents a business customer's overall assessment of the utility of a relationship with a supplier based on benefits received and sacrifices made[5] (Figure 14.1).

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[1]Ajay Menon, Christian Homburg, and Nikolas Beutin, "Understanding Customer Value in Business-to-Business Relationships," *Journal of Business-to-Business Marketing* 12 (2, 2005): pp. 1–33; see also James C. Anderson, Nirmalya Kumar, and James A. Narus, *Value Merchants: Demonstrating and Documenting Superior Value in Business Markets* (Boston: Harvard Business School Press, 2007).

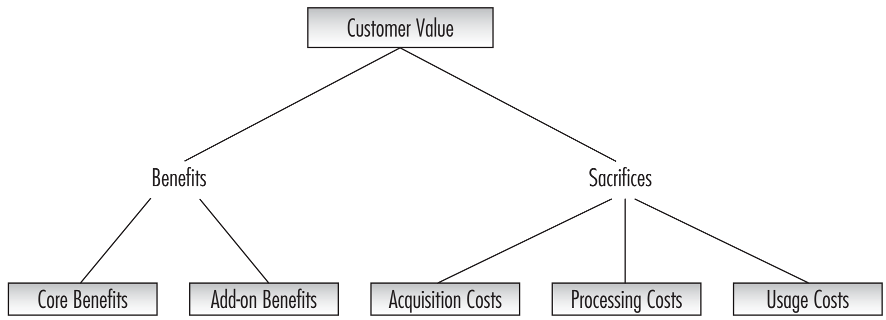
[2]Bradley T. Gale, *Managing Customer Value: Creating Quality and Service That Customers Can See* (New York: The Free Press, 1994), pp. 73–75.

[3]Richard A. D'Aveni, *Hypercompetitive Rivalries* (New York: The Free Press, 1995), p. 27.

[4]Thomas T. Nagle, *The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making* (Englewood Cliffs, NJ: Prentice-Hall, 1987), p. 1.

[5]This discussion is based on Menon, Homburg, and Beutin, "Understanding Customer Value," pp. 1–33.

FIGURE 14.1 | CUSTOMER VALUE IN BUSINESS MARKETS



SOURCE: Adapted with modifications from Ajay Menon, Christian Homburg, and Nikolas Beutin, "Understanding Customer Value in Business-to-Business Relationships," *Journal of Business-to-Business Marketing* 12 (2, 2005): pp. 1–33.

Benefits

Two types of benefits can contribute to customer value in business markets: core benefits and add-on benefits (see Chapter 8).

Core Benefits **Core benefits** are the basic requirements the business marketer must meet to be included in the customer's consideration set. Represented here would be a specific level of product quality and performance, as well as expected levels of pre- and postsales service. Likewise, by enhancing problem solving and the open sharing of ideas, a trust-based relationship adds value and the customer sees it as a core benefit.

Add-on Benefits **Add-on benefits** are those "attributes, typically not required, that assist the customer in selecting a supplier from among a qualified set of potential suppliers."[6] These are relational characteristics or services that differentiate suppliers and focus on "attractor" attributes in buyer-seller relationships.

Examples of add-on benefits would be *joint working relationships* in product development, quality control, logistics, and delivery systems. **Supplier flexibility**, or the willingness of a business marketer to accommodate a customer's unique business needs, likewise adds customer value. The supplier's **commitment**, namely the desire to make the relationship work, can also provide an add-on benefit to the customer. Supplier commitment "takes into account the supplier's willingness to make short-term sacrifices, invest in the relationship, and be tolerant of buyer's mistakes (for example, mistakes in ordering or outlining product specifications)."[7]

Sacrifices

A broad perspective is likewise needed in examining the sacrifices, or costs, a particular alternative may present for the buyer. When purchasing a product or service, a business customer always assumes various costs above and beyond the actual purchase price.

[6]Ibid., p. 6; see also Das Narayandas, "Building Loyalty in Business Markets," *Harvard Business Review* 83 (September 2005): pp. 131–139.

[7]Menon, Homburg, and Beutin, "Understanding Customer Value," p. 15.

TABLE 14.1 | CUSTOMERS' COST-IN-USE COMPONENTS

Acquisition Costs	+	Possession Costs	+	Usage Costs	=	Total Cost in Use
Price		Interest cost		Installation costs		
Paperwork cost		Storage cost		Training cost		
Transportation costs		Quality control		User labor cost		
Expediting cost		Taxes and insurance		Product longevity		
Cost of mistakes in order		Shrinkage and obsolescence		Replacement costs		
Prepurchase product evaluation costs		General internal handling costs		Disposal costs		

SOURCE: Adapted from Frank V. Cespedes, "Industrial Marketing: Managing New Requirements," *Sloan Management Review* 35 (Spring 1994): p. 46.

Many businesses buy products online to reduce paperwork and lower transaction and search costs.[8] Rather than making a decision on the basis of price alone, organizational buyers emphasize the **total cost in use** of a particular product or service.[9] Observe in Table 14.1 that an organizational customer considers three different types of costs in a total cost-in-use calculation:

1. **Acquisition costs** include not only the selling price and transportation costs but also the administrative costs of evaluating suppliers, expediting orders, and correcting errors in shipments or delivery.
2. **Possession costs** include financing, storage, inspection, taxes, insurance, and other internal handling costs.
3. **Usage costs** are those associated with ongoing use of the purchased product such as installation, employee training, user labor, and field repair, as well as product replacement and disposal costs.

Value-Based Strategies

Aided by sophisticated supplier evaluation systems, buyers can measure and track the total cost/value of dealing with alternative suppliers. In turn, astute business marketers can pursue value-based strategies that provide customers with a lower cost-in-use solution. For example, the logistical expenses of health-care supplies typically account for 10 to 15 percent of a hospital's operating costs. Medical products firms, like Becton, Dickinson and Company, develop innovative product/service packages that respond to each component of the cost-in-use equation. Such firms can reduce a hospital's acquisition costs by offering an electronic ordering system, possession costs by emphasizing just-in-time service, and usage costs by creating an efficient system for disposing of medical supplies after use.

[8]Walter Baker, Mike Marn, and Craig Zawada, "Price Smarter on the Net," *Harvard Business Review* 79 (February 2001): pp. 122–127.

[9]Frank V. Cespedes, "Industrial Marketing: Managing New Requirements," *Sloan Management Review* 35 (Spring 1994): pp. 45–60.

Differentiating Through Value Creation Value-based strategies seek to move the selling proposition from one that centers on current prices and individual transactions to a longer-term relationship built around value and lower total cost in use. Importantly, recent research suggests that benefits have a greater effect on perceived value to business customers than sacrifices (price and costs). Ajay Menon, Christian Homburg, and Nikolas Beutin note: Contrary to the general belief in a cost-driven economy, "we encourage managers to emphasize benefits accruing from a relationship and not focus solely on lowering the price and related costs when managing customer value."[10] A better way is to provide unique add-on benefits by building trust, demonstrating commitment and flexibility, and initiating joint working relationships that enhance customer value and loyalty.

In support, recent research by Wolfgang Ulaga and Andreas Eggert indicates that relationship benefits display a stronger potential for differentiation in key supplier relationships than cost considerations.[11] Based on a best-practice profile for companies seeking key supplier status, the researchers identify service support and personal interaction as core differentiators, followed by a supplier's know-how and its ability to improve a customer's time to market. Product quality and delivery performance, along with acquisition cost and operation costs, display a moderate potential to help the awarding of key supplier status to a business-to-business firm by a customer. Interestingly, price shows the weakest potential for differentiation. A specific approach for designing value-based strategies is highlighted in the next section.

The Pricing Process in Business Markets

There is no easy formula for pricing an industrial product or service. The decision is multidimensional: The interactive variables of demand, cost, competition, profit relationships, and customer usage patterns each assumes significance as the marketer formulates the role of price in the firm's marketing strategy. Pertinent considerations, illustrated in Figure 14.2, include (1) pricing objectives, (2) demand determinants, (3) cost determinants, and (4) competition.

Price Objectives

The pricing decision must be based on objectives congruent with marketing and overall corporate objectives. The marketer starts with principal objectives and adds collateral pricing goals: (1) achieving a target return on investment, (2) achieving a market-share goal, or (3) meeting competition. Many other potential pricing objectives extend beyond profit and market-share goals, taking into account competition, channel relationships, and product-line considerations.

Because of their far-reaching effects, pricing objectives must be established with care. Each firm faces unique internal and external environmental forces. Contrasting the strategies of DuPont and Dow Chemical illustrates the importance of a unified corporate direction. Dow's strategy focuses first on pricing low-margin commodity

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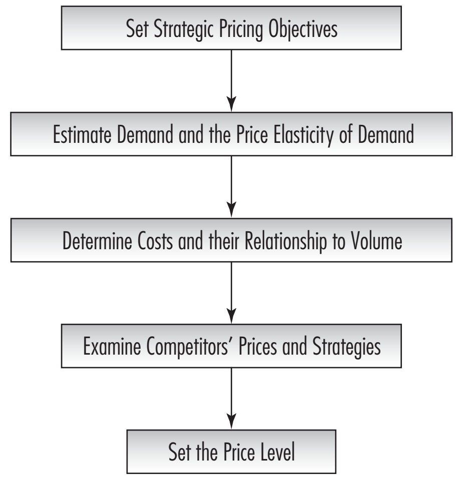
[10]Menon, Homburg, and Beutin, "Understanding Customer Value," p. 25.

[11]Wolfgang Ulaga and Andreas Eggert, "Value-Based Differentiation in Business Relationships: Gaining and Sustaining Key Supplier Status," *Journal of Marketing* 70 (January 2006): pp. 119–136.

FIGURE 14.2 | **KEY COMPONENTS OF THE PRICE-SETTING DECISION PROCESS**



goods *low* to build a dominant market share and then on maintaining that dominant share. DuPont's strategy, on the other hand, emphasizes higher-margin specialty products. Initially, these products are priced at a *high* level, and prices are reduced as the market expands and competition intensifies. Each firm requires explicit pricing objectives that are consistent with its corporate mission.

Demand Determinants

A strong market perspective is fundamental in pricing. The business market is diverse and complex. A single industrial product can be used in many ways; each market segment may represent a unique application for the product and a separate usage level. The importance of the industrial good in the buyer's end product also varies by market segment. Therefore, potential demand, sensitivity to price, and potential profitability can vary markedly across market segments. To establish an effective pricing policy, marketers should focus first on the value a customer places on a product or service. This reverses the typical process that gives immediate attention to the product cost and the desired markup.[12]

Assessing Value[13] How organizational buyers evaluate the economic value of the total offering determines the appropriateness of a pricing strategy. Two competitors with similar products may ask different prices because buyers perceive their total offerings as unique. In the eyes of the organizational buyer, one firm may provide more value than another.

Economic value represents the cost savings and/or revenue gains that customers realize by purchasing the firm's product instead of the next-best alternative. Some

[12]Robert J. Dolan, "How Do You Know When the Price Is Right?" *Harvard Business Review* 73 (September–October 1995): pp. 174–183; see also Thomas T. Nagle and George E. Cressman Jr. "Don't Just Set Prices, Manage Them," *Marketing Management* 11 (November–December 2002): pp. 29–34.

[13]This section is based on Gerald E. Smith and Thomas T. Nagle, "A Question of Value," *Marketing Management* 14 (July/August 2005): pp. 38–43.

product or service features are quite similar across competitive offerings in a category (that is, points of parity) whereas others might be unique to a particular firm's brand (that is points of differentiation). **Commodity value,** then, is the value that a customer assigns to product features that resemble those of competitors' offerings. By contrast, **differentiation value** is the value associated with product features that are unique and different from competitors'. Importantly, the price-per-unit of value that organizational buyers are willing to pay a firm for differentiating features is greater than the price-per-unit of value that they would pay for commodity features. "That's because refusal to pay a supplier's price for differentiating features means that the buyer must forgo those features. Refusal to pay a supplier's price for commodity features means simply that the customer must buy them elsewhere," says Gerald E. Smith and Thomas T. Nagle.[14] Recall that best-practice business-to-business firms create distinctive value propositions (see Chapter 4) that isolate those product and service features that matter the most to customers, demonstrate the value of their unique elements, and communicate that value in a manner that clearly conveys a deep understanding of the customer's business priorities.[15]

Isolating Value Drivers in Key Customer Segments Exploratory methods such as depth interviews are required for identifying and measuring value. For example, depth interviews can be used to probe customer needs and problems and for learning how your products or services could address these problems. The goal here is to first identify the most significant drivers of value for customers in each market segment (see Figure 14.3). Economic value embodies both cost and revenue drivers. **Cost drivers** create value by providing economic savings while **revenue drivers** add incremental value by facilitating revenue or margin expansion.[16] For example, consider the value that Sonoco, a packaging supplier, provided for Lance, the snack food maker. One improvement involved the use of flexographic painted packaging film on some of Lance's key brands.[17] These efforts drastically reduced Lance's packaging costs (cost driver) and, by enhancing the appeal of the products, spawned a growth in sales (revenue driver).

Second, once the business marketing strategist has identified the most important value drivers for customers, attention then turns to quantifying the impact of the firm's product or service on the customer's business model. To illustrate, a medical equipment company developed a new surgical product. Based on depth interviews with surgical teams at key hospitals, value research found that this product could reduce the length of a particular surgical procedure from 55 minutes to 40 minutes, freeing up precious time in capacity-constrained operating rooms.[18] In addition to estimating the value of the product, the study also revealed ways in which surgical procedures could be more tightly scheduled to capture the full value potential of the new product.

Third, the strategist should compare the firm's product or service to the next-best alternative, isolating those features that are unique and different from competitors.

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[14]Ibid., p. 40.

[15]James C. Anderson, James A. Narus, and Wouter van Rossum, "Customer Value Propositions in Business Markets," *Harvard Business Review* 86 (March 2006): p. 93.

[16] Gerald E. Smith and Thomas T. Nagle, "How Much Are Customers Willing to Pay?" *Marketing Research* 14 (Winter 2002): pp. 20–25.

[17]Maryanne Q. Hancock, Roland H. John, and Philip J. Wojcik, "Better B2B Selling," *The McKinsey Quarterly* (June 2005): pp. 1–8.

[18]Smith and Nagle, "How Much Are Customers Willing to Pay?" p. 23.

FIGURE 14.3 | **A VALUE-BASED APPROACH FOR PRICING**

Define the Key Market Segments

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Isolate the most significant drivers of value in customers' business

↓

Quantify the impact of your product or service on each value driver in customers' business

↓

Estimate the incremental value created by your product or service, particularly for those features that are unique and different from competitors' offerings

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Develop Pricing Strategy and Marketing Plan

SOURCE: Adapted from Gerald E. Smith and Thomas T. Nagle, "How Much Are Customers Willing to Pay," *Marketing Research* 14 (Winter 2002): pp. 20–25.

Does the product provide favorable points of difference that provide value that a customer cannot access elsewhere? How much value does each of these features create for the customer? Finally, by understanding how customers actually use a product or service and realize value from its use, the business marketer is ideally equipped to set the price and develop a responsive marketing strategy.

Value-Based Pricing Illustrated[19]

DataCare was planning to introduce a new data-based service targeting subacute hospitals where patients stay for longer recovery periods. Drawing on extensive operating data gathered from 300 hospitals throughout North America, DataCare developed software that enabled hospital administrators to make benchmarking comparisons with best-in-class institutions using the data. By subscribing to the service, customers could input their operating data into the firm's central operating database and, in return, would have access to the benchmarking capabilities and expert consultation from the nationally recognized physicians who founded the firm. Before introducing the service, the founders asked consultants at Strategic Pricing Research to examine this question: "Would the market be willing to pay a price of $2,000 per year?"

Value Research In addition to measuring willingness to pay, the consultants also calculated the value that DataCare's customers would receive from the new service. First, different market segments were identified and a customer interview guide was

[19]This illustration is drawn from Smith and Nagle, "How Much Are Customers Willing to Pay?" p. 23.

developed: nonprofit hospitals, for-profit hospitals, and hospital chains. Second, several value drivers emerged from the customer interviews: nurse turnover, Health Care Financial Administration (HCFA) violations (that is, an oversight agency for Medicare and Medicaid), patient mix, and infection rates. Third, the potential impact of DataCare's new service on each of these value drivers was quantified. To illustrate, the database indicated that best-in-class institutions have nurse turnover rates of 30 percent. In turn, the analysis revealed that a hospital incurs a cost of $2,200 to $2,800 each time a nurse leaves. Assume that a hospital with a nursing staff of 50 has a turnover rate of 44 percent. A reduction in nurse turnover rate to the best-in-class level would be worth 14% × 50 × ($2,200 to $2,800), or $15,400 to $19,600. After providing this calculation, the customer was asked: Does this sound correct?

By repeating this process for each of the value drivers, the consultants concluded the interviews by summarizing the potential impact of the new service on each of the value drivers: $15,400 to $19,000 for nurse turnover; $9,000 to $12,000 for lower infection rates; and $4,000 for fewer HCFA violations.

In describing the study's conclusions, Gerald E. Smith and Thomas T. Nagle observe:

> The price DataCare originally proposed was well below the estimated value the customer would receive by adopting the new service, and well below the approximate price customers would be willing to pay if they were fully informed of the value of the new service. The study led to a substantial revision in pricing strategy and the marketing plan of DataCare's new service.[20]

As the DataCare case illustrates, the business marketing strategist can secure a competitive advantage by emphasizing a value-based approach and by developing the tools to document and communicate the unique value that its products and services create for customers in each market segment.[21]

Elasticity Varies by Market Segment Price elasticity of demand measures the degree to which customers are sensitive to price changes. Specifically, **price elasticity of demand** refers to the rate of percentage change in quantity demanded attributable to a percentage change in price. Price elasticity of demand is not the same at all prices. A business marketer contemplating a change in price must understand the elasticity of demand. For example, total revenue (price times quantity) *increases* if price is decreased and demand is price elastic, whereas revenue *falls* if the price is decreased and demand is price inelastic. Many factors influence the price elasticity of demand—the ease with which customers can compare alternatives and switch suppliers, the importance of the product in the cost structure of the customer's product, and the value that the product represents to a customer.

Satisfied Customers Are Less Price Sensitive Recent research demonstrates that highly satisfied customers are less sensitive to prices, compared with those who have a moderate level of customer satisfaction.[22] This relationship is particularly strong

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[20]Ibid., p. 23.

[21]Werner Reinartz and Wolfgang Ulaga, "How to Sell Services More Profitability," *Harvard Business Review* 86 (May 2008): pp. 91–96.

[22]Ruth Maria Stock, "Can Customer Satisfaction Decrease Price Sensitivity in Business-to-Business Marketing?" *Journal of Business-to-Business Marketing* 12 (3, 2005): pp. 59–85.

for purchase decisions that involve a high level of product/service complexity and a high degree of customization. Thus, reduced customer price sensitivity represents an important payoff to a business marketer for developing a customized solution for the customer.

Search Behavior and Switching Costs The price sensitivity of buyers increases—and a firm's pricing latitude decreases—to the degree that

- Organizational buyers can easily shop around and assess the relative performance and price of alternatives. Purchasing managers in many firms use information technology to track supplier prices on a global basis.
- The product is one for which it is easy to make price comparisons. For example, it is easier to compare alternative photocopiers than it is to compare specialized manufacturing equipment options.
- Buyers can switch from one supplier to another without incurring additional costs. As Chapter 4 highlights, low switching costs allow a buyer to focus on minimizing the cost of a particular transaction.[23]

End Use Important insights can be secured by answering this question: How important is the business marketer's product as an input into the total cost of the end product? If the business marketer's product has an insignificant effect on cost, demand is likely inelastic. Consider this example:

> A manufacturer of precision electronic components was contemplating an across-the-board price decrease to increase sales. However, an item analysis of the product line revealed that some of its low-volume components had exotic applications. A technical customer used the component in an ultrasonic testing apparatus that was sold for $8,000 a unit. This fact prompted the electronics manufacturer to raise the price of the item. Ironically, the firm then experienced a temporary surge of demand for the item as purchasing agents stocked up in anticipation of future price increases.[24]

Of course, the marketer must temper this estimate by analyzing the costs, availability, and suitability of substitutes. Generally, when the industrial product is an important but low-cost input into the end product, price is less important than quality and delivery reliability. When, however, the product input represents a larger part of the final product's total cost, changes in price may have an important effect on the demand for both the final product and the input. When demand in the final consumer market is price elastic, a reduction in the price of the end item (for example, a personal computer) that is caused by a price reduction of a component (for example, a microprocessor) generates an increase in demand for the final product (personal computer) and, in turn, for the industrial product (microprocessor).

End-Market Focus Because the demand for many industrial products is derived from the demand for the product of which they are a part, a strong end-user focus

[23]Dolan, "How Do You Know When the Price Is Right?" pp. 178–179.

[24]Reed Moyer and Robert J. Boewadt, "The Pricing of Industrial Goods," *Business Horizons* 14 (June 1971): pp. 27–34; see also George Rostky, "Unveiling Market Segments with Technical Focus Research," *Business Marketing* 71 (October 1986): pp. 66–69.

is needed. The marketer can benefit by examining the trends and changing fortunes of important final consumer markets. Different sectors of the market grow at different rates, confront different levels of competition, and face different short-run and long-run challenges. A downturn in the economy does not fall equally on all sectors. Pricing decisions demand a two-tiered market focus—on organizational customers and on final-product customers. Thus, business marketers will have more success in raising prices to customers who are prospering than to customers who are hard pressed.

Value-Based Segmentation The value customers assign to a firm's offering can vary by market segment because the same industrial product may serve different purposes for different customers. This underscores the important role of market segmentation in pricing strategies. Take Sealed Air Corporation, the innovative supplier of protective packaging, including coated air bubbles.[25] The company recognized that for some applications, substitutes were readily available. But for other applications, Sealed Air had an enormous advantage—for example, its packaging materials offered superior cushioning for heavy items with long shipping cycles. By identifying those applications where the firm had a clear advantage and understanding the unique value differential in each setting, marketing managers were ideally equipped to tackle product-line expansion and pricing decisions and to ignite Sealed Air's remarkable revenue growth for nearly two decades.

Cost Determinants

Business marketers often pursue a strong internal orientation; they base prices on their own costs, reaching the selling price by calculating unit costs and adding a percentage profit. A strict cost-plus pricing philosophy overlooks customer perceptions of value, competition, and the interaction of volume and profit. Many progressive firms, such as Canon, Toyota, and Hewlett-Packard (H-P), use target costing to capture a significant competitive advantage.

Target Costing[26] **Target costing** features a design-to-cost philosophy that begins by examining market conditions: The firm identifies and targets the most attractive market segments. It then determines what level of quality and types of product attributes are required to succeed in each segment, given a predetermined target price and volume level. According to Robin Cooper and Regine Slagmulder, to set the target price, the business marketer has to understand the customer's perception of value: "A company can raise selling prices only if the perceived value of the new product exceeds not only that of the product's predecessor, but also that of competing products."[27]

Once the target selling price and target profit margins have been established, the firm calculates the allowable cost. The strategic cost-reduction challenge isolates the profit shortfall that occurs if the product designers are unable to achieve the allowable cost. The value of distinguishing the allowable cost from the target cost lies in the pressure that this exercise exerts on the product-development team and the company's suppliers. To transmit the competitive cost pressure *it* faces to its suppliers, the firm then breaks down the target price of a new product into a cascade of

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[25]Dolan, "How Do You Know When the Price Is Right?" pp. 176–177.

[26]This section is based on Robin Cooper and Regine Slagmulder, "Develop Profitable New Products with Target Costing," *Sloan Management Review* 40 (Summer 1999): pp. 23–33.

[27]Ibid., p. 26.

target costs for each component or function. For example, the major functions of an automobile include the engine, transmission, cooling system, and audio system.

A Profit-Management Tool Toyota used target costing to reduce the price of its recently modified Camry model and did so while offering as standard equipment certain features that were expensive options on the model it replaced. Similarly, Canon used target costing to develop its breakthrough personal copier that transformed the photocopier industry.[28] Rather than a cost-control technique, Japanese managers who pioneered the approach view target costing as a profit-management tool. As Robin Cooper and W. Bruce Chew assert, "The task is to compute the costs that must not be exceeded if acceptable margins from specific products at specific price points are to be guaranteed."[29]

Classifying Costs[30] The target costing approach stresses why the marketer must know which costs are relevant to the pricing decision and how these costs fluctuate with volume and over time; they must be considered in relation to demand, competition, and pricing objectives. Product costs are crucial in projecting the profitability of individual products as well as of the entire product line. Proper classification of costs is essential.

The goals of a cost classification system are to (1) properly classify cost data into their fixed and variable components and (2) properly link them to the activity causing them. The manager can then analyze the effects of volume and, more important, identify sources of profit. The following cost concepts are instrumental in the analysis:

1. **Direct traceable or attributable costs:** Costs, fixed or variable, are incurred by and solely for a particular product, customer, or sales territory (for example, raw materials).
2. **Indirect traceable costs:** Costs, fixed or variable, can be traced to a product, customer, or sales territory (for example, general plant overhead may be indirectly assigned to a product).
3. **General costs:** Costs support a number of activities that cannot be objectively assigned to a product on the basis of a direct physical relationship (for example, the administrative costs of a sales district).

General costs rarely change because an item is added or deleted from the product line. Marketing, production, and distribution costs must all be classified. When developing a new line or when deleting or adding an item to an existing line, the marketer must grasp the cost implications:

- What proportion of the product cost is accounted for by purchases of raw materials and components from suppliers?
- How do costs vary at differing levels of production?

[28]Jean-Phillippe Deschamps and P. Ranganath Nayak, *Product Juggernauts: How Companies Mobilize to Generate a Stream of Market Winners* (Boston: Harvard Business School Press, 1995), pp. 119–149.

[29]Robin Cooper and W. Bruce Chew, "Control Tomorrow's Costs through Today's Designs," *Harvard Business Review* 74 (January–February 1996): pp. 88–97.

[30]Kent B. Monroe, *Pricing: Making Profitable Decisions* (New York: McGraw-Hill, 1979), pp. 52–57; see also Nagle, *The Strategy and Tactics of Pricing*, pp. 14–43.

- Based on the forecasted level of demand, can economies of scale be expected?
- Does our firm enjoy cost advantages over competitors?
- How does the "experience effect" impact our cost projections?

Competition

Competition establishes an upper limit on price. An individual industrial firm's degree of latitude in pricing depends heavily on how organizational buyers perceive the product's level of differentiation. Price is only one component of the cost/benefit equation; the marketer can gain a differential advantage over competitors on many dimensions other than physical product characteristics—reputation, technical expertise, delivery reliability, and related factors. Regis McKenna contends, "Even if a company manufactures commodity-like products, it can differentiate the products through the service and support it offers, or by target marketing. It can leave its commodity mentality in the factory, and bring a mentality of diversity to the marketplace."[31] In addition to assessing the product's degree of differentiation in various market segments, one must ask how competitors will respond to particular pricing decisions.

Hypercompetitive Rivalries Some strategy experts emphasize that traditional patterns of competition in stable environments is being replaced by hypercompetitive rivalries in a rapidly changing environment.[32] In a stable environment, a company could create a fairly rigid strategy designed to accommodate long-term conditions. The firm's strategy focused on sustaining its own strategic advantage and establishing equilibrium where less-dominant firms accepted a secondary status.

In hypercompetitive environments, successful companies pursue strategies that create temporary advantage and destroy the advantages of rivals by constantly disrupting the market's equilibrium. For example, Intel continually disrupts the equilibrium of the microprocessor industry sector, and Hewlett-Packard stirs up the computer printer business by its consistent drives to lower price points. Moreover, the Internet provides customers with real-time access to a wealth of information that drives the prices of many products lower. Leading firms in hypercompetitive environments constantly seek out new sources of advantage, further escalating competition and contributing to hypercompetition.

Consider the hypercompetitive rivalries in high-technology markets. Firms that sustain quality and that are the first to hit the next-lower strategic price point enjoy a burst of volume and an expansion of market share. For example, Hewlett-Packard has ruthlessly pursued the next-lower price point in its printer business, even as it cannibalized its own sales and margins.[33]

Gauging Competitive Response To predict the response of competitors, the marketer can first benefit by examining the cost structure and strategy of both direct competitors and producers of potential substitutes. The marketer can draw on public statements and records (for example, annual reports) to form rough estimates.

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[31]Regis McKenna, *Relationship Marketing* (Reading, MA: Addison-Wesley, 1991), pp. 178–179.

[32]D'Aveni, *Hypercompetitive Rivalries*, pp. 149–170.

[33]Geoffrey A. Moore, *Inside the Tornado: Marketing Strategies from Silicon Valley's Cutting Edge* (New York: HarperCollins, 1995), pp. 84–85.

TABLE 14.2 | SELECTED COST COMPARISON ISSUES: FOLLOWERS VERSUS THE PIONEER

Technology/economies of scale	Followers may benefit by using more current production technology than the pioneer or by building a plant with a larger scale of operations.
Product/market knowledge	Followers may learn from the pioneer's mistakes by analyzing the competitor's product, hiring key personnel, or identifying through market research the problems and unfulfilled expectations of customers and channel members.
Shared experience	Compared with the pioneer, followers may be able to gain advantages on certain cost elements by sharing operations with other parts of the company.
Experience of suppliers	Followers, together with the pioneer, benefit from cost reductions achieved by outside suppliers of components or production equipment.

SOURCE: Adapted from George S. Day and David B. Montgomery, "Diagnosing the Experience Curve," *Journal of Marketing* 47 (Spring 1983): pp. 48–49.

Competitors that have ascended the learning curve may have lower costs than those just entering the industry and beginning the climb. An estimate of the cost structure is valuable when gauging how well competitors can respond to price reductions and when projecting the pattern of prices in the future.

Under certain conditions, however, followers into a market may confront lower initial costs than did the pioneer. Why? Some of the reasons are highlighted in Table 14.2. By failing to recognize potential cost advantages of late entrants, the business marketer can dramatically overstate cost differences.

The market strategy competing sellers use is also important here. Competitors are more sensitive to price reductions that threaten those market segments they deem important. They learn of price reductions earlier when their market segments overlap. Of course, competitors may choose not to follow a price decrease, especially if their products enjoy a differentiated position. Rather than matching competitors' price cuts, one successful steel company reacts to the competitive challenge by offering customized products and technical assistance to its customers.[34] Later in the chapter, special attention is given to this question: How should you respond to price attacks by competitors?

The manager requires a grasp of objectives, demand, cost, competition, and legal factors (discussed later) to approach the multidimensional pricing decision. Price setting is not an act but an ongoing process.

Pricing across the Product Life Cycle

What price should be assigned to a distinctly new industrial product or service? When an item is added to an existing product line, how should it be priced in relation to products already in the line?

[34]Arun Sharma, R. Krishnan, and Dhruv Grewal, "Value Creation in Markets: A Critical Area of Focus for Business-to-Business Markets," *Industrial Marketing Management* 30 (June 2001): pp. 397–398.

Pricing New Products

The strategic decision of pricing new products can be best understood by examining the policies at the boundaries of the continuum—from **skimming** (high initial price) to **penetration** (low initial price). Consider again the pricing strategies of DuPont and Dow Chemical. Whereas DuPont assigns an initial high price to new products to generate immediate profits or to recover R&D expenditures, Dow follows a low-price strategy with the objective of gaining market share.

In evaluating the merits of skimming versus penetration, the marketer must again examine price from the buyer's perspective. This approach, asserts Joel Dean, "recognizes that the upper limit is the price that will produce the minimum acceptable rate of return on the investment of a sufficiently large number of prospects."[35] This is especially important in pricing new products because the potential profits to buyers of a new machine tool, for example, will vary by market segment, and these market segments may differ in the minimum rate of return that will induce them to invest in the machine tool.

Skimming A skimming approach, appropriate for a distinctly new product, provides an opportunity to profitably reach market segments that are not sensitive to the high initial price. As a product ages, as competitors enter the market, and as organizational buyers become accustomed to evaluating and purchasing the product, demand becomes more price elastic. Joel Dean refers to the policy of skimming at the outset, followed by penetration pricing as the product matures, as **time segmentation**.[36] Skimming enables the marketer to capture early profits, then reduce the price to reach more price-sensitive segments. It also enables the innovator to recover high developmental costs more quickly.

Robert Dolan and Abel Jeuland demonstrate that during the innovative firm's monopoly period, skimming is optimal if the demand curve is stable over time (no diffusion) and if production costs decline with accumulated volume. A penetration policy is optimal if there is a relatively high repeat purchase rate for nondurable goods or if a durable good's demand is characterized by diffusion.[37]

Penetration A penetration policy is appropriate when there is (1) high price elasticity of demand, (2) strong threat of imminent competition, and (3) opportunity for a substantial reduction in production costs as volume expands. Drawing on the experience effect, a firm that can quickly gain substantial market share and experience can gain a strategic advantage over competitors. The feasibility of this strategy increases with the potential size of the future market. By taking a large share of new sales, a firm can gain experience when the growth rate of the market is large. Of course, the value of additional market share differs markedly between industries and often among products, markets, and competitors in an industry.[38] Factors to be assessed

[35]Joel Dean, "Pricing Policies for New Products," *Harvard Business Review* 54 (November–December 1976): p. 151.

[36]Ibid., p. 152.

[37]Robert J. Dolan and Abel P. Jeuland, "Experience Curves and Dynamic Demand Models: Implications for Optimal Pricing Strategies," *Journal of Marketing* 45 (Winter 1981): pp. 52–62; see also, Paul Ingenbleek, Marion Debruyne, Rudd T. Frambach, and Theo M. Verhallen, "Successful New Product Pricing Practices: A Contingency Approach," *Marketing Letters* 14 (December 2004): pp. 289–304.

[38]Robert Jacobson and David A. Aaker, "Is Market Share All that It's Cracked Up to Be?" *Journal of Marketing* 49 (Fall 1985): pp. 11–22; and Yoram Wind and Vijay Mahajan, "Market Share: Concepts, Findings, and Directions for Future Research," in *Review of Marketing 1981*, Ben M. Enis and Kenneth J. Roering, eds. (Chicago: American Marketing Association, 1981), pp. 31–42.

INSIDE BUSINESS MARKETING

Understanding the Economic Value of New Products

Measuring the economic value that a product delivers to different customer segments is an essential ingredient in launching successful new products. Because customers will compare a new product offering to the next-best alternative, the marketing strategist must also understand the value delivered by competitors. Experts suggest that the most effective way to determine the value of a new product is through in-depth surveys. Here central attention is given to learning how a company's product affects the customer's business by reducing costs and/or by increasing revenue. The results provide an important foundation for effective pricing and responsive sales strategies. For example, after uncovering the value of a new software product, the firm, which was planning on a $99 price, decided the correct price was $349. Sales results exceeded expectations.

SOURCE: John Hogan and Tom Lucke, "Driving Growth with New Products: Common Pricing Traps to Avoid," *Journal of Business Strategy* 27 (1, 2006): pp. 54–58.

in determining the value of additional market share include the investment requirements, potential benefits of experience, expected market trends, likely competitive reaction, and short- and long-term profit implications.

Product Line Considerations The contemporary industrial firm with a long product line faces the complex problem of balancing prices in the product mix. Firms extend their product lines because the demands for various products are interdependent, because the costs of producing and marketing those items are interdependent, or both.[39] A firm may add to its product line—or even develop a new product line—to fit more precisely the needs of a particular market segment. If both the demand and the costs of individual product-line items are interrelated, production and marketing decisions about one item inevitably influence both the revenues and costs of the others.

Are specific product-line items substitutes or complements? Will changing the price of one item enhance or retard the usage rate of this or other products in key market segments? Should a new product be priced high at the outset to protect other product-line items (for example, potential substitutes) and to give the firm time to revamp other items in the line? Such decisions require knowledge of demand, costs, competition, and strategic marketing objectives.

Legal Considerations

Because the business marketer deals with various classifications of customers and intermediaries as well as various types of discounts (for example, quantity discounts), an awareness of legal considerations in price administration is vital. The **Robinson-Patman Act** holds that it is unlawful to "discriminate in price between different purchasers of commodities of like grade and quality . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly, or to injure, destroy, or prevent competition. . . ." Price differentials are permitted,

[39]Monroe, *Pricing*, p. 143; see also Robert J. Dolan, "The Same Make, Many Models Problem: Managing the Product Line," in *A Strategic Approach to Business Marketing*, Robert E. Spekman and David T. Wilson, eds. (Chicago: American Marketing Association, 1985), pp. 151–159.

but they must be based on cost differences or the need to "meet competition."[40] Cost differentials are difficult to justify, and clearly defined policies and procedures are needed in price administration. Such cost-justification guidelines are useful not only when making pricing decisions but also when providing a legal defense against price discrimination charges.

Responding to Price Attacks by Competitors[41]

Rather than emphasizing the lowest price, most business marketers prefer to compete by providing superior value. However, across industries, marketing managers face constant pressure from competitors who are willing to use price concessions to gain market share or entry into a profitable market segment. When challenged by an aggressive competitor, many managers immediately want to fight back and match the price cut. However, because price wars can be quite costly, experts suggest a more systematic process that considers the long-run strategic consequences versus the short-term benefits of the pricing decision. Managers should never set the price simply to meet some immediate sales goal, but, instead, to enhance long-term project goals. George E. Cressman Jr. and Thomas T. Nagle, consultants from the Strategic Pricing Group, Inc., observe: "Pricing is like playing chess; players who fail to envision a few moves ahead will almost always be beaten by those who do."[42]

Evaluating a Competitive Threat

Figure 14.4 provides a systematic framework for developing a strategy when one or more competitors have announced price cuts or have introduced new products that offer more value to at least some of your customers. To determine whether to reduce price to meet a competitor's challenge, four important questions should be addressed.

1. *Is there a response that would cost you less than the preventable sales loss?* (See center of Figure 14.4.) Before responding to a competitor's price reduction, the marketing strategist should ask: Do the benefits justify the costs? If responding to a price change is less costly than losing sales, a price move may be the appropriate decision. On the other hand, if the competitor threatens only a small slice of expected sales, the revenue loss from ignoring the threat may be much lower than the costs of retaliation. Indeed, when the threat centers on a small segment of customers, the cost of reducing prices for *all* customers to prevent the small loss is likely to be prohibitively expensive.

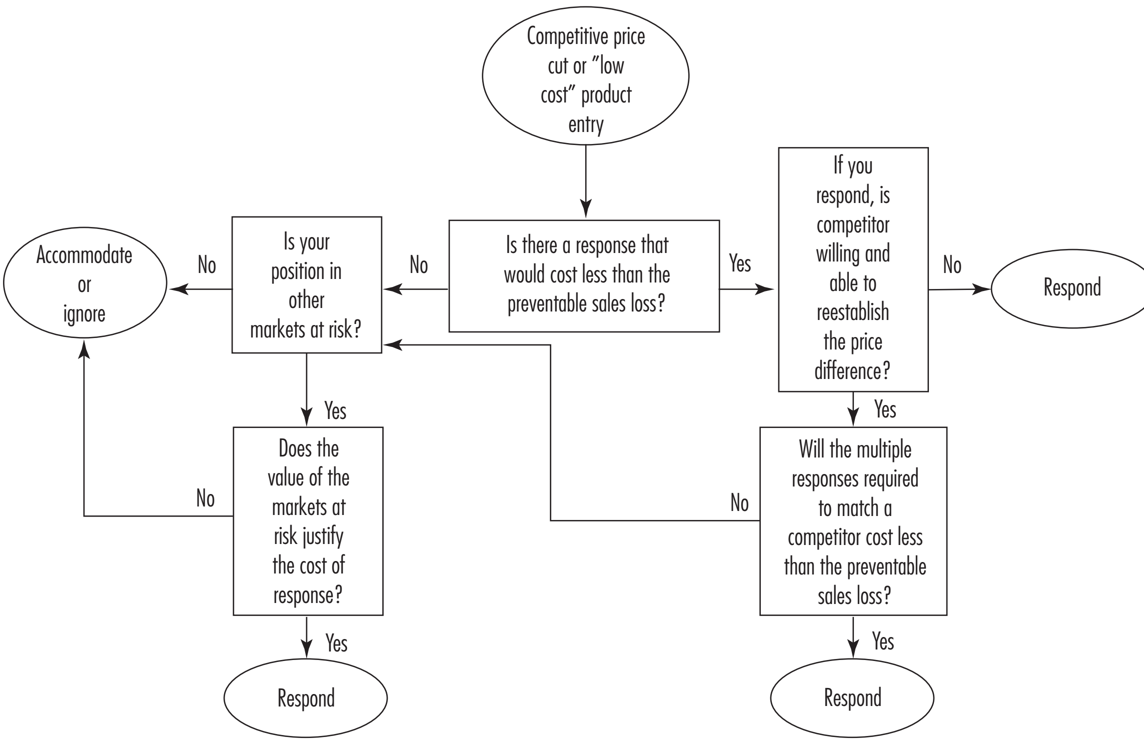
   If a price response is required, the strategist should focus the firm's competitive retaliation on the most cost-effective actions. The cost of retaliating to a price

[40]For a comprehensive discussion of the Robinson-Patman Act, see Monroe, *Pricing*, pp. 249–267; see also James J. Ritterskamp Jr. and William A. Hancock, "Legal Aspects of Purchasing," in *The Purchasing Handbook*, Harold E. Fearon, Donald W. Dobler, and Kenneth H. Killen, eds. (New York: McGraw-Hill, 1993), pp. 529–544.

[41]This section is based on George E. Cressman Jr. and Thomas T. Nagle, "How to Manage an Aggressive Competitor," *Business Horizons* 45 (March–April 2002), pp. 23–30.

[42]Ibid., p. 24.

FIGURE 14.4 | EVALUATING A COMPETITIVE THREAT



SOURCE: Reprinted from George E. Cressman, Jr. and Thomas T. Nagle, "How to Manage an Aggressive Competitor," *Business Horizons* 45 (March–April 2002): p. 25, Copyright © 2002, with permission from Elsevier.

threat can be reduced by incorporating one or more of the following elements into the pricing action:

- Center reactive price cuts only on those customers likely to be attracted to the competitor's offer (for example, rather than cutting the price of its flagship Pentium chip, Intel offered the lower-priced Cerrus chip for the cost-conscious market segment).
- Center reactive price cuts on a particular geographic region, distribution channel, or product line where the competitor has the most to lose from a price reduction (for example, Kodak might respond to a challenge from Fuji with price promotions in Japan where Fuji enjoys attractive margins and a larger market share).
- Capitalize on any competitive advantages to increase the value of your offer as an alternative to matching the price (for example, a firm that has better-quality products can respond by offering a longer warranty period to customers).

2. *If you respond, is the competitor willing and able to merely reduce the price again to restore the price difference?* Matching a price cut will be ineffective if the

competitor simply reestablishes the differential by a further price reduction. According to Cressman and Nagle, to determine the appropriate course, the strategist should attempt to understand why the competitor chose to compete on price in the first place: "If the competitor has little market share relative to the share that could be gained with a price advantage, and has no other way to attract customers, then there is little to lose from bringing the price down as low as necessary to gain sales."[43] This is especially true when competitors have made huge investments in areas such as R&D that largely represent sunk costs. Under such conditions, accommodation—market share loss—is less costly than fighting a price war.

3. *Will the multiple responses that may be required to match the competitor's price still cost less than the avoidable sales loss?* A single response is rarely enough to stop price moves by competitors that are struggling to establish a market position. Price competition is particularly likely in industries where entry requires a significant investment in fixed manufacturing capacity. Rather than idling manufacturing capacity, a competitor may be willing to aggressively pursue sales that will make at least some contribution to covering fixed costs. If competitors are likely to continue to cut prices, the best strategy for the defender is to:

   - Allow the competitor to win where it is least damaging to profitability, such as in more price-sensitive, lower-margin customer segments (for example, government contracts).
   - Create barriers that make it more difficult for competitors to reach less price-sensitive, more profitable customer segments (for example, build switching costs by developing unique solutions for the most valued customers).

4. *Is your position in other markets (product or geographic) at risk if the competitor increases market share? Does the value of all the markets that are at risk justify the cost of the strategy response?* Before responding with a price reduction, the business marketer must clearly define the long-run strategic benefits as well as the risks of a particular strategy response. The benefits might include additional sales in a particular market in the future, or immediate sales gains of complementary products (such as software, peripherals, and services associated with the sale of a computer), or a lower cost of future sales resulting from increased volume.

Understanding the Rules of Competitive Strategy

Dealing effectively with an aggressive competitor requires more than a willingness to fight—it requires a competitive strategy and an understanding of when the appropriate response to a competitor's price cut is to ignore it, accommodate it, or retaliate. George E. Cressman and Thomas T. Nagle offer these guidelines for competitive strategy development:

- Never participate in a competitive engagement you cannot win. Fight those battles where you have competitive strength, and avoid those where you are clearly at a disadvantage. . . .

[43]Ibid., p. 27.

- Always participate in competitive engagements from a position of advantage. Don't fight by competitors' rules (which they select for their advantage); use what is advantageous for you.[44]

Competitive Bidding

A significant volume of business commerce is transacted through competitive bidding. Rather than relying on a specific list price, the business marketer must develop a price, or a bid, to meet a customer's particular product or service requirements.

Government and other public agencies buy almost exclusively through competitive bidding. Competitive bidding in private industry centers on two types of purchases. One is nonstandard materials, complex fabricated products where design and manufacturing methods vary, and products made to the buyer's specifications. These types of items have no generally established market level. Competitive bids enable the purchaser to evaluate the appropriateness of the prices.[45] Second, many firms are using reverse auctions, where many sellers bid for an order from a single buyer (see Chapter 2). GE, for example, uses reverse auctions to buy both direct (for example, standard component parts) and indirect materials (for example, maintenance items, office supplies), making roughly a third of its total purchasing expenditures in this fashion. Typically, reverse auctions are best suited for product categories that buyers view as commodities.[46] Competitive bidding may be either closed or open.

Closed Bidding

Closed bidding, often used by business and governmental buyers, involves a formal invitation to potential suppliers to submit written, sealed bids. All bids are opened and reviewed at the same time, and the contract is generally awarded to the lowest bidder who meets desired specifications. The low bidder is not guaranteed the contract—buyers often make awards to the lowest responsible bidder; the ability of alternative suppliers to perform remains part of the bidding process.

Online Sealed Bid Format There is also a sealed bid format used for online auctions. The term *sealed* means that only one supplier and the buyer have access to the details of the bid. According to Sandy Jap:

> The bid process is asynchronous in the sense that the buyer and supplier take turns viewing the bid. The buyer posts the RFP (request for purchase) electronically, the supplier submits a bid, and the buyer views the submitted bid. The buyer then either makes a decision after viewing all bids or, if multiple rounds of bidding are involved, may respond to the supplier, who then resubmits a new bid.[47]

[44]Ibid., p. 30.

[45]Stuart St. P. Slatter, "Strategic Marketing Variables under Conditions of Competitive Bidding," *Strategic Management Journal* 11 (May–June 1990): pp. 309–317; see also Arthur H. Mendel and Roger Poueymirou, "Pricing," in *The Purchasing Handbook*, Harold E. Fearon, Donald W. Dobler, and Kenneth H. Killen, eds. (New York: McGraw-Hill, 1993), pp. 201–227.

[46]See, for example, C. M. Sashi and Bay O'Leary, "The Role of Internet Auctions in the Expansion of B2B Markets," *Industrial Marketing Management* 31 (February 2002): pp. 103–110.

[47]Sandy D. Jap, "Online Reverse Auctions: Issues, Themes, and Prospects for the Future," *Journal of the Academy of Marketing Science* 30 (fall 2002): p. 507.

Open Bidding

Open bidding is more informal and allows suppliers to make offers (oral and written) up to a certain date. The buyer may deliberate with several suppliers throughout the bidding process. Open bidding may be particularly appropriate when specific requirements are hard to define rigidly or when the products and services of competing suppliers vary substantially.

In some buying situations, prices may be negotiated. Complex technical requirements or uncertain product specifications may lead buying organizations first to evaluate the capabilities of competing firms and then to negotiate the price and the form of the product-service offering. Negotiated pricing is appropriate for procurement in both the commercial and the governmental sectors of the business market (see Chapter 2).

Online Open Bid Format When conducted online, open bidding takes a different form. Here suppliers are invited to bid simultaneously during a designated time period for the contract. In contrast to the sealed-bid format, all suppliers and the buyer view the bids at the same time. The goal, of course, is to push the price down. Sandy Jap, who has conducted extensive research on reverse auctions, argues that the open-bid format, when used regularly, can damage buyer-supplier relationships:

> This harm occurs because open-bid formats reveal pricing information to competition, which erodes the supplier's bargaining power. Open-bid formats also place a more explicit focus on price, a short-term variable that is usually the focus of transaction-oriented exchanges rather than relational exchanges. When buyers use an open-bid format amid a context in which relational exchanges are emphasized, they send an inconsistent message to suppliers and may foster distrust.[48]

Recent research on the use of online reverse auctions suggests that the larger the number of bidders, the larger the economic stakes, and the less visible the price in an auction, the more positive is the impact on the buyer-seller relationship.[49] However, large price drops over the course of the event have a detrimental effect on the buyer-seller relationship.

Strategies for Competitive Bidding

Because making bids is costly and time-consuming, firms should choose potential bid opportunities with care. Contracts offer differing levels of profitability according to the bidding firm's related technical expertise, past experience, and objectives. Therefore, careful screening is required to isolate contracts that offer the most promise.[50] Having isolated a project opportunity, the marketer must now estimate the probabilities of winning the contract at various prices. Assuming that the contract is awarded to the lowest bidder, the chances of the firm winning the contract decline as the bid price increases. How will competitors bid?

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[48] Ibid., p. 514.

[49] Sandy Jap, "The Impact of Online Reverse Auction Design on Buyer-Seller Relationships," *Journal of Marketing* 71 (January 2007): pp. 146–159.

[50] For example, see Paul D. Boughton, "The Competitive Bidding Process: Beyond Probability Models," *Industrial Marketing Management* 16 (May 1987): pp. 87–94.

A Strategic Approach to Reverse Auctions[51] Pricing experts suggest that customers use reverse auctions for two purposes: (1) to purchase commodity products at the lowest possible price and (2) to tempt suppliers of differentiated products to sacrifice their profit margins in the heat of bidding. If a firm's offering is not highly differentiated from competition, participating in an auction may represent the only choice. However, to minimize the risk of winning an unprofitable bid, a careful estimate should be made of the true incremental cost of supplying the customer, including the costs associated with special terms and conditions as well as unique technical, marketing, and sales support. This analysis will provide the business marketing strategist with a "walk-away" price.

In contrast, if a firm's offering provides significant value to customers relative to competition, John Bloomer, Joe Zale, and John Hogan, consultants at the Strategic Pricing Group, recommend the following decisive tactics:[52]

1. "Preempt the auction: convince the buyer not to go forward with the auction because you have a unique value proposition and are not inclined to participate.
2. Manage the process: influence bid specifications and vendor qualification criteria.
3. Walk away: simply refuse to participate. . . ."

A strategic approach to reverse auctions, then, defines success as winning only those bids that are profitable and that do not undermine pricing for other products or for other customers.

Summary

At the outset, the business marketer must assign pricing its role in the firm's overall marketing strategy. Giving a particular industrial product or service, an "incorrect" price can trigger a chain of events that undermines the firm's market position, channel relationships, and product and personal selling strategies. Customer value represents a business customer's overall assessment of the utility of a relationship with a supplier based on benefits received and sacrifices made. Price is but one of the costs that buyers examine when considering the value of competing offerings. Thus, the marketer can profit by adopting a strong end-user focus that gives special attention to the way buyers trade off the costs and benefits of various products. Responsive pricing strategies can be developed by understanding the economic value that a product provides for a customer. Economic value represents the cost savings and/or revenue gains that customers realize by purchasing the firm's product instead of the next-best alternative. By understanding how customers in a market segment actually use a product or service and realize value from its use, the business marketer is ideally equipped to set the price and develop a responsive strategy.

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[51]This discussion is based on John Bloomer, Joe Zale, and John E. Hogan, "Battling Powerful Procurement Groups: How to Profitably Participate in Reverse Auctions," *SPG Insights* (Fall 2004), pp. 1–3; accessed at http://www.strategicpricinggroup.com on August 1, 2008.

[52]Ibid., p. 2.

Price setting is a multidimensional decision. To establish a price, the manager must identify the firm's objectives and analyze the behavior of demand, costs, and competition. Hypercompetitive rivalries characterize the nature of competition in many high-technology industry sectors. Although this task is clouded with uncertainty, the industrial pricing decision must be approached actively rather than passively. For example, many business marketing firms use target costing to capture a competitive advantage. Likewise, by isolating demand, cost, or competitive patterns, the manager can gain insights into market behavior and neglected opportunities. Dealing effectively with an aggressive competitor requires more than a willingness to fight—it requires a competitive strategy and an understanding of when to ignore a price attack, when to accommodate it, and when to retaliate.

Competitive bidding, a unique feature of the business market, calls for a unique strategy. Again, carefully defined objectives are the cornerstone of strategy. These objectives, combined with a meticulous screening procedure, help the firm to identify projects that mesh with company capability.

Discussion Questions

1. Describe the core benefits and add-on benefits that FedEx provides to its business customers.
2. A Pac-10 university library recently purchased 60 personal computers from Hewlett-Packard. Illustrate how a purchasing specialist at the university could use a total cost-in-use approach in evaluating the value of the Hewlett-Packard offering in relation to the value provided by its rivals.
3. Explain why it is often necessary for the business marketer to develop a separate demand curve for various market segments. Would one total demand curve be better for making the industrial pricing decision? Explain.
4. Evaluate this statement: To move away from the commodity mentality, companies must view their products as customer solutions, and then sell the products on that basis.
5. Compare and contrast *commodity value versus differentiation value*, highlighting the significance of each in setting a price.
6. The XYZ Manufacturing Corporation has experienced a rather large decline in sales for its component parts. Mary Vantage, vice president of marketing, believes that a 10 percent price cut may get things going again. What factors should Mary consider before reducing the price of the components?
7. A business marketing manager often has great difficulty in arriving at the optimum price level for a product. First, describe the factors that complicate the pricing decision. Second, outline the approach you would follow in pricing an industrial product. Be as specific as possible.
8. Rather than time to market, Intel refers to the product development cycle for a new chip as "time to money." Andrew Grove, Intel's

legendary leader, said, “Speed is the only weapon we have.” What pricing advantages issue from a rapid product development process?

9. If a competitor’s price cut threatens only a small portion of expected sales, the sales loss from ignoring the threat is probably much less than the cost of retaliation. Agree or disagree? Explain.

10. Many companies, including GE, Quaker Oats, and United Technologies, report millions of dollars of savings from using reverse auctions rather than traditional purchasing methods. Of course, business marketing strategists fear that these auctions will transform their products and services into commodities. Propose particular strategies that marketing managers might follow to deal with this challenging situation.

Internet Exercise

1. Hill-Rom is a leading B2B firm that dominates a niche in the health-care industry. Go to http://www.hill-rom.com and, first, describe the products and services that Hill-Rom offers to hospitals. Next, describe how Hill-Rom products or solutions might reduce the total cost-in-use for a hospital.

CASE

Price Like a Retailer, Not a Widget Maker[53]

Parker Hannifin Corporation is a leading manufacturer of component parts used in aerospace, transportation, and manufacturing equipment. The company makes several hundred thousand parts—from heat-resistant seals for jet engines and components used in the space shuttle to steel valves that hoist buckets on cherry pickers. When Donald Washkewicz took over as chief executive, he came to an unnerving conclusion: the pricing approach that the company had followed for years was downright crazy.

For as long as anyone at the company could recall, the firm used this simple approach to determine the prices for its thousands of parts: Company managers would calculate how much it cost to make and deliver each product and then add a flat percentage on top, usually aiming for around a 35 percent margin. Across divisions, many managers liked this cost-plus approach because it was straightforward and gave them broad authority to negotiate prices with customers.

But the chief executive feels that the firm, which generates over $9 billion in annual revenues, may be severely restricting its profit growth. No matter how much a particular product is improved, the company often ends up charging the same premium that it would for a standard product. And if the company finds a way to make a product less expensively, it ultimately cuts the product's price as well. "I was actually losing sleep," recalls Donald Washkewicz, who believes that the company should stop thinking like a widget maker or a cost-plus price setter and start thinking like a retailer by determining prices by what customers are willing to pay.

Changing the firm's pricing approach, however, is a complex task. The company has tens of thousands of products—(1) some are high-volume commodities and there are large, formidable competitors; (2) some have unique features, fill niches in the market, and have limited competition; and (3) many are custom-designed for a single customer.

Discussion Questions

1. Describe the process that you would follow in performing an audit of the firm's product line to identify those products that represent the best and worst candidates for profit-margin expansion.
2. Provide a set of specific pricing guidelines that managers should apply as the traditional cost-plus approach is phased out and a value-based approach to pricing is implemented.

[53] Timothy Aeppel, "Seeking Perfect Prices, CEO Tears Up the Rules," *The Wall Street Journal Online*, March 27, 2007, accessed at http://online.wsj.com/public/us on May 18, 2008.