Strategic pricing in business relationships

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Abstract

Pricing of products and services is a complex task for industrial marketing practitioners. The failure to understand the connection between business strategy and the pricing decision at the level of industrial products and services may lead to lost business opportunities and unsatisfied customers. In this article, the importance of strategic pricing in business relationships is discussed by examining the effects of business strategy, business model and service model on pricing in order to make industrial pricing strategy and its implementation successful. The empirical study was conducted within high-technology more specific the knowledge and service intensive companies in Finland. The four cases emphasise that a well-defined business strategy actually limits the number of eligible business, service and pricing options. In the case companies, a misfit between business strategy, business model, service model and pricing prevented of them fully creating value for the customers.

Keywords: Pricing, business model, service model, dynamic pricing, high-technology, business relationships

1 Introduction

Knowledge intensive industry, so called ICT-industry, is characterized by hard competition, high-technology companies launching product and services, which have short product lifecycles and successive generations (Mohr, Sengupta and Slater, 2005). There are often new emerging markets, in which no traditional market research can be conducted. Information for relevant market decision making is often missing. In turn, these new products and services (e.g. software applications) are often created in close relationships with customers and other actors in business networks. Pricing decisions based on these business relationships are complex.

The business strategy typology of Porter (1996) has been one of the most used methods for discussing, categorizing and determining company strategy; differentiation, cost leadership, focus or a combination of these. The liberation of trade and the globalisation of markets, along with fast technological development are changing competitive positions between companies and economic zones (Dunning, 2000). Companies can search for a more permanent competitive advantage only by doing different things or by manufacturing and marketing products and services differently from other companies (Magretta, 2002; Porter, 2001). Achieving sustainable competitive advantage requires companies to differentiate themselves from their competitors through operational business models. Even though the drivers for this change are generally accepted, the study and know-how concerning business models remain relatively underdeveloped.

Akan ”et al.” (2006) argue that current strategy research has offered little direction to implement Porter’s generic business strategies. The strategy of a company and the pricing of products and services are closely related. However, pricing is the most neglected area in industrial marketing (e.g. Avlonitis, Indounas and Gounaris, 2005; Lancioni, 2005a). Price has tradinitionally been depicted to be a crusial element of marketing mix and consumer´s marketing (Constantinides 2006). Further, pricing is the most flexible element of marketing strategy and pricing decisions of present offerings can be implemented relatively quickly (Diamantopoulos and Mathews, 1995). Gadde, Håkansson, and Harrison (2002) in turn argue that price and pricing are key element in exchange process of industrial long-term relationships. Further, Lancioni (2005s) suggests that building value-added into a pricing program requires that a company develops a comprehensive pricing plan that integrates all of the components of the pricing process into a single document that details how the value-added strategy of the company will be implemented.

Lancioni, Schau and Smith (2005) show that sales cut prices too quickly because of competitive pressure. In addition, Lancioni (2005b) identifies the need for developing pricing and price setting in a strategic context. He also studies pricing at different decision making levels in industrial firms by showing their influences on price setting. Smith, Sinha and Forman (1999) describe pricing over the product life cycle. Avlonitis, Indounas and Gounaris (2005) in turn summarise prior research on pricing objectives over the product and service life cycle by argumenting the need for widening research into dynamic pricing.

Based on previous studies it has been pointed out the need for developing pricing: (a) in a strategic context, (b) in industrial relationships, (c) at different decision making levels in industrial companies, (d) by transparency of information (e) in dynamic pricing. (Oxenfeldt, 1975; Nagle and Holden, 1995; Dolan and Simon, 1996; Gadde, Håkansson, and Harrison, 2002).

Our objective is to further understand the strategic pricing in business relationships. According to our understanding, pricing is related to selected strategy and business model. This article explores the effects of *business strategy*, *business model* and *service model* on *pricing* in order to make industrial pricing strategy and its implementation successful. Aligning pricing with the overall business strategy requires that a company evaluates and integrates these relevant levels of the price decision making process. The prices a company charges for its products and services must reflect the selected strategy of the company. The selected strategy determines a more restricted amount of business models and service models in which the value of products and services is created to and captured by the customer. Furthermore, the success of implementing this value creation process is realized via pricing.

Thus, we are interested in:

(1) What are strategic pricing levels in industrial marketing?
(2) How are strategic pricing levels in business relationships interconnected?
(3) How is relationship value for customers evaluated in industrial pricing?

We attempt to contribute to these issues and the ongoing academic discussion on the business strategy and business relationships by employing qualitative analysis of case studies in knowledge and production intensive companies. All of these four companies have developed and launched a new high-technology product or service to the market.

This paper is organized as follows: After this brief introduction, we discuss the relation between business strategy, business model, service model and pricing and present our proposed framework. Then, we describe business models in industrial marketing. The next section describes our data and research methodology, as well as the empirical results in the case studies. Finally, we conclude the study by discussing our findings and suggest future studies.

2 The Relations Between Business Strategy, Pricing Strategy, Business Model, and Service Model

Strategic pricing requires that managers take responsibility for establishing a coherent set of pricing policies and procedures. That is consistent with the strategic goals of the company (Nagle and Holden, 2002). Using the business strategy typology of Porter (1996), the respective pricing methods can be pointed out on the basis of prior pricing literature, which is presented in Figure 1 (Dolan and Simon, 1996; Nagle and Holden, 2002; Anttila and Möller, 2000).

Porter's generic business strategies types	**Pricing strategies and pricing methods**
1. Cost-effectiveness strategy	- Product-driven pricing - Cost-based pricing - Competitive pricing
2. Differentiation strategy	- Customer-driven pricing - Value based pricing - Competitive pricing
3. Focused strategy	- Value based pricing - Price customization

Figure 1. Summary of the Literature on the Relationship between Business Strategy and Pricing Methods

Moreover, the difference between ad hoc price setting and strategic pricing is in the difference between reacting to market conditions and proactively managing them (Nagle and Holden, 2002) Strategic pricing of new products and services requires anticipating price levels and their changes in the long run even before beginning product development (Dean, 1950) This requirement is especially important nowadays in high-techonology marketing.

Despite the wide use of the term business model, no widely accepted definition has emerged. The early users of the term (e.g. Timmers, 1998) listed different new types of electronic businesses as business models. Basically a business model defines how the organisation operates in the market and the basis of its value creation. This type of definition can be called a descriptive view of a business model. Especially in this description a service model is part of a business model. A service model consists of for example the assessment of service level and the technology solution. In the development of services in e.g. the mobile business, any new idea for a service was designated a "business model". Research in recent years has produced several business models depending on the viewpoint taken. These range from a strategic level viewpoint to technological characterization.

The relationship of business models and strategy are often brought up (see e.g. Stähler, 2002; Seddon and Lewis, 2003; Hamel, 2000) What really are the differences between strategy and business models? Are they conceptually same or do they overlap and if, to what extent? When examining strategy business models and business processes, it can be maintained that they address the same questions, but at different levels and scopes. All focus on business, its objectives and its realisation, but on different time horizon and on different operational levels

Research in recent years has approached business models from a multitude of viewpoints. These range from strategic level perspective to technological description. Business models have consequently been seen as:

- the implementation of strategy into a conceptual blueprint of the company's earning logic (Osterwalder, 2004)
- an organization's core logic for creating value (Linder and Cantrell, 2000)
- a value configuration for attaining competitive advantage (Stabell and Fjeldstad, 1998; Fjeldstad and Haanäes, 2001)
- a story that explains how an enterprise works (Magretta, 2002), how the pieces of a business fit together, but as opposed to strategy do not include performance and competition.
- a description of the roles and relationships among a firm's consumers, customers, allies and suppliers and it identifies the major flows of product, information, and money, as well as the major benefits to participants (Weill and Vitale, 2001)
- architecture for the product, service and information flows, including a description of the various business actors and their roles and a description of the potential benefits for the various business actors and a description of the sources of revenues (Timmers, 1998)
- a coherent framework that takes technological characteristics and potential as inputs and converts them through customers and markets into economic outputs (Chesbrough and Rosenbloom, 2002)
- is something else than the company's business process model (Gordijn and Akkermans, 2000)
- Business model refers to the product, service, information and earning flows of the company, its position in the value network and a description of the advantages and income sources of different parties (Timmers, 1998; Rappa, 2000)
- Applegate (2001) perceives a business model as a description of a complex business that enables the study of its structure, of the relationships among structural elements, and of how it will respond to the real world

To summarise; The business models can depict relationships in emerging market situation. Further, the business model is a more concrete description of the basis of operations of the company than business strategy. Therefore, business model is positioned between business strategy and business processes. In the business model the focus is on structural aspects, i.e. how defined products and services are offered and delivered to customers and with what kind of operations they are produced.

Business model is most often used as a practical tool to develop business, often at a business unit or division levels. Business model describes how the company vision and strategy are transformed into a concrete value offering, client connections and value networks. So the business model is a concrete level testing tool for the realisation of a business strategy. The fact that business model is the concrete expression of a strategy, means in practice that it is not, and should not be, independent a strategy, but should be understood as a tool for carrying out the strategy. If a business model proves to be applicable, the strategy has been successful. On the other hand, the strategy may require modification, if a business model does not operate. Obviously business models and strategies are correlated.

The same business model can operate on one market, but may fail on another. For example, Wal-Mart has operated with the same business model in the USA and Europe. In the USA the business model has operated well, even if it has had a competitor (Kmart) who works with the same business model. However, Wal-Mart has had difficulties in Europe because the business environment, especially competition, has been different from that of USA. It has had competitors who work in Europe with the same business model and with the same strategy.

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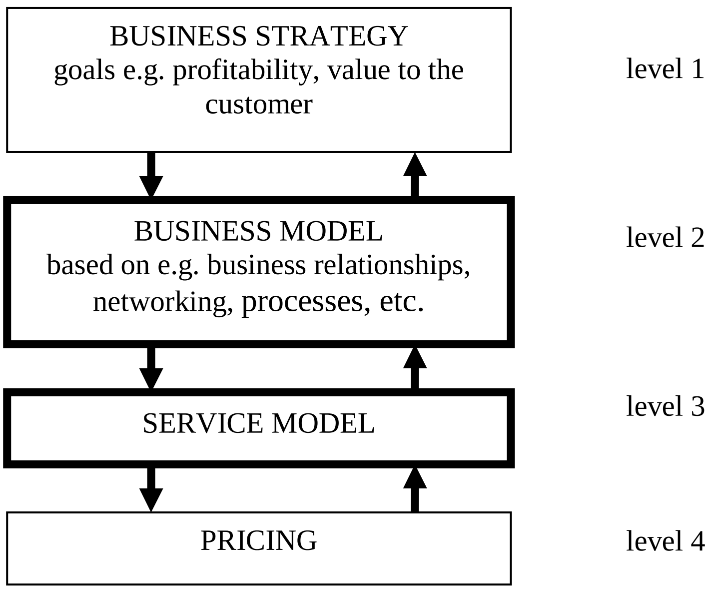

Figure 2. The Proposed Multi-Level Strategic Pricing Framework Model

It has been widely argued that strategic pricing is highly dependent of the internal and external situation of the company. Pricing literature has introduced tools to evaluate pricing situations. Still, practitioners have stated that pricing is one of the most difficult task. Oxenfeldt (1975) proposed a hierarchical price decision making framework of a company. Our contribution is to add the level of business model and service model to this hierarchical price decision making framework model. The framework is proposed in this article in Figure 2 on the basis of the conducted research. There are two-way interactions between business strategy and business model in the framework. First, decisions made in a buyer-seller relationship strategy influence all the other parts of the framework model by limiting the number of eligible models. The defined business strategy eliminates most of the possible business and service models as well as pricing options. A company is able to use only a few of these models in serving its customers. Second, by redefining the pricing and service models of a knowledge intensive product or service, a company is actually redefining its business strategy and selected business model. To sum up, the business strategy and business models are closely tied with the chosen service and pricing.

3 Business Models in Industrial Relationships

Even if the business model literature has not been in the mainstream of industrial relationships, the business models of companies has been described in industrial settings (e.g. Leminen, 2000; Rajala, Rossi, Tuunainen, 2003; Hedman and Kalling, 2002; Westerlund 2004, Westerlund “et al” 2007). As depicted earlier in this study the business model is positioned between business strategy and business processes (Osterwalder, 2004; Morris, Schinhutte and Allen, 2005; Tikkanen “et al.” 2005). Business model consists of elements of business strategy and illustrates a business strategy as well as a conceptual picture of business operations (Rajala, Rossi, Tuunainen, 2003; Seddon and Lewis, 2003; Morris, Schinhutte and Allen, 2005; Westerlund and Rajala 2006). A typical objective is to describe different types of business model (e.g. Rajala ”et al.” 2004; Westerlund and Rajala, 2006). Based on these typologies business models can be described as type of relationships and standardization of offerings. This means that different types of relationships and offerings require different business models.

Rajala ”et al.” (p. 20, 2004) propose that the main elements of business model would depict “*value creation processes* and *capturing the opportunities in the market into revenue through sets of activities, processes and transaction”s.*

Industrial marketing literature reveals the main elements of business models by describing
- (1) different types of relationships consisting different offerings
- (2) value in business relationships

(1) Industrial marketing and relationship marketing literature depict different types of relationships leading different offerings. The earlier studies of interaction and network approaches mainly describe the project (e.g. Håkansson, 1982; Alajoutsijärvi, 1996) and the product (e.g. Håkansson, 1982; Turnbull and Valla, 1989). Ford (1980) points out that product and process technologies determine the nature of buyer-seller relations. Webster (1991) states that buyer-seller relationships can be illustrated as different relationships from a simple transaction to strategic alliances in industrial marketing. Vasconcellos (1988) differentiates projects from goods and services in a transaction/production typology. In addition to that, Cova, Mazet and Salle, (1993), illustrate two main features, namely: complexity and specificity which differentiate projects from other industrial products (i.e. goods and services). While, Leminen (1997 and 1999) suggest that different types of relationship offerings (i.e. project, service, and packaged product) may exist simultaneously, which form entire relationships.

Offerings in different types of relationships been described indirectly in studies which point out that many industrial marketing situations are similar to many service situations (Grönroos, 1994), or that the service and goods quality models should be integrated (Grönroos and Gummesson 1985; Grönroos, 1993). Traditionally, projects are temporary and actors have a specific goal and a short-term strategy. Some authors have described projects as being a part of longer buyer-seller relationships (see e.g. Mattsson, 1983; Jansson, 1989; Hadjikhani, 1993). Project has described consisting of elements of services and packaged products (e.g. Ahmed, 1993).

(2) Lindgreen and Wynstra (2005) provide review of value literature and distinct recent value literature two research streams (i) value of goods and services and (ii) value of buyer-seller relationships. Anderson and Narus (1999) propose that product offerings value and price are independent of each other in the first research stream. While the second research stream depict relationship value for the buyer because of exchange, adaptation and learning in the relationships (Håkansson, 1982; Håkansson and Snehota, 1995).

4 Pricing in Business Relationships

As described earlier in this study industrial marketing and relationship literature reveal different types of offerings; i.e. product, services and project or combination of offerings. Relationships typologies are widely described in industrial marketing literature. However, our intention is not to provide fully description of all types of relationship typologies but to give some example of conducted research.

At least two major research streams of relationship typologies can be identified. The first research stream argue to need to widen marketing perspective from transactional to relationship marketing. (e.g. Grönroos, 1994; Barnes, 1995). This research stream provides description of relationship typologies in the transactional and relationship continuum. Juetter and Wehrli (1994) distinct customer relationships to transactional and relationship by describing them exchange types (dyad, at least three parties involved and system perspective). O´Loughlin and Szmigin (2006) depict four types of relationship i.e. transactional experiences, out-come focused relationship, interactive friendships and personal relationships based on Grönroos (1994). At the other end of this research stream Gummesson (1999) provides perhaps most extensive description of relationships typologies altogether 30 different types of relationships.

The second research stream reveals relationships typologies based on interaction, relationships and networks so called IMP group (e.g. Håkansson, 1982; Turnbulla and Valla, 1989; Ford, 1990). This research stream provides description of relationshipx typologies e.g. collaboration and conflict (Håkansson and Gadde, 1982), marketing strategy and purchasing strategy (Campbell, 1985), competition and cooperation (Wilkinson and Young, 1993); domination of buyer-seller relationships (Ford and Johnsen, 2001), dyad business relationships in network context (Anderson, Håkansson and Johanson, 1994); internal and external relationships (Håkansson and Snehota, 1995).

Lindgreen and Wystra, (2005) provide another relationship typology, which classiffies value creation through direct and indirect value creating functions of customer relationships.

This study depicts relationship typology based on the type of relationship i.e transactional and relationships and type of offerings i.e. product, service, project. This is on the line of current business model literature but expand a type of offerings to consist also project. This paper shares also the view that different types of interaction and networks can found in the business models representing different relationship (e.g Rajala et al. 2004).

In knowledge intensive industry even transactional marketing mix type of pricing concerning more simple technical solutions may be burdensome. High-technology market and ICT industry impedes pricing thus customer value is created environment characterised by hard competition, complex business relationships, short product life-cycles and successive generations of products and services (Mohr, Sengupta and Slater, 2005). In these business relationships buyer, seller and competitors may have simultaneously different roles. Anderson and Narus, (1998) and Lindgreen and Wynstra, (2005) argue the need for identify, determine and measure value.

Further, in emerging market situation price setting of a company is even more difficult because traditional market research can not be done. Information in decision making is missing. Capability for practical decision making is learned and developed through interaction with key customers, suppliers etc.. Further, Gadde, Håkansson, and Harrison (2002) propose that price and pricing can be used to future directions in buyer-seller relationships. Davidson and Dimonetto, (1995) argue the need for different pricing strategies supporting different kinds of strategic objectives. In addition to that, further development of sales of new products and services is determinated by the level of launch price. The level of launch price also affects take-off point of S-curve sales.

Value can be revealed in two different ways in price settings of relationships. First, relationship value is process of co-creation (Norman and Ramirez, 1993) and also with other actors in network i.e relationship value is increased based on previous experiences. Second, relationship value may also be perceived and it is often determinated by trial and error due to lack of trustworthiness information on the emerging markets. Based on this price setting is extremely complex issue in future oriented business relationships.

5 Research Methodology and The Results of This Study

In the empirical part of this study, four knowledge and service intensive companies were looked at more closely in Finland in 2004. Each company represents a single case. At the time of the study, all four companies were about to bring or had recently brought a new product or service to the market.

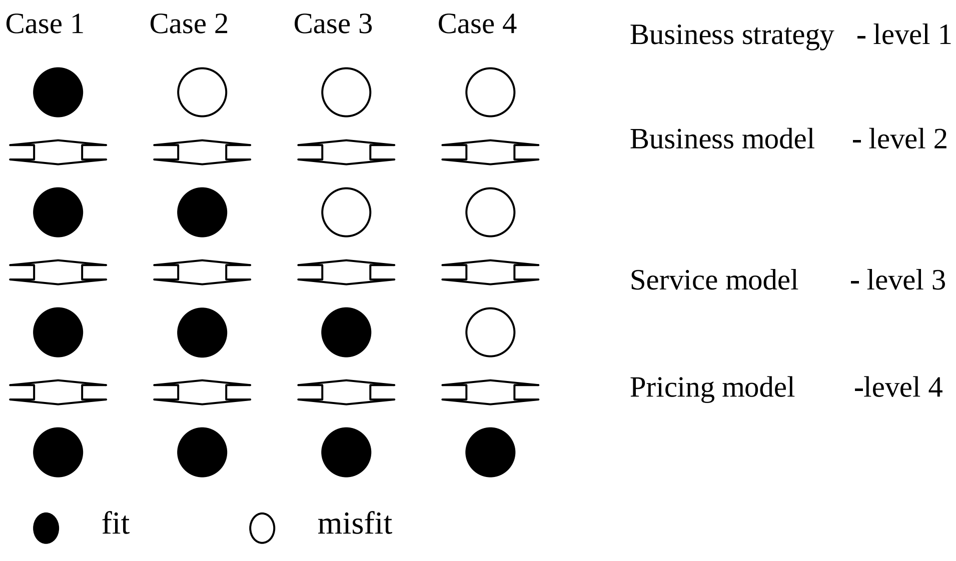

Figure 3. Summary of conducted cases

The prevailing situation was analysed against the framework to discover any misfits in implementing the business strategy in business, service and pricing models. The authors have studied all the case companies thoroughly by collecting material using several research methods; case study and the analysis of quantitative material. Action research was also conducted as the authors suggested possible solutions to the companies' strategic pricing.

Figure 3 summarises the results of conducted cases based on the proposed framework in this article. Clear fit can be seen between all the levels of proposed framework; business strategy, business model, service model and price customisation over time in Case 1. The Case 1 describes dynamic pricing of knowledge intensive company. In the Case 2, there can be seen fit between pricing, service model and business model of service intensive company. There are misfit between business strategy and the remaining levels of proposed framework, because the company and its key customers co-developed services and their pricing separately of business strategy. In the Case 3, a knowledge-intensive software company developed a new value added service to its existing customers. There are fit between service model and pricing model. A misfit can be seen between the pricing and business model. Case 4 describes ad-hoc pricing of a service-intensive company introduced a new service and adapted a reactive pricing policy and set an ad-hoc price to the service. A misfit can be seen between business strategy, business model, service model and pricing mode

Case 1 Dynamic pricing

A knowledge-intensive company introduced a new product to the market. The company changed its strategy and business model as well as service model several times based on the lifecycle of the product and the competitive situation of the company in order to face the competitive market. By evaluating the pricing decisions of the company, a clear fit can be seen between business strategy, business model, service model and price customisation over time and the dynamic pricing of company's offerings throughout the product lifecycle.

Case 2 Pricing can be seen test of implementing company's strategy

A service intensive company introduced a new service as well as defined and set a price for the service based on its existing service portfolio e.g. based on production costs. Key customers showed interest in the new service by co-developing it and wished that the company would expand its service portfolio to new areas. By evaluating the pricing decision of the company, a clear fit can be seen between pricing, service model and business model. Thus, the company and its key customers co-develop services and their pricing. However, the company failed to commercialize the business opportunities because it did not adapt the new, developed service to its present offerings.

Case 3 Pricing can be seen as a test of implementing company's strategy and selected business model

A knowledge-intensive software company developed a new value added service to its existing customers. During the launch of the value added services, the company also introduced new pricing for its services. However, the company had clear difficulties in selling the new value added services despite the interest of its customers. In evaluating the pricing decision, the customers had difficulties in making a difference between the existing services and the new ones by stating that they did not understand either the service model or the pricing of the new value added service. A misfit can be seen between the pricing and business model.

Case 4 – Ad-hoc pricing

A service-intensive company introduced a new service and adapted a reactive pricing policy and set an ad-hoc price to the service. Customers of the service-intensive company showed interest in the new service piloted inside the company. However, customers did not have enough willingness to pay the requested price for this new service. When evaluating the pricing decision, it can be seen that the company had undefined objectives in pricing. The company did not understand the effect of pricing on customers and, on the other hand, the service and business models were vague. A misfit can be seen between business strategy, business model, service model and pricing model.

This study share the view with Möller (2006) as well as Vargo and Lusch (2004) that we should develop and see benefit of multidisciplinary understanding of marketing. This study proposes that strategic pricing in business relationships, take place at the multi-level in industrial price setting process.

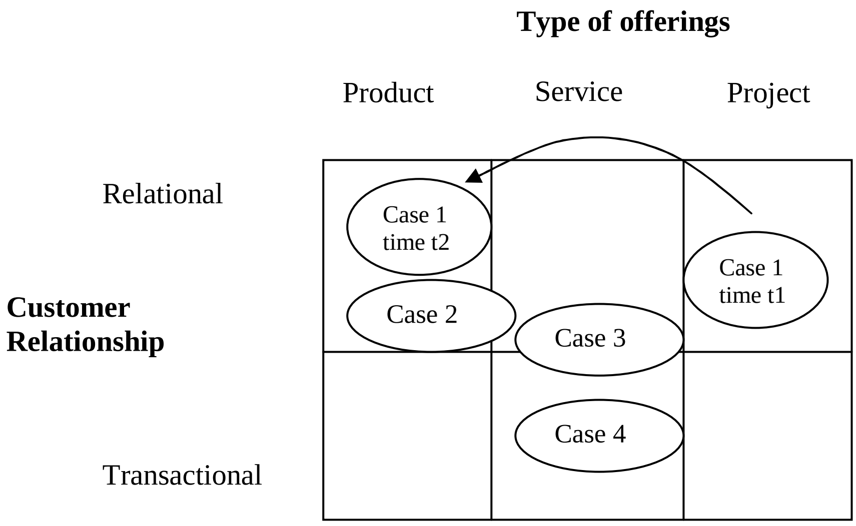

Figure 4. Summary of conducted cases

Ford ”et al.” (1998) suggest that price setting process differ in different types of relationships. This study expands on that by depicting that the degree of customer relationships or other business relationships indicate fit and misfit multi-level strategic pricing process (presented in Figures 3 and 4).

6 Discussion

Our overall concept of "integrative strategic pricing" is a decision-making process that links business model and service model with company´s goal and strategies in software industry framework. Within this context, integrativity means that the systemic holistic decision-making process is aspired. This means, for example, that all resources of a company are considered, and that holistic solutions are preferred to solutions for only a part of the decision-making process. More, relationship pricing is very demanding issue to be solved in industrial marketing.

By evaluating the cases more closely, it can be argued that price setting is dependent on decisions made concerning business strategy, business model and service model. The proposed framework consists of four levels: business strategy, business model, service model and pricing. The cases show that in order to understand buyer-seller relationships, it is important to understand each of the four levels and their connections with each other. Firstly, there are two-way interactions between business strategy and business models. Defined business strategy eliminates most of the possible business and service models as well as pricing options. Actually a company is able to use only a few of these models in serving its customers. Secondly, the cases show that all companies actually have not defined their business strategy or business model, which leads to difficulties in service models and pricing. Companies either had difficulties in selling their knowledge and service intensive products to their customers or they did not understand the benefits of service models due to a pricing failure. Therefore, pricing and service models can be used as a test of business strategy. Actually companies used pricing of certain knowledge and service intensive products to test its market. However, the objective of testing was not well-defined. Thus, by redefining the pricing and service models of a knowledge intensive product or service, a company is actually redefining its business strategy and selected business model. Most cases indicate a need for redefining the service and pricing.

This study suggests that pricing should be seen in a wider context. Pricing decisions are strategic decisions of the company, which can be implemented with the help of business and service models which managers can use to manage pricing of present offerings. This study proposes also that the degree of customer and business relationships indicate fit and misfit multi-level strategic pricing process. Moreover, pricing in industrial marketing is complex problem since relationship value especially in emerging markets is difficult to estimate and reflect to pricing decision making of a knowledge intensive company.

Future research could further develop the idea of strategic pricing of companies' present and future offerings. Another area for future research could be to describe the dynamics and interactions of pricing at different levels. In addition, the analysis should be extended to cover also other types of business to business branches. A step further would be to study options in strategic pricing. Companies should fulfil the opportunity to create value to their customers by integrating the four levels of decision making a closely as possible in strategic pricing as proposed in our framework model. Another future research avenue would stimulate research on strategic pricing options also underlying dynamics of business relationships.

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