

Governance Mechanisms and Price Level: An Empirical Study in Vertical Business-to-Business Relationships

Abstract

There is an increasing interest in the topic of governance of inter-organizational exchanges. This paper contributes to this field by examining the link between the use of several governance mechanisms (specific investments, trust, norms, and contracts) in buyer-supplier relationships and the price level customer firms are willing to pay. It is based on a survey among purchasing managers (n = 297). Using regression analysis we find a significant positive link between relational norms and price level.

Keywords: Governance mechanisms, Price level, Business Markets

Track: Business and Network Marketing

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1. Introduction

As Heide (2003, p.18) underlines: "much of the recent research on interfirm relationships in marketing has relied on the theoretical notion of governance". As a matter of fact, economic exchange processes can be organized along various governance forms. Depending upon the theoretical school of thought, long-term business relationships are thus referred to as the hybrid form (Williamson, 1991), domesticated markets (Arndt, 1979, p.70), relational exchange (Macneil, 1980), or clans (Ouchi, 1980). In a marketing perspective, Heide (1994) proposes the term "non-market governance". These arrangements comprise horizontal forms of cooperation (e.g. joint ventures, strategic alliances or R&D partnerships), and vertical buyer-seller relationships (Arndt, 1979). Following the seminal work from Dwyer, Schurr, and Oh (1987) several researches have been using the relational norms framework (Macneil, 1983) to observe, understand and explain governance phenomena. Nevertheless the use of this framework is far from having revealed the entirety of its richness.

This paper proposes to explore the links between the use of certain governance mechanisms by certain suppliers and the prices paid by their customers. Our purpose through this research is to broaden our understanding of the value the implementation of relational exchanges (versus more transactional ones) has for managers.

2. Prices and "relationality"

Surprisingly, while the notions of "price", "price premium", "willingness to pay" sound as forefront issues for managers and also for marketing scholars, the specific link between "relational norms" as they can be used to govern an exchange and the possible price premium a customer - treated in a relational way - would be ready to pay is totally understudied. A lot has been done on the consequences of "relationality" on trust, commitment and many other aspects of relationship quality, but the idea that "relationality" could be valued by a customer through a higher paid price has rarely been studied directly. Fullerton (2003) investigating the link between different forms of commitment and loyalty in the context of service exchanges recalls that researchers *"have a limited understanding of the extent to which consumers are willing to pay more for the benefits that they receive from a relationship"* (Fullerton, 2003, p. 336). Following Fullerton, a possible indirect (mediated by commitment) link between relational norms and a "willingness to pay more" can nevertheless be hypothesized on the background of different sets of results. First, Morgan and Hunt (1994) did establish a positive link between "customer commitment" and "customer acquiescence". Second, according to Fullerton (2003) *"although not explicitly recognized by Morgan et Hunt, the acceptance of price increases is one area where affectively committed consumers could acquiesce to requests from service partners"* (Fullerton, 2003, p. 336). Finally, to close the reasoning, the link between "relationality" and "commitment" has been proved by various authors.

On the other side, authors like Reinartz and Kumar (2002) would argue, on the contrary that, customers treated in a relational way would easily obtain price reductions in return for a regular frequency of their purchases.

Rauyren and Miller (2007) identify, as for them, several practitioners having contributed to the discussion of a possible link between some kinds of relationships dimensions and "price" (or related concepts). For instance, Reicheld and Sasser (1990) explain that suppliers maintaining long-term relationships with their customers can often charge them more for their products and services. But those results must be considered carefully because they mainly concern business to consumer exchange. Reicheld, (1996) - incorporating both BtoC and BtoB examples in his work - argues that those long-term customers are less price sensitive than "transactional customers", and so are often *"willing to pay a premium for same product and services that are also offered elsewhere"* (Reicheld 1996). Rauyren and Miller (2007) also make reference to De Chernatony and McDonald (1998) who

argue "that firms with more loyal customers can ask for higher price premium and a have the ability to command higher prices". Finally the authors stress that "business-to-business customers are willing to pay a higher price just to keep the relationship going. Customers place more importance on the relationship than on the price of the product. As a result, these customers are less price sensitive and do not mind paying a price premium" (Rauyren & Miller, 2007, p. 3).

The key account management (KAM) literature provides us with several discussions on the possible outcomes of a relational treatment of a customer. But as Wengler, Ehret and Saab (2006) recall, KAM outcomes are most of the times "soft" (outcomes) (trust, commitment, satisfaction..) and economic aspects appear rather neglected. Workman et al. (2003) do support the idea of a KAM effectiveness but still expressed in terms of "trust, information sharing, reduction of conflict and commitment". And, this the case for the majority of this literature, (Sengupta, Krapfel & Pusateri, 2000; Homburg, Workman and Jensen, 2002; Georges and Eggert, 2003; Napolitano, 1997). This scarcity of analyses of *economic* outcomes of this paragon of relationally that KAM constitutes is all the more intriguing that as Sengupta et al. (2000) recall KAM programs "require a great deal of investments" and so their "implementation has to be justified on an economic basis" (Sengupta, Krapfel & Pusateri, 2000, p.253). This justification is all the more necessary when looking at the current focus put on performance issues (Wengler, 2006; Homburg, Workman & Jensen, 2002). References to an "economic" outcome of relationality is then hard to be found. Stevenson presented the key account customer as "receiving better prices" (Stevenson 1981, p.119). Barret put into evidence an increase in sales when implementing KAM program (Barret, 1986). Boles, Pilling and Goodwyn (1994) supported that "major accounts will pay more for the value added by the holistic approach of national account marketing" (Boles, Pilling & Goodwyn 1994, p.26). But, on the opposite, Boles, Barksdale and Jonhson (1999) showed that "quantity discounts" was part of what a key customer could expect from his supplier. Much more recently Pressey, Tzokas and Winklhofer (2007) recalled that in key account relationships (relational by nature) buyers are not "looking for the lowest possible price but the best value from their suppliers" (Pressey, Tzokas & Winklhofer, 2007, p.291).

Within the IMP Group, a few authors have argued that "Long-term relationships can result in fewer price changes. [...] . In other words prices are changed infrequently because this is considered by actors to be disruptive to long-term relationships". (Gadde, Håkansson and Harrison, 2002). But in such a situation the use of some "relationality" with certain customers does not allow any price increase or reduction but freezes the relationship in its initiation features.

Other theoretical ways could be explored to investigate the antecedents of "price premium" paid by customers and then to link these antecedents to relational norms. For instance, Wathne and Heide (2000) recall the work of Rao and Bergen (1992) which shows that "under conditions of uncertainty and complexity buyers may knowingly pay price premiums to sellers in order to prevent them from cheating on quality" (Wathne and Heide, 2000, p. 45). Ravald and Gronroos (1996) argue that a firm can justify a price premium through the creation of value. But in none of these examples an explicit link is discussed between relational norms used by a supplier to govern an exchange and the price paid by the customers in this exchange.

3. Governance mechanisms

Our paper focuses on the topic of governance mechanisms, not on the broader topic of governance form. Governance refers to the "mode of organizing transactions" (Williamson 1975). Thus, a governance mode can be defined by a *place* (market, organization, ...), a *mechanism* (price, authority,...), and forms of control or "monitoring and enforcement". monitoring (Heide, 1994 ; Williamson and Ouchi 1981). Our paper is specifically concerned with those monitoring or enforcement aspects of governance.

It appears that, for managers, the design of effective governance structures is a complex issue. The challenge lies in the large number of available control mechanisms (Bradach & Eccles, 1989). Recent contributions focus on three governance mechanisms: formal contracts (e.g. Cannon, Achrol & Gundlach, 2000, Lusch & Brown, 1996, Stinchcombe, 1985), relational norms (Dant & Schul,

1992, Heide & John, 1992, Pilling, Crosby & Jackson, 1994), and specific investments (Gundlach, Achrol, & Mentzer, 1995; Jap & Ganesan, 2000).

- *Written contracts* are formal documents stating that two parties have agreed upon certain objects and conditions of exchange (Gundlach & Murphy, 1993).
- *Norms* have been defined as expectations developed by actors concerning other actors' behavior in a given context (Jap & Ganesan, 2000; Heide & John, 1992). Following Kaufmann (1987) we distinguish between two types of norms: norms that help exchange partners *create value* and norms that help controlling *value-claiming* behaviors.
- Because of their adaptation to the customer's needs *specific investments* represent at least partially sunk costs and thus an incentive for the actor who has made them to be loyal (Heide & John, 1988). They represent pledges (Anderson & Weitz, 1992), commitment inputs (Gundlach, Achrol & Mentzer, 1995) or control mechanisms (Jap & Ganesan, 2000).
- *Trust* is an attitude that can be defined as the "willingness to rely on an exchange partner in whom one has confidence" (Moorman, Deshpandé & Zaltman, 1993, p. 82). Trust in a business partner leads actors to reduce monitoring activities, and thus, is part of the control structure in a dyad.

In empirical research, scholars have studied the interaction between formal contracts and norm-based behavior (Lusch & Brown, 1996), and the effect of contracts and norms on relationship performance (Cannon, Achrol & Gundlach, 2000). The most detailed study available to date (Jap & Ganesan, 2000) examines the time-dependent nature of contracts, norms, and specific investments on commitment in retailer-supplier dyads. Moreover, several authors have studied the effect of governance mechanisms on output variables of relationships such as satisfaction or trust. However, little attention has yet been paid to the question whether the price level a customer firm is willing to buy is dependent upon the existence of certain governance mechanisms in its relationship with a supplier firm. The aim of this paper is to empirically analyse whether such a relationship exists.

4. Methodology

4.1 Data collection and sample

The study is based on a written survey among managers involved in professional purchasing processes. In order to control for environmental influences it was conducted in a business-to-business setting. Two supplier industries were selected. The packaging industry represents a classical industrial goods market whereas the market research sector was chosen as an industrial service market. In both industries, long-term relationships play an important role. Questionnaires were distributed to purchasing managers for packaging goods on the leading international trade show. Potential participants were identified at the entrance, asked to complete the questionnaire at their office and to return it within four weeks. On the market research side questionnaires were sent out to those members of a leading national market research association who are concerned with the purchasing process of market information. Participants were asked to select one important supply relationship and to answer all questions referring to this one supplier. Selection criteria were relationship duration (at least two years) and the supplier's economic importance to the customer company.

The response rate for the packaging sample was 28.5 %. In the market research sample it amounts to 31.9%. Empirical results are based on a total of 297 questionnaires. These questionnaires are completely filled-in. An analysis of potential non-response effects (Armstrong and Overton 1977, comparison of early vs. late responses) revealed no significant differences concerning the core constructs. In all cases, the respondents had been concerned with the relationship for at least two years, so that we assume that they are knowledgeable. The responding customer companies cover all three major industry sectors (industry, retail and services). The sample consists of SMEs as well as large companies. The size structure of the supplier companies is closely correlated to the relative importance of these types of companies in their markets. Hence, sample representativity appears to be established.

4.2 Measures

All relevant constructs were operationalised based upon measurement instruments documented in the extant literature. Scales which had initially been developed for alternative research settings (e.g. channel relationships) needed to be reformulated to fit the two industries selected for this study. In order to test the questionnaires usability, in a pre-test phase all scales were intensively discussed and where necessary modified in interviews with buyers as well as sellers from both supplier industries. This process led to the final questionnaire which was pre-tested again with a different set of buyers and sellers from both industries. Scale reliability was tested in two steps. First, coefficient alpha was calculated. All scales fulfil the generally accepted criterion of $\alpha > 0.7$. In addition, each construct was assessed using confirmatory factor analysis. The results (factor reliability, average variance extracted, t-values) equally meet the criteria formulated in the literature.

5. Results

The regression model we estimated has an adjusted R^2 of .404 (F-value 41.183, $p > 99\%$). Hence, the five independent variables explain an important proportion of the variance in the outcome variable price level. Interestingly, however, only two of the five independent variables have a statistically significant impact on the dependent variable, i.e. relational norms of value creation and relational norms of value claiming. Among the two norm constructs, the value creating norms clearly have a stronger impact on price level (std. beta = .599) than the value claiming norms (std. beta = .110).

To compare the effects of the five governance mechanisms studied here with a benchmark estimation we also calculated the relationship between governance mechanisms and a classical variable used in the relationship marketing literature, i.e. customer commitment. Here the adjusted R^2 is slightly higher at .468 (F-value 52.978, $p > 99\%$). There is a highly significant link between trust resp. value-creating norms and customer commitment and a somewhat significant link between the existence of formal contracts and commitment.

Comparing both models we observe that the five governance mechanisms are important predictors of economic as well as pre-economic outcomes in industrial customer-supplier relationships. However, the significance of individual mechanisms varies between the two models. Interestingly, whereas price level is only influenced by the level of norms in the relationship, commitment is positively influenced by value creating norms and trust.

<i>Governance mechanism</i>	<i>Price level</i>	<i>Commitment</i>
Specific investments	0.059	-.077
Trust	-0.048	.185***
Formal contract	-0.014	.063*
Value creating norms	0.599***	.560***
Value claiming norms	0.110**	.057
R^2	.404***	.468***

Table 1: Standardized beta coefficients for two regression models (independent variable in model 1 = price level, in model 2 = customer commitment; *** = significant at the 99% level, ** = significant at the 95% level)

6. Discussion

This paper provides some evidence that for a well specified set of governance mechanisms and within a clearly delimited field, two industries which we assume to be representative of typical industrial goods and industrial services markets, there is a link between governance mechanisms and the price level customers are willing to pay.

This result is potentially important for managers as in many industries, today, the opportunities for growth through increases in sales quantity are limited. Hence, extending revenue through price increases is a relevant alternative. The question which mechanisms may allow reducing customer resistance to higher price levels is important. In the light of our results the design of governance mechanisms and more precisely the implementation of relational exchange norms is a key element.

Customers seem to particularly value suppliers who develop strong value creating norms such as flexibility, mutuality, or information exchange. To a lesser extent but still at a significant level the existence of relational value claiming norms (e.g. restraint in the use of power) also foster the possibility of achieving higher price levels.

From a theoretical vantage point our results are interesting as there has been little research addressing the relationship between governance mechanisms and outcome variables in general. There is a particular lack of studies examining the link between governance mechanisms and economic outcome variables such as relationship profitability, turnover or price level. Hence, our study - despite its limitations - provides an extension of extant theoretical and empirical knowledge. By estimating an alternative regression model with commitment as dependent variable we also see that different governance mechanisms may have a significant impact on different dependent variables. As a consequence, future studies should include not only several governance variables as independent variables but also a broad set of economic and pre-economic dependent variables in order to better understand the complex interrelationships between key concepts in the relationship marketing literature.

The limitations of this study are at least threefold. The data collected stem from only two industry sectors (packaging goods and market research), they were collected in a specific national setting, and a single respondent approach was chosen. All of these points offer possibilities to refine the design in the future.

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