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Supply-chain pricing—A new perspective on pricing in industrial markets

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Abstract

There is growing recognition that collaborative business relationships within the supply chain provide interesting opportunities for mutually increased benefit. However, while efforts on improving collaboration within the supply chain are indeed already widespread in some aspects of goods and services—for example, many manufacturers integrate their logistics function with those of their suppliers—such efforts are lacking when it comes to pricing. In contrast to the predominant position of pricing in most industries, the following article will investigate the opportunities for suppliers and customers to collaborate on pricing in order to establish mutually beneficial relationships. The article will demonstrate that this goal can only be attained when price is no longer regarded as an ex ante distributive parameter between market partners, but as a joint tool for outcome optimization within the overall supply chain process. We will clarify this new perspective with a calculation example and point out managerial implications for practical implementation.
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1. Introduction

Changes in competition (globalization, standardization in production and so on) have recently led to many businesses cutting production in order to focus on key competencies. Thus, an even larger portion of value added is subcontracted resulting in significant expansion in the supply chain in many industrial markets. While this trend has brought benefits in that businesses have been able to concentrate on their strengths and focus their main assets in specific areas, this strategic orientation also has increased the need to collaborate and integrate activities between the different companies in the supply chain. Therefore, most companies today try to establish relationships with their partners in the supply chain rather than concentrating on purchasing (Cannon & Perreault, 1999; Narayandas & Rangan, 2004). This development is further supported by today's business relationships offering one of the most effective remaining opportunities for significant cost reduction and value improvement (Christopher & Gattorna, 2005). However, Frazier, Spekman Robert, and O'Neal Charles (1988) observes that these opportunities mainly depend on the *closeness* of the relationship.

In this sense, suppliers in particular have cultivated business relationships for years by investing in their customers with a view to safeguarding subsequent business dealings from out suppliers (Jackson, 1985). However, there comes a point where making business relationships closer is only possible when both the supplier and the customer are prepared to invest in this special type of collaboration, as relationships in which the reason for staying in are solely determined by investments made on the part of the supplier are unstable by their very nature. As soon as competitors offer comprehensive benefits in alternative business transactions, there is an economic reason for customers to switch suppliers (Bonner & Calantone, 2005). This means that further investments will only become financially viable from the supplier's point of view if the customer is also prepared to put himself into a position of some dependence on the supplier. Both transaction partners then may devolve their economic welfare, at least in part, to the conduct of the other partner.

Accordingly, we distinguish two kinds of business relationship in this paper; on the one hand, business relationships in which suppliers invest in customers in order to create switching costs to prevent customers from changing supplier, to which we refer as *wide business relationships* (Rokkan, Heide, & Wathne, 2003), and on the other hand, business relationships in which both supplier and customer invest in each other with a

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view to making the business relationship closer, which we will call *partnerships* or *close business relationships*.

The essence of *close business relationships* or *partnerships* manifests itself in practically all aspects of commercial activity. Against this background, sellers try to induce and use customers' investment activity as a means of creating switching costs with a variety of different tools (Jackson, 1985). However, efforts on building up partnerships based on reciprocal specific investments are indeed still mainly concentrated on particular aspects of goods and services; for example, efforts are aimed towards collaborative research and development and to the inclusion of customers in the production process, but not to pricing-related issues. Interestingly, the few relationship tools that do exist in that area still rely on the traditional wide-relationship perspective by only implying specific investments on the seller's side. Thus, pricing continues to represent a distribution parameter within a transaction rather than being regarded as a collaborative process. Pricing practices thus are often still tactical and short-term in nature (Anderson & Narus, 2004).

However, this view is becoming increasingly dangerous for many industrial goods—markets, considering the important role that price plays as a marketing tool. Whilst trends toward price competition may not be universal, there can be no doubt that most industrial markets are more price-driven than they were a decade ago. One reason for this development is certainly market globalization, while increasing similarity in services offered by competitors also plays a major role.

In contrast to the predominant position of pricing in most industries, Chapter 2 will address the key question—do suppliers and customers also have the opportunity to develop *partnerships* in pricing? We will demonstrate that traditional pricing tools only offer limited scope for developing partnerships in order to shift attention towards a more co-operative view of pricing in Chapter 3. We will also show that *close business relationships* can only be developed in pricing when the price is regarded as a joint tool for outcome optimization within the overall supply chain process rather than as an ex ante distributive parameter between market partners. In order to clarify our envisaged shift in the understanding of pricing, we will then introduce what is referred to as *supply-chain pricing* as a new conceptual approach, which we will illustrate with a calculation example. Here, we investigate the basic actions required, the benefits as well as the limitations, and suggest some managerial implications for its practical implementation. The article will end with a short conclusion in Chapter 4.

2. Building partnerships with traditional pricing

Research into methods used to develop partnerships between suppliers and manufacturers to date have mostly been focussed on the subject of services and goods, as we have already mentioned. Here, there are clearly fewer findings related to spin-off benefits that therefore explore the possibilities for using pricing to do this. One major reason for this is certainly the fact that most industrial companies still separately calculate their optimal price aspirations based on internal cost structures and dynamics before entering price negotiations with their transaction partners (Garda, 1984). Moreover, they arm themselves with comparison data and draw on tools such as price analysis in order to bolster their own bargaining position without seeking creative and non-obvious solutions in advance to meet the goals of both sides (Anderson & Narus, 2004). Under these circumstances, it only seems clear that price is hardly regarded as a possible relationship tool that may generate mutual benefit.

However, examining pricing policy in detail will reveal that there are at least some starting points for encouraging business relationships. One obvious approach would be to use any kind of price discrimination to initiate relationships; sellers frequently give their customers special price offers (for example, discounts on the first purchase) and thus invest in their buyers (for an overview of price discrimination issue, see also Philips, 1983; Varian, 1989; Wilson, 1993). Moreover, sellers also try to involve their customers in the relationship by using appropriate price mechanisms (for example, contract agreements) (Seshadri, 2004). The strategy is always the same. The seller brings specific investments (such as price reductions) into the transaction, which may transform business transactions from relatively isolated events to a *series* of steady, sustained interactions over the course of time.

However, the duration of these interactions is highly arguable. This one-sided character of specific investments raises the question what type of investment the customer brings into the transaction in order to extend the duration of the interaction, and thus to build up and enhance the stability of a close business relationship. Even if one argues that the customer, for example, makes some sort of time-related investment by entering into a fixed term contract agreement with a supplier and thus taking on a commitment to make so many purchases from this supplier over a certain period of time, or possibly making a quantity-related investment by agreeing to make a fixed minimum quantity of purchases, all of these customer-related commitments do not imply switching costs on the buyer's side, and thus cannot be considered as specific investments in terms of our *close* relationship perspective discussed before. On the one hand, these agreements do not go beyond declarations of intent, nor are they related to true specific investment, and thus always give the buyer some kind of exit option from the relationship. On the other hand, they only occur between a series of overlapping transactions and not within one single business transaction. The supplier thus does not come to regard the customer-related investments as a source of security to awaken trust in a long-term relationship or to make further investments in the customer.

To summarise, the first point is that traditional pricing policies only offer an initial opportunity for forming business relationships due to the one-sided character of the specific investments required. In this sense, the pricing policies discussed largely still imply distributive bargaining elements due to win–lose negotiation settings with the "value pie" of the transaction fixed in size. Moreover, as far as relationship pricing tools are concerned, buyers always focus their efforts on a *series of overlapping transactions* to develop a

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