# Pricing as Entrepreneurial Behavior

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Conventional pricing is being turned on its head. Netscape makes its browser source code available for free. Glaxo takes over a pharmaceutical market by charging more than the competition for a comparable product. Bally Total Fitness Centers introduces more than 20 different pricing arrangements for the basic opportunity to perspire while working hard. Where the Encyclopedia Britannica used to sell for $1,500 or more, its content now becomes available for no direct fee on the Internet. Priceline.com introduces negotiated prices for almost any product or service one can imagine. The online PriceSearch service makes it possible to compare prices instantly on just about anything. When using this service for an American Airlines ticket, a traveler will find that the rates for a trip between Point A and Point B change by the hour, as the company refines its use of yield management software.

Deciding what prices to charge represents one of the more visible decision variables confronting managers. Product prices send clear messages about customer value and company objectives. Few business decision areas can have a more rapid or dramatic impact on profitability than improved price management. And yet pricing has historically been one of the least emphasized of strategic issues, one that managers are hesitant to critique or discuss.

Historically, managers have taken price for granted, concluding that its principal function was to cover costs and generate a reasonable rate of return. Some assumed that most firms charge about the same, and/or that legal and regulatory constraints limit their ability to use price as a strategic weapon. But a more fundamental explanation for managers' "price avoidance" is the fact that many do not really understand how to price and are insecure about the adequacy of the pricing approach they employ. As a result, they rely on overly simplistic rules of thumb and place an exaggerated emphasis on cost-based formulas.

Nevertheless, as noted before, there is considerable evidence to suggest that this state of affairs may be changing. Companies are beginning to adopt more sophisticated approaches to price management, and are coming to appreciate the strategic importance of the price variable. A number of notable examples exist in which prices are managed in a proactive and value-based manner. For instance, companies are developing more complex price structures (banks, financial institutions), initiating more frequent price changes (car rental agencies), and customizing their prices to individual market segments (telecommunication companies, magazine publishers).

> The old days of cost-driven, fixed, reactive prices are gone. The new buzzwords for pricing are variable, value-creating, visible, virtual, and variety.

These changes do not represent isolated events or random occurrences. Companies are being forced to change their pricing approaches, and the pressures for these changes are environmentally based. As external environments become less predictable and more uncontrollable, managers find they must be more strategic in their pricing behaviors in order to survive, much less prosper. Moreover, environmental conditions that are increasingly dynamic, hostile, and complex create a need for opportunistic or entrepreneurial pricing.

## What Is a Price? A Contemporary View

A price is ultimately a number. For many managers, it is a number that, more than anything, captures the costs involved in providing a product or service to a customer. These costs can differ quite a bit, though, depending on the firm. Determining average unit cost can also be somewhat arbitrary. The reality is that cost should have very little to do with what is actually charged by the firm, indicating only what the firm *must* charge to break even (in some instances, exceeding break-even is not even the objective). Consider any five people on a given airline flight. The likelihood is that each is paying a different amount to get from Point A to Point B, and it has nothing to do with the airline's costs of providing that flight.

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At their core or essence, the prices a company charges can be viewed in five ways:

*Price Is Value.* The amount a customer is willing to pay is, in the final analysis, a statement of the amount of value he perceives in the product or service. The customer who pays $7.50 for a garden salad in one restaurant and $1.20 for the same salad in another restaurant is making a statement regarding value perceptions.

*Price Is a Variable.* What any customer actually spends to acquire a product or service can be manipulated or varied in many ways, including the absolute amount of payment, the time of payment, the form of payment, the terms of payment, and the person doing the paying.

*Price Is Variety.* Firms typically sell multiple products and services, and may be attempting to use price to accomplish different things for different items—using some items to influence the sales of others, bundling and unbundling sets of items, and distinguishing among items with higher versus lower contribution margins.

*Price Is Visible.* Customers see and are aware of the prices of most things they buy, though they do not always consider all the components of the actual price they are paying. Because of its visibility, price sends signals to customers about value, image, product availability, demand conditions, exclusivity, and related characteristics of the transaction.

*Price Is Virtual.* Among marketing decision variables, an item's price is arguably the easiest and quickest to change. Many companies can make adjustments to their price schedules instantaneously, especially in an electronic age. Technology is one way to achieve real-time pricing, but there are many examples of long-standing pricing practices resulting in prices that are set at the time of purchase and can be changed quickly (such as negotiated pricing, spot markets, and black markets).

Many managers fail to recognize and capitalize on these price characteristics. Instead, they rely on relatively inflexible and reactive pricing methods. The beginning point in changing this state of affairs is to adopt a more comprehensive view of pricing decisions.

## A Strategic Perspective on Pricing

*Price* is a verb as well as a noun. Whereas a price is something one charges, "to price" is to determine how much, when, where, and how a buyer will pay. Price management includes a large number of decisions. Although some managers focus solely on determining the level at which to fix a price for each item in the company's product mix, a more systematic approach recognizes the need for decisions in five key areas:

- Price Objectives – measurable performance levels that management is trying to accomplish with the prices it charges customers. Performance outcomes could range from a specific profit level or the conveyance of a desired image in the marketplace to the discouragement of market entry by potential competitors.
- Price Strategy – the theme or direction of a firm's pricing efforts. The strategy provides the glue that holds together all individual pricing decisions. Examples include skimming, penetration, and price leadership strategies.
- Price Structure – the architecture around which a firm's price mix is designed. The structure specifies how prices will vary based on aspects of the product/service (bundling/unbundling), the customer (price differential by market segment), and time and form of payment (the discount structure).
- Price Levels – the establishment of actual prices for individual products and services (including odd-pricing), and the determination of specific price gaps among items in a given line.
- Price Promotions – the situational employment of various types of price promotions and special discounts, such as a cents-off coupon, a two-for-the-price-of-one deal, or a rebate.

Within each of these areas can be found a whole host of options, as we shall discuss later. The key to strategic pricing is to make the decisions in a systematic fashion, reflecting the company's overall marketing strategy, competitive positioning, and target markets. Moreover, there is a logical order to these decisions. Price objectives should be set first, then a pricing strategy should be determined, followed by structural decisions, and so forth. Just as important is the need to ensure internal consistency among these five decision areas.

### The Underlying Pricing Orientation of a Company: Toward Entrepreneurial Pricing

The overall approach management brings to making and implementing price-related decisions can be considered the firm's "pricing orientation." A guiding philosophy about pricing behavior underlies the decisions a firm makes regarding the various options in each of the five areas outlined above. The elements of this orientation can be explicitly stated, formalized, and planned. However, they are often implicit in pricing decisions, and emerge over time.

Little is known about company pricing orientations. Our research suggests, however, that pricing actions have at least four key underlying dimensions. The first of these is the extent to which pricing decisions are *cost-based* versus *market-based*. Cost-based pricing finds management placing far more emphasis on covering its own costs than on other determinants of price (demand conditions, competitive market structures, company marketing strategy, and so on). It typically involves a reliance on some sort of cost-plus, keystone, or target-return formula. Market-based pricing is more customer-centered; the principal purpose is to reflect the amount of value a customer is getting from the firm's total product offering.

The second component is whether pricing is more *risk-aversive* or *risk-assumptive*. Risk-aversive pricing represents a conservative approach. Prices are modified only when absolutely necessary, price levels are kept in close proximity to those of competitors, and the price structure is kept as simple as possible. Risk-assumptive pricing finds managers employing pricing schemes that are novel, untested, and have the potential to produce revenue losses.

The third component emphasizes whether a firm's pricing is *reactive* or *proactive*. The former involves mimicking the price moves of competitors, responding after the fact to customer signals, and adjusting prices only after a change in regulations or a new technological breakthrough that radically affects costs. The latter means taking a leadership role not only in changing prices but in being the first to introduce new pricing structures and payment schemes. It also reflects more aggressiveness in pricing, as well as speed in adjusting prices to reflect new opportunities.

The fourth underlying component is the extent to which management emphasizes *standardization* versus *flexibility* in pricing. Standardization is reflected in a tendency to charge a universal price for one's product or service regardless of the user, the buying situation, or the environmental (including competitive) contingencies. Flexibility finds the company varying prices based on segment or user elasticities and time and place of purchase, as well as in response to opportunities for product or service unbundling or bundling, or anticipated or actual moves by competitors, among other factors.

There may be other underlying dimensions that characterize a firm's pricing behavior, such as ethical considerations, but we believe these four are the dominant ones. Moreover, while each of these dimensions captures an important aspect of pricing behavior, they clearly interact with one another. For instance, being more proactive with one's pricing actions may entail greater risk.

The success of companies in virtually all industries depends more and more on their ability to engage in pricing that is market-based, risk-assumptive, proactive, and flexible. We refer to this combination of elements as opportunistic or *entrepreneurial* pricing. Examples of this type of approach can be found with growing frequency in a wide range of industries. Let's consider some examples, and explore the underlying need for such an approach.

### The New Pricing: Examples of Emerging Practices

Entrepreneurial pricing manifests itself in a variety of ways. As with any type of innovation, and especially with a decision area that is not only visible but has significant implications for financial performance, the new pricing methods frequently take the form of experimentation, trials, and limited scale tests. The diversity of approaches can be seen in an examination of developments in eight industries.

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Software. Firms are moving away from the traditional reliance on a onetime payment for software, relying instead on leasing, yearly licensing, and usage-based pricing. Another novel approach involves a point system, whereby points are assigned based on what the software is managing (say, a desktop versus a server), with prices set for various point ranges.

Communications. Some companies are basing their prices on the expected return to the customer. Using input on customers' expectations of the company's network and its financial impact on the organization, unique prices are determined for different communication systems.

Chemicals. Companies are concentrating on total economic value for the customer in their pricing methods. One example involves the pricing of pipe-sealing gaskets based on the cleanup costs and potential liabilities buyers could avoid.

Public Utilities. Utilities are beginning to unbundle their offerings to create product and service packages of different values. This can include removing some element of the product/service for customers who insist on low price points. They parade a menu of offerings and prices before different customer segments, and attempt to shift the focus to customer energy management.

Financial Services. Beyond offering different mortgage products to different borrowers, lenders are beginning to adopt risk-based pricing, whereby loans are priced individually based on a borrower's risk.

Construction. Firms are enabling buyer choice by reducing standard features on new homes in favor of options and upgrades, each of which is pre-priced and has a profit margin that is often greater than it would be as a standard item. Another approach involves systematically raising prices for plan changes the closer the project comes to completion.

Services. Adopting new yield management systems by service providers with capacity constraints (such as ski resorts, airlines, and theme parks) permits efficient management of time-based pricing, early discounts, limited early sales, over-locating, and so on.

The pervasiveness of these emerging approaches suggests that cost-based methods and fixed list prices may soon become a relic of a fading industrial age. Replacing an era in which standardized prices were needed to support scale economies, mass production, product standardization, mass marketing, and intensive distribution, a new set of forces is driving contemporary pricing efforts.

## Forces Creating a Need for Entrepreneurial Pricing

Corporate strategy experts such as Morris, Avila, and Pitt (1996) have written extensively on the need for companies to design strategies and make structural changes to counter threats and capitalize on opportunities in the external environment. In most industries, the external environment—competitive conditions, technological developments, economic conditions, customer demands, and so on—is becoming more turbulent, which means it is (a) experiencing rapid rates of change, (b) becoming hostile or threatening, and (c) growing in heterogeneity and complexity.

Environmental turbulence has numerous managerial implications. A faster pace of change means the company's products move through their life cycles more quickly, new market segments with distinct needs continually emerge, new forms of competition regularly appear, and managerial decision windows get shorter. A more hostile environment is characterized, in part, by more aggressiveness on the part of competitors. Firms find it harder to differentiate their offerings, and there is downward pressure on margins. Higher rates of product innovation occur, entailing higher rates of product failure. In an environment marked by greater complexity, we find firms engaging in more product and market specialization and "nichemanship." Mass markets disappear in favor of markets that are more fragmented and segmented.

Faced with such circumstances, successful firms tend to be those that demonstrate more adaptability and flexibility, as well as higher levels of innovation and entrepreneurship, than their less successful counterparts. Marketing activities (including pricing) become especially critical under such conditions. For instance, McKenna (1995) has suggested that a faster-changing and more complex environment is resulting in a greater emphasis by companies on niche marketing, relationship marketing, customization of marketing programs, the obsolescence of mass advertising, the use of speed as strategy, and a general pervasiveness of marketing throughout the organization.

At the same time, scholars have devoted relatively little attention to determining the specific implications environmental dynamics hold for pricing strategy. Some have recognized that pressures from the external environment make pricing decisions more delicate, complex, and important in companies. Environmental turbulence elicits fear, uncertainty, and doubt among sellers and buyers alike when it comes to making price-related decisions, but also forces firms to make faster and more frequent price decisions. Beyond these fairly general observations, few systematic insights have been provided.

However, consideration of some of the more pervasive environmental developments leads to some fairly clear pricing implications. Market fragmentation is resulting in more price differentiation, and prices are being set based on the market segment. A blurring of industry definitions is leading to experimentation in which pricing approaches long used in one industry are being adapted for use in a different one. Competitive intensity is forcing greater emphasis on customer relationships, and price becomes a potential indicator of the quality of the relationship. Technological change is producing software that makes activity-based costing, data-mining, yield management systems, and revenue optimization much easier for the typical firm. Smart cards are transforming the basic nature of transactions not only by empowering the buyer but also by placing a wealth of customer-specific data at managers' fingertips. The speed wrought by new information and communication technologies supports the emergence of new business models in which some or all of a firm's core offering can be given to customers for no charge.

A vivid picture of how environmental influences will change pricing in the coming years can be seen by considering the contemporary impact of the Internet and e-commerce. Figure 1 groups some of the more significant changes based on whether they are likely to represent threats or opportunities (or both) to managers. The Internet is making price the determining issue for many transactions, in effect commoditizing the business. Consumers can do more and quicker product and price searches; they can propose and negotiate prices; and they can transact whenever they want. For their part, firms can more easily modify their prices based on what is purchased, when, and by whom. They can collect data in real time on purchase patterns and demand conditions, which leads to revenue-optimizing price adjustments. The Net can also be used to stage buying experiences in ways that allow managers to sell more and charge more. Transaction costs are reduced markedly through the efficiencies created via e-commerce. It is only a matter of time before developments such as these influence all companies, regardless of what is being purchased or through which channel.

Figure 1
How E-Commerce Is Changing Pricing

| *New Opportunities for the Manager* | *New Challenges for the Manager* |
|---|---|
| 1. Use differentiated pricing all the time.<br>2. Use customer data to optimize pricing by creating customer switching barriers.<br>3. Use technology to de-menu pricing.<br>4. Become much better at differentiation—stage experiences.<br>5. Recognize that customers may be willing to pay more than you thought.<br>6. Establish electronic exchanges.<br>7. Maximize revenue and price. | 1. Technology facilitating customer price search<br>2. Customers making (rather than taking) prices<br>3. Customers controlling transactions<br>4. A return to one-on-one negotiation<br>5. Commoditization and efficient markets |

In the final analysis, a more turbulent environment creates a need for fundamental changes in the way companies determine and manage their prices. More specifically, companies are apt to find that their long-term success depends on a move to entrepreneurial pricing. Managers are forced to abandon conservative, risk-aversive pricing methods when faced with rapidly maturing products, demands from customer groups for unique product/service packages, and aggressive competitor forays into their markets. Companies are likely to turn to market-based pricing as cost-based approaches fail to provide the adaptability needed to keep abreast of customer expectations, to take advantage of opportunities created by niche markets, and to respond quickly to competitor initiatives.

Companies will also be more comfortable taking the lead in initiating price actions as rapid environmental change undermines the stability of traditional market positions. Competitor hostility is apt to create more price-based than non-price-based competition, but this does not mean simple price cutting. Rather, it will likely result in more creativity in manipulating the whole range of price variables. Environments that are more complex allow firms to act independently (or undetected) on price within a given niche.

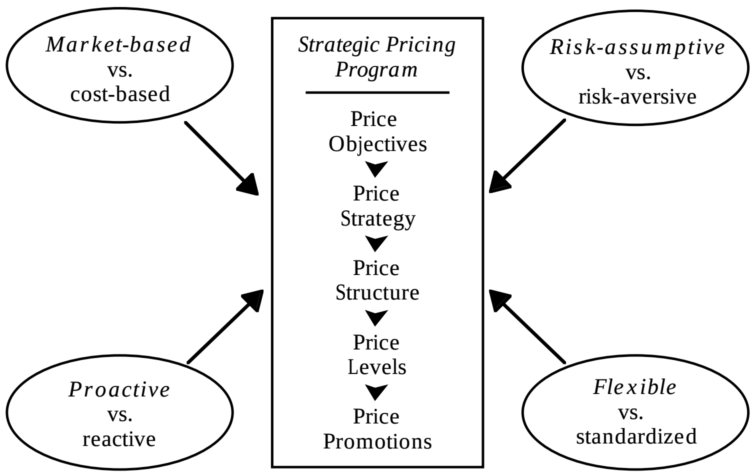
Finally, new opportunities will emerge for capitalizing on the different price/value perceptions found in various parts of the marketplace when environments are rapidly changing, as well as for reflecting differences in price elasticity among the numerous niche markets that appear. These opportunities will be coupled with competitive pressures for different treatment of key accounts. Again, the ability to address such opportunities will require that prices become more flexible and less standardized.

## Applying an Entrepreneurial Orientation to a Firm's Pricing Program

The key components of a company's pricing orientation can be applied to the formulation of objectives, strategies, structure, levels, and price promotions (see Figure 2). In terms of price objectives, price can be used for much more than just generating an acceptable or even relatively high rate of return. Objectives that focus on the use of price to encourage particular buyer behavior, establish a foothold in a new market, speed the exit of marginal competitors, take advantage of the learning curve, demotivate certain groups of customers, or use one product line in the company's portfolio to generate sales of another line reflect a more entrepreneurial perspective.

Similarly, entrepreneurial pricing is reflected in strategies that are value-based, capturing the total value proposition as perceived by individual segments and customers. Companies may need to develop multiple strategies, depending on the market context. Both premium and parity pricing strategies might be used by the same firm operating in different markets, and the firm may serve

Figure 2
Integrative Framework for Entrepreneurial Pricing




as price leader and price taker, depending on the product context.

Price structure is the decision area that invites the greatest amount of innovation and creativity. It is concerned first with which aspects of each product or service have a price attached. Sample pricing approaches might include bundling (say, a bank charges one price for which a customer receives check-writing privileges, a savings account, use of an ATM, a monthly statement, returned checks, and traveler's checks at no additional charge) and/or unbundling (the same bank charges individual prices for each of these services). Value-added services could be provided to the customer without raising price. Alternatively, the marketer could sell its basic offering at a very low price, then make money on higher margin consumables or add-ons. Selling the same product under different brand names for different prices is a further variation. Time-period pricing, whereby the product (or aspects of it) is priced differently at particular times, such as at peak or low-capacity periods, also represents a structural option. Two other variations might be the unlimited use of a given product or service for a set fee, and an initial base price followed by a variable charge once usage exceeds some threshold. The price could also be tied to the performance of the product or service, such that customers pay in direct proportion to the benefits they receive.

The second aspect of structure concerns how prices will vary for different customers and usage situations. Charging price differentials based on market segment or individual account is the principal focus. Arguably the most significant trend in pricing today, this means that segments with different price elasticities can be charged accordingly, although many firms remain fairly naive in the way they implement segment differentials (such as senior citizen discounts). Other alternatives include loyalty schemes for repeat or heavy users and establishing price differences for users who can consume only at certain time periods. Tying price to some variable customer aspect, such as foot size for a shoe store or car size for a car wash, is another possibility. Current technology allows firms to take price differentials even further, making one-to-one pricing a practical reality.

Price structure is also concerned with the conditions, time, and form of payment. The chief consideration is the formal discount structure, including cash or early payment discounts, volume discounts (cumulative or noncumulative), and functional or trade discounts (for distribution of logistical services, cooperative advertising, and so on). Also included here are various time payment schemes and trade-in allowances.

In a similar vein, price levels and tactics lend themselves to a more entrepreneurial approach. Price levels, or the actual amounts charged for each product or service and the actual discounts given, require creativity in deciding on such issues as the use of odd prices ($9.95 instead of $10.00), the use of price to convey the level of product quality, and the gap to allow between items in a given line (such as the low-end, middle-of-the-road, and high-end versions of the same product).

Finally, the use of such short-term tactics as rebates, coupons, cents-off deals, and price promotions represents an ongoing means of achieving market-oriented flexibility and proactiveness in pricing. Such tactics can be quick, precisely targeted, and relatively inexpensive. Moreover, any number of “guerrilla” tactics are possible, such as reusable coupons that increase in value with each use, or a price promotion that is conducted jointly with another firm.

Each of these areas has ample room for experimentation, and conventional rules need not apply. A restaurant might charge different prices for a meal depending on the table at which the customer is seated. A college might charge higher prices depending on how many credit hours a student has completed. An industrial manufacturer may price today based on the accuracy of the industrial buyer's demand forecasts over the past 18 months. The challenge is to identify and find inventive ways to capitalize on the creative variables that can have important profit impact over time, and that contribute to the customer value equation. Answering this challenge requires not only an intimate understanding of the customers but a willingness to lead them rather than simply follow them or take them for granted.

Price is currently the most neglected variable in companies' marketing efforts. Managers have tended to view it simplistically in terms of margins and costs, not as a strategic marketing variable or a core part of corporate strategy. The mindset is often to compete on a price basis on which one absolutely must compete, but otherwise to focus on non-price forms of competition (sales promotions, product quality, after-sale service, relationship-building).

Such an orientation may be increasingly untenable. In fact, formulaic and cost-based approaches to price determination are becoming a liability. In turbulent times, companies find that sustainable competitive advantage lies in flexibility, adaptability, speed, aggressiveness, and innovation. Pricing can play a key role in achieving such advantage, but only if managers (a) develop a better understanding of the multiple dimensions and component decisions that come under the general banner of "pricing," (b) address these components in a systematic and integrated fashion, and (c) ensure that these efforts are driven by a consistent underlying corporate philosophy toward pricing. In terms of the latter issue, our recommendation is that managers adopt a philosophy of "entrepreneurial pricing."

More specifically, managers should consider pricing approaches that are more market-based, proactive, flexible, and reflect a willingness to assume calculated risks. They should regularly apply the following key questions to business operations:

- How novel is our pricing approach? Are we creating value for the customer in the ways we price? On what sorts of assumptions are our prices predicated, and do those assumptions reflect the contemporary and emerging marketplace and technology?
- Are we proactive enough in terms of price raises and cuts, or changes in the various price components? Are we willing to move quickly and take the lead in instituting price moves relative to our competitors? Do we prefer to undo competitors rather than cooperate with them?
- Do we pursue pricing actions that entail a degree of calculated risk in terms of customer response, distributor receptivity, and competitor reaction? Instead of employing single, dramatic pricing actions, do we manage these risks by pursuing a number of different price moves? Do we continually experiment with price components and conduct pricing test markets in various market niches?
- Are we flexible enough in terms of tailoring prices to different markets, segments, and key accounts? Can we get closer to our customers by understanding the sources of value they get from our offerings and the trade-offs they'll make between price and various product attributes?

From a managerial standpoint, price must be a strategic-level decision variable, which means developing programs that take full advantage of its various components. There is a danger, of course, that firms will develop pricing programs that are too managerially cumbersome or confusing to customers. Weigand (1999) talks about how too many choices confuse company staff and exasperate customers. And complexity can result in customers who are not as price-sensitive paying less than they might otherwise have paid. Weigand also warns of a need for creative tactics in dealing with customers angered at discovering they are paying more than others for items that represent a meaningful slice of their budgets. This problem can be minimized if price managers carefully and consistently segment their markets, develop reliable indicators of segment price sensitivity, and effectively communicate price policies to key decision-makers in those segments. Moreover, the administration of the price structure must appear "seamless," helping to counter the perception that the price a given customer is being asked to pay is arbitrary.

Just as important is the need for managers to move their focus away from variables and events inside the company. Pricing must be externally focused, with formal and ongoing environmental monitoring efforts. The ability to anticipate variability in rates of change, movements toward greater market heterogeneity, or intensification of competitor aggressiveness—and to quickly adapt price strategy—would seem paramount.

The underlying dimensions of price identified here are likely to be interrelated. Managers may find that risk-taking in pricing may lead to more flexibility, which in turn permits price proactiveness within segments. And the underlying pricing dimensions are likely to interact with other elements of the marketing mix. For example, it could be that advertising expenditures will be positively associated with pricing that is more flexible or more proactive, given the need to communicate such pricing efforts to the correct audiences and on a timely basis.

The time has come for companies to redefine the role of price as a strategic variable. Price must become an innovative means of adapting to and capitalizing on the increasingly complex changes in the external environment. This is the essence of entrepreneurial pricing, and the key to a turbulent future. Ironically, by bringing a more disciplined approach to price management, firms can realize this entrepreneurial potential. ❐

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