Ilona Bondos, Marcin Lipowski

Usage of assumptions of value-based pricing in bundling strategy

Zarządzanie. Teoria i Praktyka nr 2 (12), 39-44

2015

Artykuł został opracowany do udostępnienia w internecie przez Muzeum Historii Polski w ramach prac podejmowanych na rzecz zapewnienia otwartego, powszechnego i trwałego dostępu do polskiego dorobku naukowego i kulturalnego. Artykuł jest umieszczony w kolekcji cyfrowej bazhum.muzhp.pl, gromadzącej zawartość polskich czasopism humanistycznych i społecznych.

Tekst jest udostępniony do wykorzystania w ramach dozwolonego użytku.

MUZEUM HISTORII POLSKI

Ilona Bondos
Maria Curie Sklodowska University, Lublin, Poland
Marcin Lipowski
Maria Curie Sklodowska University, Lublin, Poland

Zarządzanie. Teoria i Praktyka 12 (2) 2015
ISSN 2081-1586
str. 39-44

Usage of assumptions of value-based pricing in bundling strategy

Adres do korespondencji:
email: ilona.bondos@poczta.umcs.lublin.pl
email: marcin.lipowski@gmail.com

Abstract
The purpose of this article is to present the bundling strategy on the background of pricing strategy based on value (value-based pricing, VBP). The authors have attempted to identify the convergence of the two approaches and specifically to show the possibilities of using the assumptions VBP strategy in bundled offerings. Service/product bundling is becoming more and more popular, however, it does not guarantee success if it is not based on the premise of offering and communicating real value for the customer. Popularity of bundled offers on the Polish market while also a lack of understanding of the bundling essence are the main reasons for choice of such a topic. The authors formulated for bundled offers providers some tips based on the crux of strategy based on values.

Key words: bundling; value-based pricing; price setting; pricing.

1. Introduction.

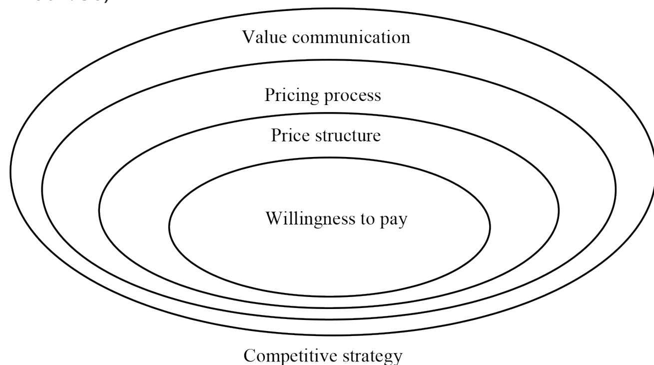
Price management is a neglected issue in Polish scientific literature. The observation of market reality entitles to the conclusion that the marketing practice is anticipating the theoretical achievements connected with pricing. An example is the bundling strategy, which is gaining on popularity on the Polish market - especially on the telecommunications market. The purpose of this article is to present the bundling strategy on the background of pricing strategy based on value. Value-based pricing is applicable in a competitive market where the key issue is the appropriate value communication to potential buyers.

2. Value-based pricing – a contemporary attitude to pricing strategy

Undoubtedly, pricing has a huge impact on profitability. Prices send unequivocal messages about what the firms believes in, what it thinks of its customers, and how it wants to interact with them. These messages can drive customers away and destroy value (Bertini, Gourville, 2012). According to Nagle and Holden (2002), pricing strategy is the coordination of interrelated marketing, competitive and financial decisions to maximize the ability to set prices profitability. Nagle claims that only after reasonable pricing objectives are developed and made an objective of business strategy is it possible to select target markets, create product and service bundles, develop promotional messages that communicate value and design price structure that will maximize customers' willingness to pay. It is important to understand the difference between price setting and pricing stra-

tegically - it is the difference between reacting to market conditions and proactively managing them. Pricing strategically involves managing customers' expectations to induce them to pay for the value they receive (Nagle, Cressman, 2002). Figure 1 illustrates this broader perspective on pricing. It should be emphasized that even when price structures reflect value and the pricing process forces customers to make price-value trade-offs, value-based pricing will have limited success unless the company's marketing program effectively communicates the value.

Figure 1. The Domain of Strategic Pricing (Nagle and Cressman 2002: 30)



Buyers who are ignorant of the monetary value of a firm's product and service differentiation generally tend to underestimate it. The purpose of value communication is to raise uninformed buyers' willingness to pay to a level comparable to that of well-informed buyers. According to Brandenburger and Stuart (1996: 8), value created is defined as willingness to pay minus opportunity cost. Best (2013: 272) is right in saying that market-based pricing requires extensive customer and competitor intelligence. Without having high levels of both, it is simply not possible to implement this kind of pricing. Market-based pricing starts with a good understanding of customer needs and the benefits that a product offers relative to competitors' products. On the basis of product performance benefits, the price is set relative to competition to create a superior value. In this way, the price is determined in the market, not at the factory or in the finance department. Value-based pricing (VBP) occurs when a company stops setting prices by simply marking up production costs or calibrating against competitors' prices and instead charges according to the offering's worth to the customer (Michel 2014: 81). There are a few kinds of value pricing, one of them is *Customerization Value Pricing* – price is set by unbundling a product's features or performance levels, placing a price on each, and then allowing customers to select the features and performance that they want at a price that they are willing to pay. The price of the top-performing product that has all features serves as the reference price. Customers who buy the product with only the features and performance level they desire have an inferred savings (value) relative to reference price (Best 2013: 273). In this case, there is to some extent the situation in which consumers themselves determine the price to be paid ultimately. That type of pricing can be called a participative pricing mechanisms, which can be considered innovative, in the sense of being unconventional, because they involve consumers in the price-setting process (Kim, Natter and Spann 2009: 44). The crucial issue is that a buyer's control over the price setting is at a quite high level. According to Schons et. al (2014: 27), because customers alone specify prices the most extreme form of participative pricing is pay-what-you-want pricing (PWYW) - sellers must accept any price, even if it is below their costs or zero. PWYW allows the buyer to pay a very low price, even a price of zero, for a service or product. Therefore, it can be argued that PWYW is similar to a price reduction to zero. Assuming a buyer who behaves purely rationally may lead to a price of zero given PWYW. Consequently, at first glance, PWYW does not seem to be a promising pricing instrument, as there is the obvious risk for the seller to receive a lower price for the product than the cost of producing it. However, based on theoretical and empirical findings, it seems that buyers do not exploit the pricing mechanism (Kim et al. 2014: 411-412). Contrary to the prediction of egoistic materialistic individuals in traditional theory, but in line with the experimental results, many consumers of products sold via PWYW pay a price higher than zero (Greiff, Egbert and Xhangolli 2013: 1-15). However, it should be stressed the distinction aforementioned types of VBP and the mechanism PWYW - these are distinct innovation strategies within the innovation category - changing the price-setting mechanism (Michel 2014: 81).

In a value-based price structure, prices change with the value delivered. Nagle and Cressnan (2002: 30) pay attention to the difference between internally and externally focused companies – first type of company usually build price structures that reflect their costs, while externally focused companies build structures that reward customers with greater purchasing power. In either case, they end up with pricing, and therefore profitability, that is not proportionate to the value they deliver. Value pricing strategy is used by firm that have an objective of utilizing pricing to communicate positioning (Marshall and Johnston 2010). Without a doubt VBP differs from other common pricing strategies in its focus on what

a customer or group of customers is buying rather than on alternative factors (Meehan et al. 2011).

Customer value-based pricing uses buyers' perceptions of value, not the seller's cost, as the key to pricing. Value-based pricing means that the marketer cannot design a product and marketing program and then set the price. Price is considered along with the other marketing mix variables before the marketing program is set. VBP inverts chain: *product – cost – price – value - customer* to another one which corresponds with the economic realities of the marketplace: *customers – value – price – cost – product*. According to Nagle and Holden, the purpose of value-based pricing is not simply to create satisfy customers but to price more profitably by capturing more value, not necessarily by making more sales. Authors claim that, when marketers confuse the first objective with the second, they fall into the trap of pricing at whatever buyers are willing to pay, rather than at what the product is really worth (Nagle Holden 2002).

There are two major characteristics of the value-based pricing approach. First, firms adopting value-based pricing have the capacity to offer reasonable prices because they have engineered themselves to be a low-cost provider in their industry. Value-based pricing requires that the firm be highly efficient in operations and marketing in order to keep costs, and prices, low. Second, firms adopting value-based pricing maintain consistent prices over time; they use sales, discounts, and other pricing tactics infrequently. Value-based pricing naturally draws customers because they have confidence in the value of the products they buy. Customers also like the approach because it requires less effort to find good prices on the products they want and need (Ferrell Hartline 2011: 249).

Pricing strategies vary considerably across industries, countries and customers. Among three alternative approach to pricing (cost-based pricing, competition-based pricing and customer value-based pricing) customer VBP is increasingly recognized in the literature as superior to all other pricing strategies (Hinterhuber 2004) and even one of the best pricing methods, when feasible. Marketing and pricing studies recommend VBP as a modern and advanced pricing approach. However, the implementation and internalization of VBP requires deep organizational changes that transform the fabric of a firm's life and its identity as well as the identity of its members. This transformation is marked by a slow 'mutation of firm DNA' from cost or competition to customer value. The implementation and internalization process of VBP is a long, tenuous, and sometimes painful journey of change for the organization and its actors. The process requires intense and sustained organizational mobilization to transform established structure, culture, processes, and systems (Liozu et al. 2012).

3. Bundling – package of value to customers and providers

At the very beginning of explaining the essence of bundling it should underline the confusion in the literature arises from inconsistent use of terms, ambiguous distinctions between important constructs, and an unclear domain of application (Stremersch Tellis 2002: 56).

Bundling has been studied for several decades (Ferrer et al. 2010). The literature on bundling has a long history beginning with the observation by G.J. Stigler in 1963 that bundling can increase sellers' profits when consumers' reservation prices for two goods are negatively correlated (Hitt Chen 2005). The problem of optimal bundling strategy has received much attention over the last quarter of a century in the marketing and economics literature also from behavioral perspectives (Bitran Ferrer 2007). The literature on the economics of bundling can be categorized into three broad groups: benefits of bundling as a tool for price discrimination, as a cost saving mechanism and finally as a means of entry deterrence (Sheikhzadeh Elahi 2013). According to Cao et. al (2015: 91) two main reasons why a firm bundles are: bundling results in better price discrimination against consumers and bundling serves as an effective competition tool.

Bundles can adopt one of three strategic forms: pure, mixed, and unbundled (Andrews et al. 2010). Under the pure components (or unbundling) strategy, the seller offers the products separately (but not as a bundle), under the pure bundling, the seller offers the bundle alone, under mixed bundling, the seller offers the bundle as well as the individual items. Mixed bundling is a form of second degree price discrimination (Prasad 2015: 1). As researchers observe, the reservation prices for the various products or services are independently distributed across the population of the consumers, the mixed bundling strategy generally yields higher profits than either pure bundling or a pure component strategy (Yan et al. 2014: 49). Undoubtedly during the bundling strategy implementation a wide range of bundle pricing problems should be taken into account, including the assumption of the free disposal of unwanted components, profit maximization subject to consumer self-selection, and the provision of a sufficiently large range of products that customers may select from the bundle (Hanson

and Martin 1990: 155–174). An interesting solution is also the option of customized bundling which is kind of common ground between a variant of mixed and pure bundling. This strategy gives the consumer the right to choose a maximum M products from n-element set. (Wu et al. 2008: 609.) The relationship with the assumptions of Customerization Value Pricing is quite visible in this case.

No single strategy always dominates all others. Wu et al. (2008) pay attention to some practical difficulties associated with this pure bundling strategy. Describing the types of bundling it is crucial to clearly underline the difference between product and price bundling. Price bundling is not the same as feature bundling (product bundling). The difference is the integration between elements in the package. Price bundling is the sale of two or more separate products as a package at a discount, without any integration of the products (Stremersch Tellis 2002). According to Smith (2012: 215) in feature bundling, disparate features of and benefits of different products are combined into a single multifunctional product. Feature bundling delivers additional value over pure price bundling by combining multiple features of distinct products into a single bundled product. In other words, when a price discount is a part of the bundle offer, the practice is characterized as price bundling.

Pricing strategy choice between pure and mix strongly depends on the reservation prices, which are the consumer's maximum willingness to pay for each component (Ferrer et al., 2010). Since the reservation prices for individual components varies from customer to customer, bundles allow companies to capture more consumer surplus from the buyers because excess consumer surplus is transferred from one component of the bundle to another (Bitran Ferrer 2007: 93). In this way, companies implicitly price discriminate.

According to some researchers bundling is a value-based pricing method (Rautio et al. 2007: 46). Main argument for such reasoning is strong dependence the effectiveness of bundling on the value which is offered to buyers of products or services combined in one package. Smith (2012: 216) claims that in general, the larger the number of goods bundled, the greater the reduction in disparity in willingness to pay. However, statement about the relationship between the number of package elements and the propensity to buy should not be taken for granted. According to our research (2015: 1216), the degree of exploitation of individual components the service package reduces the likelihood of changing supplier. It should be emphasized that this finding is not identical with the statement that the more elements in the package, the better for customer retention. Companies which offer service packages should not add to the package these services that are unnecessary to the customer, because the lack of full exploitation of the services from package is a factor associated with a tendency to abandon the package. In turn, the strategy of adding new services to the package according to the changes in the real needs of the consumer (e.g. when household entrances in the next phases of its life cycle) can effectively linked the customer with a service provider. This is consistent with the findings Yadav and Monroe who show that buyers would like to evaluate the bundled products from the most important to less important and form an overall evaluation about these bundles (Yadav and Monroe, 1993: 350–358.). Because uncertainty about the value that customers place on a products is an enemy of effective pricing, the predictive power of bundling can be highly profitable. The role of a bundling strategy is to encourage multi-item purchases in buyer groups that would normally purchase fewer products than those included in the bundle (Andrews et al. 2010). Guiltinan (1987: 75) notes that by bundling the products together essentially it is possible to obtain a new product. If the two products are independent in demand, some customers who would buy only one of the products if they were priced individually will now buy both products. The reason is that the value these customers place on one product is so much higher than its price that the combined value of the two products exceeds the bundled price. In economic terminology, the consumer surplus from the highly valued product is transferred to the less valued product. Some researchers show that even the bundling of independent products can still be better than no-bundling. Moreover, the authors show that if the retailer could monitor the purchases, then a mixed bundling strategy can almost always be more profitable than no-bundling. To achieve this result, the authors assume that the retailer can prevent consumers from purchasing both product 1 and product 2 separately (Sheikhzadeh Elahi 2013). A confirmation that bundling strategy is based on offer value idea are the results of Venkatesh and Kamakura (2003), their findings show that consumers are willing to pay more for the bundle of complements than for standalone products. According to Yan et al. (2014: 52) the price discount to the identical products must be attractive to customers and the degree of product complementarity to the complementary products must be large enough, and then the bundling strategy with advertising can obtain a success in the market. Furthermore, their results also show that when the degree of the complementarity between two products increases, firm should invest

less on advertising to promote the bundled products. It means that at a certain level complementary elements of the package, the key to convince the customer is a package value not the advertising. This is due to the perceived usefulness of the package, which is guaranteed by the strong complementary relationship between the components of bundled offer.

It should be emphasized, however, that despite the numerous studies on bundling profitability this issue is still not fully understood, there is no final statement about it. As Chen and Riordan (2013: 51) said "the profitability issue still is not completely settled". Basu and Vitharana (2009: 793) identified three factors that determine the nature of the optimal pricing plan: marginal costs of the components, the distribution of knowledge over the customer population, and the relative sizes of customer segments where each segment is interested in the same subset of components (for instance, for two components, the segments are customers interested in both components, only the first component, only the second component, and neither component).

4. Summary

Undoubtedly bundling strategy is gaining in popularity. Considering the importance of the total value of bundled offer, it seems advisable to qualify that pricing approach to the value-based pricing strategy. It can be assumed that in the near perspective Polish consumers will be increasingly disposed to use heterogeneous packages of services - packages that include various services, e.g. telecommunication services and delivery of so-called commodities (gas, water, electricity). The aim of the service users will be to maximize the benefits of cooperating with a one service provider, who in order to acquire the customers will need to provide not only the package of services but also a credible message about its value to potential buyers. The issue of the valuation (price setting) of the package and its individual components will be significantly shaped the effectiveness of the implemented bundling strategy.

It is worth noting that currently some service providers are trying to differentiate themselves in the market by making the advertising, which emphasize the offering of individual services (not a package that can be unattractive to the customer). The effectiveness of such communications due to the fact that currently some bundled offers do not correspond to the actual needs of the buyers. The problem is not bundled offer as such but its improper uses – offering customers more products at an attractive price without considering whether these products are attractive to customers. The key to the success of bundling strategy is to include assumptions of pricing strategy based on value - value that is perceived by a potential buyer as a result of proper communication strategy. Contrary to appearances, consumers do not expect the lowest prices, they expect such a package of services, the value of which will justify required price (Bondos 2014: 435).

Another recommendation concerns the flexibility of bundled offerings. Undoubtedly, interest in the various components of the package of services / products varies with changes in the life cycle of the household. Thus, a real nod to the client would be to offer him the opportunity to make changes in owned package. Changes that would result from the changing needs of the household - one service becomes no longer needed while another would be necessary (eg. a child growing up will need to have mobile internet while becoming independent children eliminates such a service). It is important to emphasize the flexibility of time to make changes in the package components – not at the expiry of the current contract but at the moment chosen by the customer.

References

1. Andrews M.L., Benedicktus R.L., Brady M.K., *The effect of incentives on customer evaluations of service bundles*, "Journal of Business Research" 63(1), 2010, pp. 71–76.
2. Basu, A., Vitharana P., *Impact of Customer Knowledge Heterogeneity on Bundling Strategy,* "Marketing Science", 28 (4), 2009, pp. 792–801.
3. Bertini M., Gourville J.T., *Pricing to create shared value*, „Harvard Business Review" 90(6), 2012, pp. 96-104.
4. Best R.J., *Market-based management*, Pearson, Boston 2013.
5. Bitran G.R., Ferrer J.C., *On Pricing and Composition of Bundles*, "Production and Operations Management" 16(1), 2007, pp. 93–108.
6. Bondos I., *Price and service bundling – an example of the telecommunications market in Poland*. Proceedings of MakeLearn Conference, Portoroz , 2014, pp. 427–436.
7. Bondos I., Lipowski M., *Determinants of Bundled Service Users' Retention.* Proceedings of the MakeLearn and TIIM, Bari, 2015, pp. 1211–1219.
8. Brandenburger A.M., Stuart H.W. Jr., *Value-based business strategy*, "Journal of Economics & Management Strategy" 5(1), 1996, pp. 5–24.
9. Cao Q., Geng X., Zhang J., *Strategic Role of Retailer Bundling in a Distribution Channel*, "Journal of Retailing" 91(1), 2015, pp. 50–67.
10. Chen Y., Riordan M.H., *Profitability of product bundling*, "International Economic Review" 2013, vol. 54, no. 1., pp. 35–57.

11. Ferrell O.C., Hartline M D., *Marketing strategy*, Cengage Learning, Mason 2011.
12. Ferrer J.C., Mora H., Olivares F., *On pricing of multiple bundles of products and services*, "European Journal of Operational Research" 206(1), 2010, pp. 197–208.
13. Greiff, M., Egbert, H., & Xhangolli, K. (2013). *Pay What You Want – But Pay Enough! Information Asymmetries and PWYW-Pricing*, „Joint Discussion Paper Series in Economics" no. 04, 2013, pp. 1–15.
14. Guiltinan J.P., *The price bundling of services: a normative framework*, "Journal of Marketing" 51(2), 1987, pp. 74–85.
15. Hanson W., Martin R.K., *Optimal bundle pricing*, "Management Science" 36 (2), 1990, pp. 155–174.
16. Hinterhuber A., *Towards value-based pricing—An integrative framework for decision making,* "Industrial Marketing Management" 33(3), 2004, pp. 765–778.
17. Hitt L.M., Chen P., *Bundling with Customer Self-Selection: A Simple Approach to Bundling Low-Marginal-Cost Goods*, „Management Science" 51(10), 2005, pp. 1481–1493.
18. Kim, J.-Y., Kaufmann, K., & Stegemann, M., *The impact of buyer-seller relationships and reference prices on the effectiveness of the pay what you want pricing mechanism*, "Marketing Letters" 25(4), 2014, pp. 409–423.
19. Kim J.-Y., Natter M., & Spann M., *Pay What You Want: A New Participative Pricing Mechanism*, "Journal of Marketing" 73(1), 2009, pp. 44–58.
20. Liozu S.M., Hinterhuberb A., Perellic S., Boland R., *Mindful pricing: transforming organizations through value-based pricing*, "Journal of Strategic Marketing" 20(3), 2012, pp. 197–209.
21. Marshall G.W., Johnston M.W., *Marketing management*, McGraw – Hill Irwin, Boston 2010.
22. Meehan J., Simonetto M., Montan L., Goodin Ch., P*ricing and profitability management. A practical guide for business leaders*, Wiley, New Yersey 2011.
23. Michel, S., *Capture more value*. Harvard Business Review, 92(10), 2014, pp. 78–85.
24. Nagle T.T., Holden R.K., T*he strategy and tactics of pricing. A guide to profitable decision making*, Upper Suddle River, New Jersey 2002.
25. Nagle T.T., Cressman G.E. Jr., *Don't just set prices, manage them*, "Marketing Management" 11(6), 2002, pp. 29–33.
26. Prasad A., Venkatesh R., Mahajan V., *Product bundling or reserved product pricing? Price discrimination with myopic and strategic consumers*, „International Journal of Research in Marketing" 32(1), 2015, pp. 1–8.
27. Rautio T., Anttila M., Tuominen M., *Bundling of information goods: a value driver for new mobile TV services*, „International Journal of Revenue Management", 1(1), 2007, pp. 45–64.
28. Schons L., Rese M., Wieseke J., Rasmussen W., Weber D., & Strotmann W. C., There is nothing permanent except change-analyzing individual price dynamics in "pay-what-you-want" situations., "Marketing Letters" 25(1), 2014, pp. 25–36.
29. Sheikhzadeh M., Elahi E., *Product bundling: Impacts of product heterogeneity and risk considerations*, "International Journal of Production Economics" 144(1), 2013, pp. 209–222.
30. Smith T.J. *Pricing strategy,* CENGAGE Learning, Mason 2012.
31. Stremersch S., Tellis G.J., *Strategic Bundling of Products and Prices: A New Synthesis for Marketing,* "Journal of Marketing" 66(1), 2002, pp. 55–72.
32. Wu S., Hitt L.M., Chen P., Anandalingam G., C*ustomized bundle pricing for information goods: a nonlinear mixed-integer programming approach,* "Management Science" 54(3), 2008, pp. 608–622.
33. Venkatesh R.,Kamakura W., *Optimal bundling and pricing under a monopoly contrasting complements and substitutes from independently valued products*, "Journal of Business" 76(2), 2003, pp. 211–231.
34. Yadav M.S., Monroe K.B., *How buyers perceive savings in a bundle price: an examination of a bundle's transaction value,* "Journal of Marketing Research" 30(3), p. 356, 1993, pp. 350–358.
35. Yan R., Myers Ch., Wang J., Ghose S., *Bundling products to success: The influence of complementarity and advertising*, "Journal of Retailing and Consumer Services" 21 (1), 2014, pp. 48–53.