

## CHAPTER 8

### ON THE (DIS)ABILITY OF THE FIRM TO QUANTIFY CHAINS

*A marketing perspective on sharing financial rewards*

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**Abstract.** Although the marketing discipline originates from agricultural economics, it currently moves to a new logic that is marked by, among other things, customer value, customer satisfaction, relationships, market orientation and resource-based theories. This article uses this evolving logic in marketing to examine the problem of sharing financial rewards in agricultural supply chains. Building on resource-advantage theory it is suggested that the potential reward that firms may derive from participating in a supply chain depends on the competitive position of the chain as a whole and on the competitive position of the individual firm within the chain. To understand what its contribution to the chain is worth, the firm should be able to quantify relative customer value. The paper identifies inter- and intra-organizational barriers that may disable the firm to do so. Inappropriate assessments lead to a disability of the firm to take financial rewards in exchange for its contribution to the chain. It is questioned whether academicians currently provide chain practitioners with the appropriate approaches to deal with this problem.

**Keywords:** competition; marketing; pricing; resource-based theory

#### INTRODUCTION

Having its roots in agricultural economics, the marketing discipline for a long time had a vocabulary and assumptions comparable to those of agricultural economics. Over the last decades, however, marketing is “moving towards a new dominant logic” (Vargo and Lusch 2004, p. 1), which provides an interesting avenue to understand the challenges that agricultural chains nowadays see themselves confronted with. In particular, the number of agricultural chains that differentiate themselves from mainstream production by offering unique products to the consumer seems to increase. These chains have set themselves apart from mainstream production, create more value than their competitors do, and may also have to search for new ways to share the financial rewards for the creation of customer value.

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In a perfect market, rewards for economic behaviour are determined by the price mechanism, whereas in hierarchies the principal determines the payments to the agent. In a supply chain that is embedded in a network of competing firms, however, firms are torn between the options of competition and collaboration. Relationships emerge when two parties recognize that they both benefit more from exchange within the context of a relationship than from different types of transactions or from transactions with different partners (Anderson and Narus 1984; 1990; Dwyer et al. 1987). The extent to which firms will extract financial rewards from relationships within an integrated supply chain will strongly determine their willingness to participate in that chain. The alternative to a satisfying solution for all participants on how financial rewards are divided would be that some of the participants share the costs while others reap the gains. This may go at the expense of the motivation and income of those participants that share the costs, and it may finally lead to a disintegration of the system.

The remainder of this chapter is structured as follows. The next section will provide some background information on the new dominant logic in marketing. Next, the resource-advantage theory of competition, a cornerstone of this new dominant logic, is described. This theory provides a basis for the subsequent argumentation. First, it is argued that firms compete both *with* and *within* their chain (the topic of the third section). This leads, in the fourth section, to an understanding of the potential reward for contributing to a supply chain. This *potential* reward may, however, deviate from the *actual* reward that the firm receives. If firms are incapable of quantifying the appropriate indicators within their chain (in particular relative customer value), the actual reward may strongly deviate from the potential reward. The fifth section discusses several barriers that may inhibit a firm to quantify relative customer value and thus to cash the full potential reward. The chapter finishes with some conclusions.

#### THE EVOLVING NEW DOMINANT LOGIC IN MARKETING

The new dominant logic in marketing is marked by concepts like customer value (Woodruff 1997), customer satisfaction (Oliver 1997) and relationship marketing (Dwyer et al. 1987; Morgan and Hunt 1994). A driving force behind these developments has been the field of services marketing (cf. Berry and Parasuraman 1991). The mainstream economic vocabulary appeared to be of little use to the marketing of services. However, according to Vargo and Lusch (2004) services marketing is not the exception but the rule, because in every transaction services are exchanged even if it concerns a transaction between a physical product and a monetary payment. To this respect, a farmer does not just sell his crops: he sells a 'service' by bringing together resources and developing knowledge and the ability to grow crops. This 'service' enables the customer to focus on his own capabilities and deliver services to others. According to Vargo and Lusch (2004) the physical product and the monetary payment (which shape the actual transaction according to economists) 'mask' the actual exchange of services.

Similar to these developments, marketing-strategy literature has shifted its focus from strategy content – like studies on the Profit Index of Marketing Strategies (Buzzell and Gale 1987) – to the resources of firms on which these strategies build. A central concept in the marketing-strategy literature that builds on the resource-based view of the firm (e.g. Dierckx and Cool 1989; Penrose 1959; Wernerfelt 1984) is market orientation. Market orientation refers to the organization-wide generation, dissemination and use of market information pertaining to current and potential customers and competitors (Kohli and Jaworski 1990). Because it is rooted in an organizational culture, market orientation is a resource (Homburg and Pflesser 2000). This resource is leveraged in business processes like strategy-making, new product development and service delivery (Day 1994), which are therefore executed by the organization in ways that lead to the creation of superior customer value (Slater 1997). The creation of customer value subsequently leads to customer satisfaction, customer retention, attraction of new customers (Woodruff 1997) and in the end financial performance (see Rodriguez Cano et al. (2004) for a meta-analysis of relationships between market orientation and business performance).

An important hallmark in the development of the new dominant logic in marketing, are the works of Hunt and Morgan (1995; 1996; 1997) on resource-advantage (R-A) theory. Sharing similarities with many research

*Table 1. Foundational premises of perfect competition and resource-advantage theory (derived from Hunt and Morgan (1997))*

		<b>Perfect competition theory</b>	<b>Resource-advantage theory</b>
P 1	Demand:	Heterogeneous across industries, homogeneous within industries, and static	Heterogeneous across industries, heterogeneous within industries, and dynamic
P 2	Consumer information:	Perfect and costless	Imperfect and costly
P 3	Human motivation:	Self-interest maximization	Constrained self-interest seeking
P 4	The firm's objective:	Profit maximization	Superior financial performance
P 5	The firm's information:	Perfect and costless	Imperfect and costly
P 6	The firm's resources:	Capital, labour and land	Financial, physical, legal, human, organizational, informational and relational
P 7	Resource characteristics:	Homogeneous and perfectly mobile	Heterogeneous and imperfectly mobile
P 8	The role of management:	To determine quantity and implement production function	To recognize, understand, create, select, implement and modify strategies
P 9	Competitive dynamics:	Equilibrium-seeking, with innovation exogenous	Disequilibrium-provoking, with innovation endogenous

traditions that deviate from perfect competition theory, R-A theory should be seen as a theory in development, with the final goal to develop into a general theory of competition (Hunt 2000). R-A theory has formulated foundational premises that are closer to actual business practice than those of perfect competition theory (see Table 1). Therefore, it has formulated a theoretical structure on competition that is appealing to both academicians and business people, and that provides a helpful perspective to understand how firms in supply chains share the financial rewards generated by the chain.

RESOURCE-ADVANTAGE THEORY

R-A theory can be explained on the basis of Figures 1 and 2. According to R-A theory, organizations strive to achieve superior financial performance, which can be achieved through a market position of competitive advantage. A position of competitive advantage is a consequence of an organization’s advantage in resources compared to competitors (Figure 1). Superior financial performance is “a level of financial performance that exceeds that of its referents, often its closest competitors” (Hunt and Morgan 1995, p. 6). Firms do not maximize profits because they generally lack the information to do so.

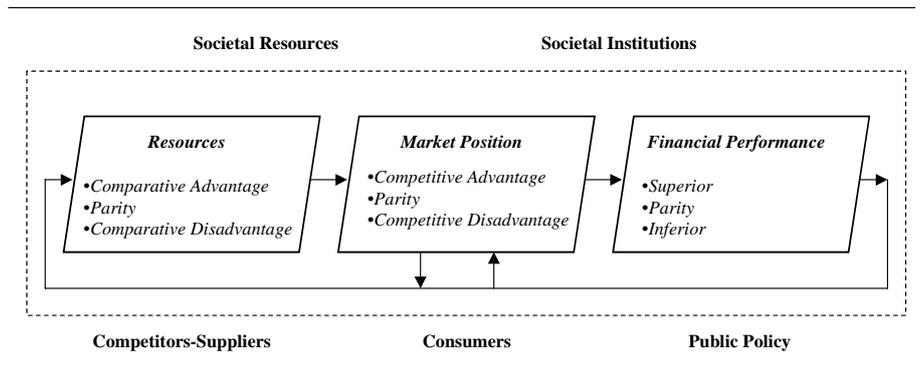


Figure 1. Resource-advantage competition (derived from Hunt and Morgan (1997))

Market positions depend on the value that the firm creates to a certain market or market segment on the basis of its resources compared to competitors, as well as on the relative costs that the deployment of resources brings about (Figure 2). Market segments “are intra-industry groups of consumers whose tastes and preferences for an industry’s output are relatively homogeneous” (Hunt 2000, p. 11). This suggests that organizations do not compete necessarily within certain industries, but do compete necessarily on certain markets or market segments. Value “refers to the sum total of all benefits that customers perceive they will receive if they accept a particular firm’s market offering” (Hunt 2000, p. 32). “Relative superior value therefore, equates with *perceived to be worth more*” (Hunt 2000, p. 32, italics in

original). This suggests that it is the customer who decides how valuable a market offering is.

		Relative Resource-Produced Value		
		Lower	Parity	Superior
Relative Resource Costs	Lower	1 Indeterminate Position	2 Competitive Advantage	3 Competitive Advantage
	Parity	4 Competitive Disadvantage	5 Parity Position	6 Competitive Advantage
	Higher	7 Competitive Disadvantage	8 Competitive Disadvantage	9 Indeterminate Position

Read: The marketplace position of competitive advantage identified as Cell 3 results from the firm, relative to its competitors, having a resource assortment that enables it to produce an offering for some market segment(s) that (a) is perceived to be of superior value and (b) is produced at lower costs.

Derived from Hunt and Morgan (1997)

*Figure 2. Competitive Position Matrix*

Firms achieve a position of competitive advantage if they create superior value at costs lower than, or equal to their competitors' (cells 3 and 6 in Figure 2, respectively), or if they create value equal to competitors at lower costs (cell 2). In other words: to capture a position of competitive advantage, a firm needs a comparative advantage in its resources that enables it to produce more effectively and/or efficiently than its competitors. A firm obtains a position of competitive disadvantage if it creates relatively lower value at costs equal to or higher than their competitors (cells 4 and 7), or if it creates value equal to their competitors' at higher costs (cell 8). Cell 5 represents a parity position. In this situation, all firms competing on a certain market or market segment have relatively equal resource-produced value and relatively equal resource costs. A firm that occupies a market position represented by cell 1, in which it creates lower value at lower costs, will have to set lower prices than competitors in order to have a chance at achieving

competitive advantage. Also if the firm creates relatively higher value at relatively higher costs, its position is indeterminate (cell 9). Its competitive advantage depends here on the willingness of customers to pay premium prices in return for market offerings of superior value.

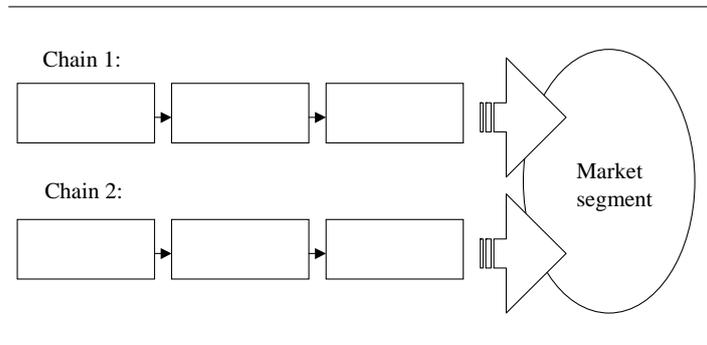
The process of R-A competition is dynamic. In order to achieve a position of competitive advantage, firms continuously seek for a comparative advantage in resources. R-A theory defines resources as: “the tangible and intangible entities available to the firm that enable it to produce efficiently and/or effectively a market offering that has value to some market segment(s)” (Hunt 2000, p. 11). Resources are of various kinds in R-A theory: financial, physical, legal, human, organizational, informational and relational. Resources may be the result of the firm’s past and they may be imperfectly mobile, such as relationships with customers and suppliers. Achieving superior financial performance enables the firm to invest in resources. Firms can improve their market positions by introducing innovations to the market. As such, competitive positions are not stable. Positions of competitive advantage can be sustained if competitors base them on resources that are difficult to imitate or obtain.

Firms may learn from the process of competition. If the firm achieves a certain degree of performance, it may learn about the competitive position and the specific resources on which this position is based. By learning from the process of competition, a firm may learn in which resources it should invest in order to improve its position. Considering that a firm may learn the wrong things, a position can be harmed if the firm invests in the resources that do not lead to a position of competitive advantage.

Customers, competitors, suppliers, societal institutions, public policy and societal resources influence the process of R-A competition. Customers’ preferences may change, competitors may imitate certain types of resources, suppliers may raise their prices, etc. These stakeholders may impact on the comparative advantage of resources as well as on the explicit and implicit ‘rules of the game’. Societal resources impact on the firm’s resources, like the availability of natural resources such as oil, or the level of education in a society. Resources of a legal nature, like patents, may protect innovations, while environmental or safety laws may force firms to modify production plants and processes.

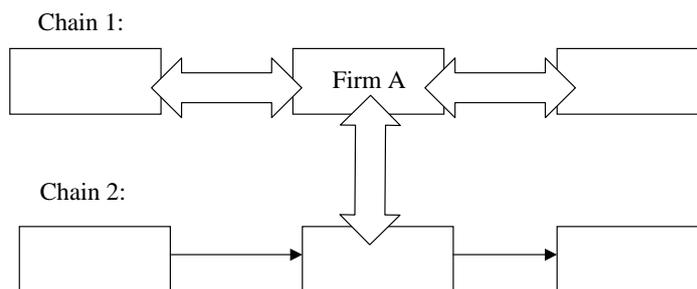
#### COMPETITION WITHIN AND BETWEEN CHAINS

In R-A terms chains strive for a comparative advantage in resources, which results in a position of competitive advantage in a certain market or market segment, which yields superior financial performance to the chain as a whole. Chains are clear examples of how relational resources may work out: together chain members may compete more effectively and/or efficiently than they might individually. Competition between chains is depicted in Figure 3. Both chains compete in the same market segment, trying to be more effective and/or efficient than the competing chain.



*Figure 3. Competition between chains*

However, in order to achieve superior financial performance, firms do not compete with their chain against other chains alone, they also compete within their chain (see Figure 4). In the continuous struggle for a comparative advantage in resources, chains may improve their stock of resources by involving new partners in the chain and removing others. Firms that possess resources that make the chain compete more effectively and/or efficiently, may enter the chain at the expense of others. Firms may participate in multiple chains, strategically deploy resources over them, scan the environment for new opportunities, assess the importance of current relationships, and assess the potential of new ones. If the firm has a strong resource stock, it can easily switch (think of the powerful positions that many food retailers occupy). However, if relationships are strong, it is unlikely that firms are quickly removed from a supply chain when they find themselves in a position of competitive disadvantage. Instead, chain partners are more likely to allow them some time to strengthen their positions (Morgan and Hunt 1994).



*Figure 4. Competition within a chain*

In sum, both competition *between* chains and competition *within* a chain determine firms' financial performance. The frameworks of R-A competition can be applied both to the firm and to the chain. Firms compete within these two – sometimes-conflicting – systems.

#### THE POTENTIAL REWARD FOR CONTRIBUTIONS TO A SUPPLY CHAIN

Considering that the financial performance of a chain should be divided over its members, the reward that a firm will receive for participating in a chain is some share of the financial performance of the chain as a whole. We can write the firm's reward for chain activities (R) therefore as:

$$R = f[\textit{share}, \textit{financial performance}_{\textit{chain}}]. \quad (1)$$

In order to reward a firm for its contribution to the financial performance of the chain, the ratio of distribution should be based on the firm's market position. If the firm deploys a comparative advantage of resources in the chain, this contributes to the market position of the chain. Rewarding firms on the basis of their market position strengthens the relationships between resources and market positions and between market positions and financial performance, thereby speeding up the process of R-A competition, productivity and economic growth. Given that the ratio of distribution is in reality often not entirely based on the firm's market position, we speak of a normative function in which we try to explain the firm's potential reward for chain activities (PR) rather than its actual reward. The potential reward is the maximum amount of money that a firm may extract based on its contribution to the chain.

$$PR = f[\textit{market position}_{\textit{firm}}, \textit{financial performance}_{\textit{chain}}]. \quad (2)$$

Given that in R-A theory financial performance is a consequence of a market position, we can replace the financial performance of the chain in this function by the market position of the chain:

$$PR = f[\textit{market position}_{\textit{firm}}, \textit{market position}_{\textit{chain}}]. \quad (3)$$

Since relative value and relative costs determine a market position, we can specify the function further. By relative costs is meant the costs of deploying resources in the activities of the chain relative to a perceived alternative. This is an alternative for a firm's activities in a chain, which may be either a competitor, forward integration, backward integration, or a network extension. Relative value is the sum total of all benefits that the next link in the chain perceives it will receive from chain collaboration relative to a perceived alternative (based on Hunt 2000, p. 32).

Costs represent the lower boundary: the minimum amount the firm should receive for enabling its resources in the chain without making a loss. Value

represents the upper boundary: what the result of deploying resources is worth to the customer (see also Figure 5). The potential reward for deploying resources is therefore a function of the relative value (RV) created by the firm minus its relative costs (RC) of enabling resources, and the relative value created by the chain to the target market (segment) minus the costs of enabling the resources of the chain:

$$PR = f[(RV_{\text{firm}} - RC_{\text{firm}}), (RV_{\text{chain}} - RC_{\text{chain}})]. \quad (4)$$

### QUANTIFYING CUSTOMER VALUE

In agricultural chains that differentiate themselves from mainstream production by delivering unique benefits to the consumer, it is essential to assess the upper-boundary, i.e. to quantify relative customer value. Clearly, if the firm uses some proxy to quantify value that is actually much lower than the value perceived by the customer, it grants the customer with a surplus that is higher than necessary.

In an empirical analysis of the effects of firms' pricing practices on profit margins of innovations, Ingenbleek et al. (2004) show that firms that create superior value are often incapable of expressing this value in the price they receive in return. This inability may be caused by a lack of information on a reference point in the market (what do others charge for their products) and/or a lack of information on how much better the firm's innovation is compared to this reference point (see Figure 5).

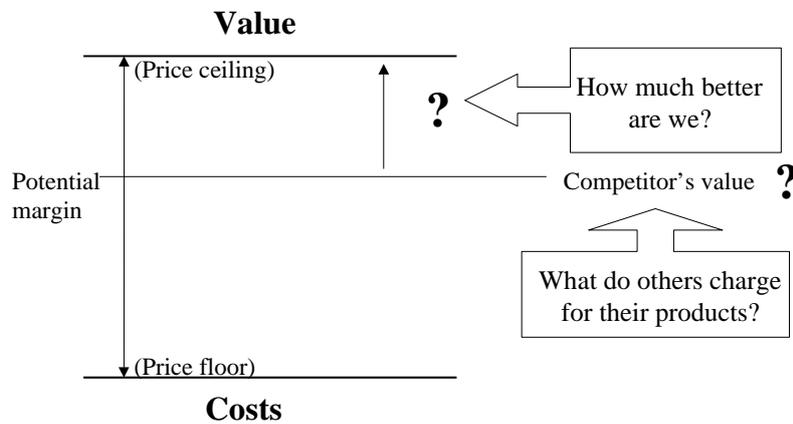


Figure 5. Quantifying the potential reward (adapted from Monroe 2003)

Given this process of quantifying relative customer value, firms may bring the actual reward for their chain activities close to the potential reward if two conditions are satisfied. First, they should be able to assess reasonably their position of relative customer value (meaning that they should be able to detect the reference points in

the market and to assess how much more value they deliver as compared to these reference points). Second, other chain partners should also be capable of quantifying their relative-value position, because the degree to which downstream chain members are rewarded will determine the extent to which they can possibly pass on these rewards to upstream chain members. In the next section the barriers are discussed that disable firms to assess relative customer value.

### BARRIERS TO QUANTIFY RELATIVE CUSTOMER VALUE

A *potential* reward suggests that this reward is not for granted. In fact, it is probably impossible to extract the full potential reward for a firm's activities in a supply chain, because it is virtually impossible to quantify what a market offering is precisely worth to the customer. Information on customer value is ambiguous by definition (Sinkula 1994) and it may be quickly outdated in the dynamic process of R-A competition. In the barriers that prevent firms to take the potential reward for chain activities, we may distinguish between inter-organizational barriers (referring to relationships between firms) and intra-organizational barriers (referring to relationships within firms).

#### *Inter-organizational barriers*

Information to assess customer value may be acquired from multiple sources, of which relationships in the chain and its surrounding network are probably the most important (Granovetter 1973; Hansen 1999; Rindfleisch and Moorman 2001). Quantifying customer value requires insight into the customer (Anderson and Narus 1999). In order to assess how much one contributes as an upstream supplier to the market position of a downstream customer, one needs insight into the market position that the customer occupies at his/her customer (Ingenbleek 2004). This requires detailed information from the customer, which can be obtained only if the firm has developed a strong relationship with its customer. Weak relationships within chains, i.e. relationships that lack a sufficient level of trust and commitment (Morgan and Hunt 1994) are therefore the first barrier to quantifying relative customer value.

The second barrier may be a lack of contacts beyond the strong relationships in the chain. A drawback of strong relationships may be that they have a blinding effect on actors (Granovetter 1973). As indicated in Figure 5, to assess relative customer value, firms need to be able to assess reference points, which are most likely their closest competitors. In order to keep track of these competitors and possible new entrants, firms should not concentrate too much on the relationships within their own chain, but stay in business (through weaker relationships than the relationship in their major chain) with others that can provide such information (Ingenbleek 2004).

Third, because innovative means of value creation often require innovative price mechanisms that determine the rewards for the created customer value, the existing price mechanisms within chains may be a barrier. There are often well-established

ways on how prices (rewards) are calculated or determined in chains, laid down in contracts, routines or perhaps institutions such as auctions. If these established price mechanisms are not based on a quantification of relative customer value and if actors are reluctant to switch to new price mechanisms, they are a barrier.

#### *Intra-organizational barriers*

If the firm has established the appropriate network contacts and thus can acquire the appropriate information, several barriers within the firm may inhibit its ability to quantify relative customer value. A first barrier may be the transmission of the information within the firm (Huber 1991; Maltz and Kohli 1996). Information should be transmitted to those who are responsible for the price decision or negotiations with customers. In order to enable chain partners to increase their rewards, firms should also reward upstream partners for their contribution to the chain. This requires information to be transmitted to purchasers.

Second, managers should not just have the information; they should also interpret it correctly. In order to use both customer and competitor information in price decisions, managers need interpretation schemes that are rooted in a market-oriented culture (Day and Nedungadi 1994). In organizations there may exist tendencies to use other types of information in order to avoid the ambiguity of value information (Adams et al. 1998). When weighted against less ambiguous information such as price discounts, purchasers put less weight on value information (Anderson et al. 2000).

Third, even if information on relative value is acquired, distributed to the relevant business functions and correctly interpreted, it may not always be used in decision-making. Management systems should be aligned with the firm's objectives of value creation. If the firm rewards its sales people for market share rather than profits, and its purchasers for cost-cutting rather than value increases, these managers are unlikely to use the information on relative value (cf. Ingenbleek and De Vlieger 2004).

## CONCLUSIONS

To ensure that chain members remain motivated to invest in the chain and to provide them with sufficient financial resources to do so, it is in the common interest of all chain members that each of them is rewarded for its contribution to the competitive position of the chain. It is also in the best interest of public policy, if public policy aims for economic growth. In other words: the actual reward for the chain members' contributions to the chain should be as close as possible to the potential reward. Chain members should both 'live and let live': cash the rewards for their own contribution to the market position of the chain and allow other chain members to take a share based on their contribution. To this respect, the view of pricing as a capability is endorsed here. As Dutta et al. (2003, p. 629) suggest: "Managers in a firm without effective pricing processes may be unable to set prices that reflect the wishes of their customers, so the customers may misuse resources. As such effects

ripple through a supply chain or a market sector, society may be worse off because resources are used inefficiently”.

The capability that enables firms to take the rewards for their activities in a chain, is fed by both competitor and customer information. These types of information enable it to assess relative customer value. In order to collect these types of information, distribute them to the appropriate business functions, interpret them correctly and use them in actual decision-making, firms may see themselves confronted with barriers that exist within their own firm and between their firm and their chain partners.

The view presented here to clarify the problem of sharing financial rewards in chains, poses an important question to widely used approaches for studying agricultural chains, such as industrial economics and transaction-cost economics: are these approaches still helpful to solve questions on how financial rewards should be divided among chain partners, or should we move to alternative approaches? As agricultural chains increasingly seek to create customer value and differentiate themselves from mainstream production, new approaches based on the new dominant logic in marketing may be promising for the future.

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