



GO-TO-MARKET & PRICING

What is value-based pricing?

Value-based pricing aligns transaction prices with quantified customer economic value and willingness to pay rather than cost or competitor parity.

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MANAGEMENT SUMMARY

Value-based pricing sets commercial transaction prices according to the quantified economic value delivered to a defined customer segment rather than historical input costs or competitor benchmarks. By establishing the customer's next best alternative, isolating differentiated operational value drivers, and negotiating a transparent value-sharing split, firms capture higher margins while leaving substantial surplus for the buyer. This guide formalizes the Economic Value to the Customer (EVC) model, contrasts value-based pricing against cost-plus and market-indexed architectures, details an enterprise capital replacement scenario, and outlines an auditable organizational protocol to prevent margin erosion and unearned discounting.

Keywords: Value-based pricing · Economic value to customer · Willingness to pay · Pricing architecture · B2B commercial negotiation

Value-based pricing is the commercial practice of setting transaction prices primarily on the quantified economic value delivered to a specific customer segment, rather than relying on historical production costs or competitor price parity. Grounded in managerial economics, it establishes that the upper boundary of price is bounded by customer willingness to pay, which is driven by the net financial gains generated by the offering.

Unlike cost-plus pricing, which calculates a price by adding an arbitrary margin percentage to internal input expenses, value-based pricing works backward from customer operations. It asks a disciplined economic question: how much incremental cash profit does the customer generate, or how much operating expense do they avoid, by adopting our solution relative to their next best alternative?

In commercial governance, adopting value-based pricing transforms sales, product, and finance functions. When enterprises fail to operationalize value-based pricing, they suffer from persistent discount leakage, commoditize highly differentiated innovations, and cede legitimate commercial surplus to buyers who actively measure what vendors fail to quantify.

How is economic value to the customer formally calculated?

Value-based pricing operationalizes the Economic Value to the Customer (EVC) model. The framework decomposes customer valuation into two structural pillars: reference value and differentiation value.

The EVC equation

The total economic value delivered to a buyer represents the absolute monetary threshold of value creation:

$$\text{EVC} = \text{Reference Value} + \text{Differentiation Value}$$

Where:

- Reference Value (V ref) is the net purchase price of the customer's next best alternative (NBA), adjusted for comparable operating units.
- Differentiation Value (Delta V) is the net monetary value of all quantifiable performance advantages and operating savings offered by the vendor's solution over the reference alternative.

Differentiation value is further divided into revenue enhancements and cost reductions:

$$\text{Delta V} = \text{sum Delta Revenue Gains} + \text{sum Delta Cost Reductions} - \text{sum Delta Adoption Costs}$$

The value-sharing mechanism

A vendor cannot capture 100% of the differentiation value. If a vendor sets price exactly equal to EVC, the customer receives zero incremental surplus and has no economic rationale to incur switching risks. Consequently, realized price (P) is governed by the value-sharing ratio (alpha):

$$P = V_{\text{ref}} + \alpha \times \text{Delta V}$$

Where alpha in (0 , 1) represents the fraction of differentiation value captured by the vendor through bilateral commercial bargaining. The remaining fraction, (1 – alpha) × Delta V, represents customer surplus, providing the compelling financial incentive required to drive adoption.

Grennan (2013) is a structural estimate on medical-device bargaining, and its reported magnitudes are modest rather than overwhelming: ending price discrimination through the competitive effect alone moves prices +1.7%,

manufacturer profits +8%, hospital surplus –1.4% and total welfare +0.7%. What transfers is the mechanism, not a share of surplus: with asymmetric buyers uniform pricing softens competition, and with symmetric buyers it sharpens it. Bargaining ability is a real term in the price, which is the point this page needs.

Lawrence et al. (2019) examine multichannel customer profitability using “a complex data set from a large industrial seller”, and find that online search and purchasing “interact positively with both salesperson contact and customer-specific discounts”. The channels are complementary, which is the reason to coordinate them; that uncoordinated discounting erodes realization is my inference from the interaction rather than a measured effect of theirs.

Kleinaltenkamp et al. (2022) is a qualitative study: 95 interviews across 47 companies, 79 semi-structured plus 16 repertory-grid, producing eleven customer-success implementation antecedents grouped around expected value in use, experienced value in use and relationship value. The divergence it reports is specific rather than systematic: customers place greater relevance on project or relationship phase than suppliers do, while suppliers weight follow-up projects more heavily. That is enough to argue for validating value during execution instead of asserting it before the sale.

Biemans et al. (2022) review the sales-marketing interface literature, “we identify 73 articles” published 1990 through 2021, and report a mechanism rather than a cause: the “thought-world differences between the two functions that” form pervasive subcultures produce communication problems and a lack of trust. Misaligned qualification is one instance of that, reported through the review rather than measured by it.

Figure 1 The Economic Value to the Customer (EVC) framework

Valuation tier	Component	Calculation logic	Commercial governance role
Reference Value (V ref)	Incumbent Baseline Price	Price of customer’s Next Best Alternative	Sets the absolute price floor of market relevance
Positive Differentiation (+ Delta V p)	Tangible Financial Gains	Incremental revenue uplift + direct cost savings	Quantifies verifiable operational advantages
Negative Differentiation (– Delta V n)	Switching & Incompatibility	Implementation, re-training, and migration overhead	Identifies customer friction requiring mitigation
Net Differentiation (Delta V)	Net Differentiated Value	$\Delta V p - \Delta V n$	Defines total pool of created incremental surplus
Total Economic Value (EVC)	Maximum Customer WTP	$V_{ref} + \Delta V$	Upper theoretical ceiling of customer valuation
Vendor Capture (P)	Realized Contract Price	$V_{ref} + \alpha \times \Delta V$ (where alpha approximately 0.30 – 0.50)	Captures sustainable gross margin for reinvestment
Customer Surplus (C S)	Incentive to Switch	$(1 - \alpha) \times \Delta V$	Justifies procurement approval and deployment risk

Author’s commercial pricing framework grounded in empirical bargaining, channel governance, and customer-success literature from Grennan (2013), Lawrence et al. (2019), Kleinaltenkamp et al. (2022), and Biemans et al. (2022).

How does value-based pricing compare to alternative pricing models?

Commercial organizations typically utilize one of three pricing architectures: cost-plus, competitor-indexed, or value-based pricing. Conflating these methods creates structural margin leakage.

Table 2 How does value-based pricing compare to alternative pricing models?

Dimension	Cost-Plus Pricing	Competitor-Indexed Pricing	Value-Based Pricing
Starting point	Internal accounting cost ledger	Competitor published price list	Customer operational economic impact
Focus of analysis	Historical production and delivery expense	Market average and rival feature sets	Customer business case and cash flow lift
Reference metric	Standard unit cost + markup %	Competitor discount parity	Next best alternative + net differentiation
Customer sensitivity	Ignores demand elasticity and value perception	Assumes customer treats solutions as identical	Measures segment-specific willingness to pay
Sales negotiation stance	Defends cost accounting allocations	Matches rival concessions and discounts	Defends quantified business case and ROI
Innovation incentive	Penalizes cost reduction innovations	Triggers price wars and margin erosion	Rewards high-impact customer value creation
Primary risk	Overpricing low-value goods; underpricing high-value goods	Commoditization and sub-optimal margins	Requires rigorous value modeling and proof

Table from this essay. Sources and interpretation are given in the article.

Understanding the distinction between theoretical willingness to pay and realized value capture is essential. As explored in What is Willingness to Pay? and What is Price Elasticity?, customer reservation prices are not static market constants; they depend directly on the presence of verified operational substitutes.

Worked commercial example: B2B industrial automation replacement

Consider an enterprise software vendor selling an automated quality-assurance platform to mid-sized manufacturing facilities. The prospective buyer currently uses a legacy manual inspection process (the Next Best Alternative).

1. The baseline reference alternative (NBA)

- Annual manual inspection labor and tooling costs: \$240,000.
- Annual defect escape rate: 2.0% on 10 , 000 , 000 in o u t p u t (200,000 in scrap, returns, and warranty claims).
- Total annual reference operating cost: \$440,000.

2. Differentiated economic value of the automation platform

- Labor reduction: Replaces 60% of manual inspection, saving \$144,000 annually.
- Defect reduction: Reduces defect escapes from 2.0% to 0.4%, saving \$160,000 in warranty and scrap.
- Incremental cloud hosting and sensor maintenance cost: -\$24,000 annually.
- Net annual differentiation value (Delta V): $144,000 + 160,000 - 24,000 = 280,000$.

3. Comparing pricing architectures

Under cost-plus pricing, the vendor leaves 235,000 in annual surplus on the table because internal costs have a relationship to the client's 280,000 operational gain. Under value-based pricing with an equitable 40% sharing ratio, the vendor captures 112,000 in revenue (generating 82,000 in contribution profit), while the buyer secures \$168,000 in net operational savings. The transaction presents an undeniable 4.8-month payback, eliminating procurement hesitation while maximizing vendor returns.

Connecting this calculation to unit economics is paramount. As established in *What is Contribution Margin?*, capturing differentiation value flows directly into marginal cash contribution without inflating dedicated variable delivery costs.

Which operational miscalculations undermine value-based pricing?

Table 3 Which operational miscalculations undermine value-based pricing?

Miscalculation	Root cause	Commercial failure	Corrective protocol
Confusing cost savings with total value	Focusing exclusively on operational cost reduction	Ignores revenue expansion, risk reduction, and velocity gains	Build comprehensive multi-vector value models
Assuming value is universally perceived	Pitching identical economic models to different personas	Technical buyers reject business metrics; executives reject feature lists	Segment value models by buyer role and operating maturity
Treating list price as value-based pricing	Publishing elevated list prices without sales negotiation tools	Field sales reps discount aggressively when challenged by procurement	Provide sales reps with audited ROI calculators and walk-away floors
Ignoring customer adoption friction	Omitting integration, training, and change management costs	Customer encounters negative differentiation and feels misled	Deduct adoption expenses explicitly in the EVC equation
Failing to verify post-sale realization	Handing off accounts without tracking achieved milestones	Customer disputes value claims during contract renewal negotiations	Mandate customer success reviews tracking verified business outcomes

Table from this essay. Sources and interpretation are given in the article.

What auditable protocol establishes value-based pricing governance?

- 1 Identify the true next best alternative (NBA). Interview lost opportunities and churned accounts to identify what prospects actually buy or build when they decline your solution.
- 2 Isolate quantifiable economic drivers. Catalog differentiation into measurable financial categories: labor productivity, direct cost reduction, revenue acceleration, and risk mitigation.
- 3 Build validated customer business cases. Construct transparent, parameter-driven ROI models where prospects can adjust underlying operating assumptions with their own data.
- 4 Establish a target value-sharing corridor. Target capturing 30% to 50% of net differentiation value, ensuring customer surplus remains compelling enough to overcome institutional inertia.
- 5 Enforce deal-desk walk-away thresholds. Link sales compensation and discounting governance to realized value metrics rather than gross booking volume.
- 6 Harmonize cross-channel discounting. Coordinate field sales negotiations with digital pricing tiers to eliminate arbitrage, following the principles of Lawrence et al. (2019).
- 7 Institutionalize post-onboarding value audits. Partner customer success teams with client finance sponsors to audit and certify realized economic gains prior to contract renewal, as outlined by Kleinaltenkamp et al. (2022).

Where are the empirical limits of value-based pricing?

Value-based pricing is an analytical framework for commercial price structuring, not a universal guarantee of monopoly rent extraction. It requires verifiable operational differentiation. In purely commoditized markets where offerings lack defensible performance advantages, differentiation value approaches zero, collapsing EVC to the reference price.

Furthermore, value-based pricing demands sophisticated buyer-seller collaboration. When purchasing departments operate under strict cost-breakdown procurement mandates or when buyers face extreme capital rationing, suppliers may struggle to negotiate value-sharing contracts regardless of calculated economic benefits.

The empirical foundations of this framework derive from peer-reviewed literature in commercial bargaining, multichannel governance, customer success, and sales-marketing integration, specifically Grennan (2013), Lawrence et al. (2019), Kleinaltenkamp et al. (2022), and Biemans et al. (2022). The mathematical formalizations, worked industrial calculations, and operational protocols represent the author's synthesis for rigorous commercial execution.

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END OF ESSAY

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