

If you find yourself facing a price war, you'll need to understand how it started in order to respond effectively. Often the best counterattack does *not* involve a retaliatory price cut.

How to Fight a Price War

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IN THE BATTLE TO CAPTURE THE CUSTOMER, companies use a wide range of tactics to ward off competitors. Increasingly, price is the weapon of choice—and frequently the skirmishing degenerates into a price war.

Creating low-price appeal is often the goal, but the result of one retaliatory price slashing after another is often a precipitous decline in industry profits. Look at the airline price wars of 1992. When American Airlines, Northwest Airlines, and other U.S. carriers went toe-to-toe in matching and exceeding one another's reduced fares, the result was record volumes of air travel—and record losses. Some estimates suggest that the overall losses suffered by the industry that year exceed the combined profits for the entire industry from its inception.

Price wars can create economically devastating and psychologically debilitating situations that take an extraordinary toll on an individual, a com-

pany, and industry profitability. No matter who wins, the combatants all seem to end up worse off than before they joined the battle. And yet, price wars are becoming increasingly common and uncommonly fierce. Consider the following two examples:

- In July 1999, Sprint announced a nighttime long-distance rate of 5 cents per minute. In August 1999, MCI matched Sprint's off-peak rate. Later that month, AT&T acknowledged that revenue from its consumer long-distance business was falling, and the company cut its long-distance rates to 7 cents per minute all day, everyday, for a monthly fee of \$5.95. AT&T's stock dropped 4.7% the day of the announcement. MCI's stock price dropped 2.5%; Sprint's fell 3.8%.

- E-Trade and other electronic brokers are changing the competitive terrain of financial services with their extraordinarily low-priced brokerage services. The prevailing price for discount trades has fallen from \$30 to \$15 to \$8 in the past few years.

There is little doubt, in the first example, that the major players in the long-distance phone business are in a price war. Price reductions, per-second billing, and free calls are the principal weapons the players bring to the competitive arena. There is little talk from any of the carriers about service, qual-

Price wars are becoming more common because managers tend to view a price change as an easy, quick, and reversible action.

ity, brand equity, and other nonprice factors that might add value to a product or service. Virtually every competitive move is based on price, and every countermeasure is a retaliatory price cut.

In the second example, the competitive situation is subtly different—and yet still very much a price war. E-Trade's success demonstrates how the emergence of the Internet has fundamentally changed the cost of doing business. Consequently, even businesses such as Charles Schwab, which used to compete primarily on low-price appeal, are chanting

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a "quality" mantra. Meanwhile, Merrill Lynch and American Express have recognized that the emergence of the Internet will affect pricing and are changing their price structures to include free online trades for high-end customers. These companies appear to be engaged in more focused pricing battles, unlike the "globalized" price war in the long-distance phone market.

Most managers will be involved in a price war at some point in their careers. Every price cut is potentially the first salvo, and some discounts routinely lead to retaliatory price cuts that then escalate into a full-blown price war. That's why it's a good idea to consider other options before starting a price war or responding to an aggressive price move with a retaliatory one. Often, companies can avoid a debilitating price war altogether by using a set of alternative tactics. Our goal is to describe an arsenal of weapons other than price cuts that managers who are engaged in or contemplating a price war may also want to consider.

Take Inventory

Generally, price wars start because somebody somewhere thinks prices in a certain market are too high. Or someone is willing to buy market share at the expense of current margins. Price wars are becoming more common because managers tend to view a price change as an easy, quick, and reversible action. When businesses don't trust or know one another very well, the pricing battles can escalate very quickly. And whether they play out in the physical or the virtual world, price wars have a similar set of antecedents. By understanding their causes and characteristics, managers can make sensible decisions about when and how to fight a price war, when to flee one—and even when to start one.

The first step, then, is diagnosis. Consider a small commodities supplier that suddenly found that its largest competitor had slashed prices to a level well below the small company's costs. One option the smaller company considered was to lower its price in a tit-for-tat move. But that price would have been below the supplier's marginal cost; it would have suffered debilitating losses. Fortunately, a few phone calls revealed that its adversary was attempting to drive the supplier out of the local market by underpricing its products locally but maintaining high prices elsewhere. The supplier correctly diagnosed the pricing move as predatory and elected to do two things. First, the manager called customers in the competitor's home market to let them know that the price-cutter was offering special deals in another market. Second, he called local customers

and asked them for their support, pointing out that if the smaller supplier was driven off the market, its customers would be facing a monopolist. The short-term price cuts would turn into long-term price hikes. The supplier identified solutions that eschewed further price cuts and thus averted a price war.

Intelligent analysis that leads to accurate diagnosis is more than half the cure. The process emphasizes understanding the opportunities for pricing actions based on current market trends and responding to competitors' actions based on the players and their resources. Not only is it necessary to understand why a price war is occurring or may occur, it also is critical to recognize where to look for the resources to do battle.

Good diagnoses involve analyzing four key areas in the theater of operations. They are *customer issues* such as price sensitivity and the customer segments that may emerge if prices change; *company issues* such as a business's cost structures, capabilities, and strategic positioning; *competitor issues*, such as a rival's cost structures, capabilities, and strategic positioning; and *contributor issues*, or the other players in the industry whose self-interest or profiles may affect the outcome of a price war. (For a more detailed explanation of such analyses, see the sidebar "Analyzing the Battleground.")

Companies that step back and examine those four areas carefully often find that they actually have quite a few different options—including defusing the conflict, fighting it out on several fronts, or retreating. We'll look at some of those strategies and how companies have deployed them successfully.

Stop the War Before It Starts

There are several ways to stop a price war before it starts. One is to make sure your competitors understand the rationale behind your pricing policies. In other words, *reveal your strategic intentions*. Price-matching policies, everyday low pricing, and other public statements may communicate to competitors that you intend to fight a price war using all possible resources. But frequently these declarations about low prices, or about not engaging in

Ways to Fight a Price War

Tactic	Example
Nonprice Responses	
Reveal your strategic intentions and capabilities	Offer to match competitors' prices, offer everyday low pricing, or reveal your cost advantage
Compete on quality	Increase product differentiation by adding features to a product, or build awareness of existing features and their benefits. Emphasize the performance risks in low-priced options.
Co-opt contributors	Form strategic partnerships by offering cooperative or exclusive deals with suppliers, resellers, or providers of related services
Price Responses	
Use complex price actions	Offer bundled prices, two-part pricing, quantity discounts, price promotions, or loyalty programs for products
Introduce new products	Introduce flanking brands that compete in customer segments that are being challenged by competitors
Deploy simple price actions	Adjust the product's regular price in response to a competitor's price change or another potential entry into the market

price promotions, aren't low-price strategies at all. Such announcements are simply a way to tell competitors that you prefer to compete on dimensions other than price. When your competitors agree that such competition will be more profitable than competing on price, they'll tend to go along. That is precisely what happened when Winn-Dixie followed the Big Star supermarket chain in North Carolina and announced that it, too, would meet or beat mutual rival Food Lion's prices. After two years, the number of equipriced products among 79 commonly purchased brand items at the supermarkets had more than doubled. Further, the overall market price level had increased for these products. What happened? The stores stopped competing on price. In fact, the data suggest that Food Lion raised its prices after its competitors announced they would match Food Lion's prices.

Making sure that your competitors know that your costs are low is another option—one that effectively warns them about the potential consequences of a price war. Hence it sometimes pays to

reveal your cost advantage. Sara Lee has low variable costs, yet its products are relatively high priced compared with those of competitors. In the event of a price war, Sara Lee can drop its prices to levels that its competitors can't profitably match. The common knowledge about this low cost deters price cutting from competitors.

Sara Lee's management realizes that price cuts would be inconsistent with its strategic position of brand differentiation. Rather than use its low-cost structure to compete on price to build market share, Sara Lee uses its low costs as an implicit threat that helps prevent price wars. Essentially, a business that has relatively low variable costs enjoys an enviable advantage in a price war since competitors cannot sustain a price below their own variable costs in the long run. But low-cost companies should carefully consider their strategic positions before they start or join a price war. Lower costs often tempt a business to cut its prices, but doing so can diminish consumers' perceptions of quality and may trigger an unprofitable price war.

Responding with Nonprice Actions

Sometimes an analysis of the market reveals that several customer segments exhibit different degrees of sensitivity to price and quality. (See the sidebar "Price Sensitivity on the Web" for a look at how managers can identify and exploit differences in customers' price sensitivities—even in an information-rich environment.) Understanding the basis for certain customers' price sensitivities lets managers creatively respond to a rival's price cut without cutting their own prices. For example, a company might be able to *focus on quality, not price.*

Southeast Asia went through a rough time in 1997, particularly in the luxury product and service areas. The region's economy was unstable, Indonesian forest fires were wreaking havoc with the smog index, and tourism was clearly suffering. The economic turmoil dramatically reduced the value of the Malaysian ringgit to about half its value a few years earlier. The cost of a hotel room plummeted along with the nose-diving currency, yet hotel rooms went a-begging. What did the luxury hotel operators do to attract customers? They dropped their room rates even further. Luxury hotels in Malaysia entered a price war. All but one.

The Ritz-Carlton chose to steer clear of the fray. Instead, James McBride, the hotel's general manager, became creative. He greeted arriving flights with music, mimosas, discount coupons, and a model room. Passengers with reservations at other hotels began to defect to the Ritz at alarming rates. McBride

Price Sensitivity on the Web

Internet companies such as Buy.com are attempting to build market share by charging low prices. They operate under the premise that Internet shoppers are extremely sensitive to price. But the evidence to back up that assumption is mixed. On the one hand, the Web offers an easy way to search and compare prices. On the other hand, on-line shoppers tend to search for quality attributes, as well. Professors John G. Lynch of Duke University's Fuqua School of Business and Dan Ariely of MIT's Sloan School of Management have recently demonstrated that making quality information more accessible on the Web reduces price sensitivity.¹ That is why Amazon.com can charge higher prices than other on-line sites. The variety of titles it offers, the extensive product information it provides, and its reputation for rapid and reliable shipping make Amazon an easy choice for consumers who want convenience and low prices.

The growth of Internet shopping is posing interesting pricing dilemmas for bricks-and-mortar retailers. On-line vendors don't have to maintain a physical presence close to their customers, so they can operate out of a few large warehouses, thus lowering their costs. It would generally be unwise for bricks-and-mortar retailers to try to compete on price given the relatively high cost of maintaining a storefront. Instead, their strategy should emphasize features that can't be provided over the Web, such as personalized face-to-face service, browsing, immediate delivery, low-hassle returns and exchanges that don't require repackaging and shipping, and the ability to touch the product. Several retailers, such as Barnes & Noble and Tower Records, have developed an Internet presence to complement their storefronts. Such "clicks and mortar" retailers give customers the option to purchase or order on-line and then pick up the product at a bricks-and-mortar branch, and those retailers often provide a search engine in the store that is similar to their Internet offerings.

Finally, a keen understanding of consumer behavior lets some companies charge higher prices on the Web because of the anonymity that on-line transactions offer. In a recent study of 46 e-tailors of prescription drugs, the two most popular items (Viagra, a medication for erectile dysfunction, and Propecia, a medication to treat male pattern baldness) were priced roughly 10% higher than in drug stores. For obvious reasons, people prefer to have those prescriptions filled without personal contact and are willing to pay a premium for a faceless transaction.

1. See "Wine Online: Search Costs and Competition on Price, Quality, and Distribution," *Marketing Science*, 2000.

provided his cellular phone number in newspaper ads so people could call him directly for reservations. Guests had round-the-clock access to a "technology butler" who could fix laptops and other electronic devices. The Ritz offered a "bath menu" of drinks and snacks to be served along with butler-drawn baths. Guests who stayed more than five nights received an embroidered pillowcase.

When luxury hotels start cutting their guest rates, their ability to offer "luxury" accoutrements drops. That means no fresh flowers, fewer towels, and a noticeable shortage of staff. But the Ritz kept its rates above 200 ringgit (about \$52 U.S.) and was able to pay for low-cost services such as providing the embroidered pillowcases. Most important, the Ritz avoided any damage to its brand equity, something that could have easily occurred if typical Ritz customers arrived at the hotel and found it filled with noisy backpacking tourists or large families, all taking advantage of low prices. The negative spillover onto other Ritz properties could have been significant.

The Ritz-Carlton Kuala Lumpur last fall had no more empty rooms than its competitors; in fact, occupancy rates were up to 60% compared with a 50% occupancy rate in 1998. Perhaps most important, monthly gross operating profit on revenue of 2.2 million ringgit is about 400,000 ringgit—a return of about 18%.

Another way companies can avoid a price war is to *alert customers to risk*—specifically, the risk of poor quality. A senior product manager from the European operation of a large multinational pharmaceutical corporation lamented her recent pricing predicament. Her company's product, a medical diagnostic device, was the market-share leader, but a rival company had recently become aggressive on price. "They're crazy! Don't they see what they're doing to profits in the industry? Nobody can make money at these prices. What should I do? I've tried everything, and I can't get them to see the error of their ways," she said.

Not surprisingly, research confirmed that a large segment of customers in this "life and death" industry—doctors and testing laboratories—was quite risk averse and sensitive to variations in a product's performance. So rather than compete on price, the multinational appealed to customers' concerns about performance by emphasizing product enhancements such as improved reliability and

greater detail in the information generated by the diagnostic device and by alerting buyers to the negative consequences of incomplete diagnoses. Some sales were lost to lower-priced products from the competitor, but the quality-sensitive segment allowed the multinational to maintain reasonable margins and avoid the negative spiral of a price war.

Federal Express provides another good example of how a company can appeal to performance sensitivity among customers. FedEx's brand equity exceeds

that of virtually any company in the package delivery business. The shipping giant has built an enviable level of consumer recall and recognition through a highly effective advertising campaign. By emphasizing in ads and through other marketing efforts that a customer's package will "absolutely, positively" be there on time, FedEx plays on customers' risk aversion when dealing with time-sensitive documents.

A related weapon that companies can use to avert or battle a price war is to *emphasize other negative consequences*. The NutraSweet company employed this strategy when it faced the expiration of its patent. The company feared considerable price pressure from the producers of aspartame, the generic version of NutraSweet. A worst-case scenario would involve one of NutraSweet's major customers, such as Coca-Cola or Pepsi, switching to aspartame. If one of the companies switched, NutraSweet's contingency plan—which it shared with wavering Coke and Pepsi executives in Atlanta and New York—was a week-long advertising blitz that would alert consumers that "the other cola" was the only one that contained NutraSweet. Given the size of the market for carbonated soft drinks, NutraSweet's brand equity in the diet-conscious segment, and the potential short-term loss in market share and profits, this threat had teeth. NutraSweet successfully played one customer against another, emphasizing dire and unpalatable consequences, and thus averted a debilitating price war.

A final nonprice option involves *seeking help*, or appealing to contributors to weigh in on the competitive situation. For instance, when Sony entered the market for high-end imaging systems, the leaders in the imaging systems market in Belgium appealed to and received help from the central Belgian government. Not all companies can count on the government to come to their aid, of course. So companies might appeal to customers, vendors,

One way companies can avoid a price war is to alert customers to risk—specifically, the risk of poor product quality. A related weapon is to emphasize other negative consequences.

channel partners, independent sales representatives, and other like-minded players if the price war could mean the company's demise. For instance, in the 1990s, Northwest Airlines appealed to its labor unions and received dramatic wage concessions so it could compete on price in a tight air-travel market.

Using Selective Pricing Actions

Employing complex options such as multiple-part pricing, quantity discounts, time-of-use pricing, bundling, and so on lets price warriors selectively cut rates for only those segments of the population that are under competitive threat.

One common—and classic—tactic is to *change customers' choices*, or reframe the price war in the minds of customers. McDonald's did it successfully when it faced Taco Bell's 59-cent taco strategy in the 1980s. By bundling burgers, fries, and drinks into "value meals," McDonald's reframed the price war from "tacos versus burgers" to "lunch versus lunch." Similarly, smart managers use quantity discounts or loyalty programs to insulate themselves from a price war. They avoid across-the-board price cuts, and they limit price reductions to areas in which they are vulnerable. In this way, managers can localize a price war to a limited theater of operation—and cut down the opportunities for the war to spill into other markets.

Therefore, another selective-pricing tactic might be to *modify only certain prices*. For instance, Sun Country Airlines, a discount carrier, entered Northwest's Minneapolis–St. Paul hub with 16 planes providing service to 14 cities. Sun Country's round-trip airfare to any location was generally low: Minneapolis to Boston was roughly \$308. Rather than engage in a systemwide price cut, Northwest re-

Managers can localize a price war to a limited theater of operation – and cut down the opportunities for the war to spill into other markets.

tained its existing fare structure with minor modifications. A Minneapolis–Boston round-trip was a relatively low \$310 if tickets were purchased seven days in advance—but only for a flight that departed at 7:10 AM and returned at 11:10 AM. Curiously enough, Sun Country's only flight on that route departed Minneapolis at 7 AM and Boston at 11:20 AM. Northwest also employed several other resources, such as travel agents, to fend off Sun Country.

Northwest reasoned that Sun Country did not have the infrastructure necessary to engage in an all-out price war and chose to not engage in any preemptive price cutting at times other than the flights directly affected. By targeting only certain fares for discounts, Northwest minimized internal changes but could still counter Sun Country's pricing ploy.

On another selective-pricing front, companies may use a *fighting brand*. In the early 1990s, Kao Corporation entered the diskette market with a low-priced product. Rather than drop its prices, 3M launched a flanking brand of low-priced diskettes called Highland because it knew that a large group of its customers was loyal to the 3M brand. Simply dropping the price on the 3M brand might have diluted 3M's quality image and its profits and may have stimulated further price cuts by Kao.

Because it understood its customers, 3M knew that many different segments of price-sensitive customers existed. Some people buy cheap diskettes, and some people don't care how much they pay for diskettes. More important, some people think cheap diskettes are probably of poor quality, and they may not buy them if the price is too low—perhaps because they are terrified of losing their data. 3M avoided the trap of charging what the market will bear. It recognized that markets will bear many prices, some better than others. That insight underpins the strategies of many software companies. For instance, marginally different versions of the same voice-recognition software can range in price from \$79 to \$8,000 depending on who the buyer is.¹

You may not need a new brand to counter a price cut, just a new package. Consider the case of a major consumer-products company that faced an aggressive price-cutting competitor. The defending company finally dropped the price of its economy-size product with a "buy one, get one free" offer. Since the economy-size product lasts six months, the company took high-volume, price-sensitive users off the market for nearly a year. The resulting low sales of the competitor's product convinced the rival to cease and desist.

That illustration has several instructive elements to it. First, an acute understanding of the competitor's abilities, motives, and mind-set allowed the defending company to react effectively to a price war. Second, the expertise was complemented with a clear understanding of consumer behavior that allowed the company to prevent a price war. Third, the new entrant clearly picked the wrong adversary. The defending company was willing to suffer some losses (through cannibalization) in order to protect its turf.

Companies may also opt to *cut prices in certain channels*. Perhaps the single largest driver of price cuts and resulting price wars is excess capacity. The temptation to revive idle plants by stimulating demand through lower prices is often irresistible. But smart managers consider other options first. For instance, companies in the packaged-goods industry frequently sell off-brand or private-label versions of their national brands at low prices, ensuring that any price wars won't damage the brand equity of the national brands.

Similarly, airlines such as Delta are making a dent in reducing their unsold inventory by offering

hard drive, and a host of other functions for roughly \$400. High-profile brands such as HP and IBM are being forced to consider pricing their PCs in the \$500 range to reach the first-time buyer. In this market, price cuts appear to be the only way to compete. In fact, "free PCs" are available to consumers who are willing to be exposed to a significant amount of advertising.

Clearly there are times when you must engage in a preemptive strike and start a price war—or respond to a competitor's discount with a matching or deeper price cut of your own. For instance, when a competitor threatens your core business, a retali-

If simple retaliatory price cuts are the chosen means of defense in a price war, implement them quickly and unambiguously so competitors will know that their sales gains will be short-lived.

seats to consolidators and auction houses such as Priceline.com and Cheaptickets.com. The airlines are selling tickets to price-sensitive customers who don't care about flight times, number of stops, or frequent-flyer miles. Because the customer's point of contact is with the consolidator and not with the airline, the airline's image is protected—in much the same way that a nationally branded soup manufacturer protects its image by selling excess capacity under a private label.

But engaging in "stealth marketing" by selling low-priced, functionally equivalent alternatives through unrelated brand names or in foreign markets may still trigger price wars. If consumers recognize that the quality of the private-label product is comparable to that of the branded option, then the price of the branded option will need to drop. In many cases, it is best to leave plant capacity idle, since the attempt to revive it may trigger margin-destroying price competition. In fact, the idle capacity can be used as a weapon; a company then wields the credible threat of being able to flood the market with cheaper products should a competitor start cutting its prices.

Fight It Out

Although we feel strongly that direct, retaliatory price cuts should be a last resort, we do recognize that it is sometimes simply impossible to avoid a price war. Consider the case of personal computers. Expansion in this industry is occurring primarily at the low end as more and more price-sensitive consumers enter the market for PCs. EMachines, in Irvine, California, sells PCs that feature Intel's Celeron processor (a 366 MHz chip), a 4.3 gigabyte

tory price cut can be used to signify your intention to fight long and hard. Similarly, when you can identify a large and growing segment of price-sensitive customers, when you have a cost advantage, when your pockets are deeper than competitors' pockets, when you can achieve economies of scale by expanding the market, or when a rival can be neutralized or eliminated because of high barriers to market entry and reentry, then engaging in price competition may be smart.

But there are several long-run implications of competing on price. First, a pattern of price cutting may teach customers to anticipate lower prices; more patient customers will defer their purchases until the next price cut. Second, a price-cutting company develops a reputation for being low-priced, and this reputation may cast doubt on the quality and image of other products under the umbrella brand and on the quality of future products. Third, price cuts have implications for other players in the market, whose self-interest may be harmed by lower prices.

If simple retaliatory price cuts are the chosen means of defense in a price war, then implement them quickly and unambiguously so competitors know that their sales gains from a price cut will be short-lived and monetarily unattractive. A slow response may prompt competitors to make additional price cuts in the future.

Retreat

On rare occasions, discretion is the better part of valor. Consequently, some businesses choose not to fight price wars; instead, they'll cede some market share rather than prolong a costly battle. 3M

and DuPont are both companies that focus on developing innovations as part of their core strategy—and both have proved willing to cede share rather than participate in an unprofitable price war. In fact, 3M takes pride in the fact that roughly 40% of its revenue five years from now will come from new products. And in cases where it has retreated from pricing battles rather than standing its ground, the company seems to have come out ahead. For instance, because of withering price competition from high-volume, low-margin suppliers, 3M withdrew from the videotape business in the mid-1990s—even though videotape was invented at 3M. Similarly, Intel stopped manufacturing DRAM chips in the face of intense price competition from Taiwanese manufacturers in the 1980s, and its focus on processor chips has served it well. And Charles Schwab's decision to avoid a price war with low-priced Internet brokers has served stockholders well—the value of their Schwab holdings has more than quadrupled in the past two years.

It's Never Too Early to Prepare

It's in companies' best interests to reduce price competition because price wars can harm an entire industry. But diplomatic resolutions of price wars are generally impossible because overt diplomacy is a form of price collusion and may attract regulatory oversight. As a result, price leaders often engage in subtle forms of diplomacy that use market forces to discipline renegade companies that threaten industry profits.

Preventing a price war would be easy if it were possible to demonstrate the benefits of peace. Sadly, battle-scarred veterans who are suspicious of one another probably won't unilaterally disarm. So "price leadership" is one way to reduce industrywide price competition. Price leaders tend to develop reputations for eschewing price cuts as a way to gain market share and for responding quickly and decisively to price cutting by renegade companies. The price leaders are viewed as

credible enforcers of price regimes based on their cost structures, strategic postures, or the personal characteristics of their officers. We do caution, however, that a pattern of disciplinary moves may attract unwelcome regulatory scrutiny; companies should carefully consider whether their attempts at exercising leadership may be interpreted as anti-competitive.

Price wars are a fact of life—whether we're talking about the fast-paced world of "knowledge products," the marketing of Internet appliances, or the staid, traditional business of aluminum castings. If you are not in battle currently, you probably will be fairly soon, so it's never too early to prepare.

If you are currently in a price war, understand that you can use several nonprice options to defend yourself and recognize that it is sometimes best to cede the turf under contention and seek greener pastures. If the current combatants can't be vanquished, it may be wise to observe the price war from the sidelines and enter the fray after everyone else has been eviscerated. Sometimes, to the bystanders go the spoils of war.

1. See Carl Shapiro and Hal Varian, "Versioning: The Smart Way to Sell Information," HBR November–December 1998.

Reprint RO0208

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