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Special Report

E-COMMERCE: GOOD-BYE TO FIXED PRICING?

How the wired economy could create the most efficient market of them all

Coca-Cola Co. has a bold idea: Why should the price of a can of Coke be the same all the time? Would people pay more for a cola fix on a sweltering summer day than they would on a cold, rainy one? The beverage giant may soon find out when it begins experimenting with "smart" vending machines that hook up to Coke's internal computer network, letting the company monitor inventory in distant locales--and change prices on the fly.

Sure, consumers might balk if Coke's prices were suddenly raised. But they also might be persuaded to buy a cold soda on a chilly day if the vending machine flashed a special promotion, say 20 cents off--the digital equivalent of the blue-light special. Says Sameer Dholarka, director of pricing solutions for Austin-based software maker Trilogy Systems: "List pricing is basically irrelevant."

Forget sticker prices. Forget sales clerks, too. There's a revolution brewing in pricing that promises to profoundly alter the way goods are marketed and sold. In the future, marketers will offer special deals--tailored just for you, just for the moment--on everything from theater tickets to bank loans to camcorders.

Behind this sweeping change is the wiring of the economy. The Internet, corporate networks, and wireless setups are linking people, machines, and companies around the globe--and connecting sellers and buyers as never before. This is enabling buyers to quickly and easily compare products and prices, putting them in a better bargaining position. At the same time, the technology allows sellers to collect detailed data about customers' buying habits, preferences--even spending limits--so they can tailor their products and prices. This raises hopes of a more efficient marketplace.

Today, the first signs of this new fluid pricing can be found mostly on the Internet. Online auctions allow cybershoppers to bid on everything from collectibles to treadmills. Electronic exchanges, on the other hand, act as middlemen, representing a group of sellers of one type of product or service--say, long-distance service--that is matched with buyers.

The pricing revolution, though, goes beyond the Net. Companies also are creating private networks, or "extranets," that link them with their suppliers and customers. These systems make it possible to get a precise handle on inventory, costs, and demand at any given moment--and adjust prices instantly. In the past, there was a significant cost associated with changing prices, known as the "menu cost." For a company with a large product line, it could take months for price adjustments to filter down to distributors, retailers, and salespeople. Streamlined networks reduce menu cost and time to near zero.

This will clearly benefit consumers. Already, many are finding bargains at the hundreds of online auction sites that have cropped up. And on the Net, it's a cinch to check out product information and compare prices--thanks to a growing army of shopping helpers called "bots" (page 84). That, says Erik Brynjolfsson, a management-science professor at Massachusetts Institute of Technology, "shifts bargaining power to consumers."

But that doesn't mean sellers get a raw deal. Businesses can gather more detailed information than ever before about their customers and run it through powerful database systems to glean insights into buying behavior. While the concept of point-of-sale promotions, such as Coke's, is not new, in a wired world, it takes on a whole new dimension. Suddenly, marketers can communicate directly with prospective buyers, offering them targeted promotions on an individual basis. Says Yanni Bakos, a visiting professor at MIT's Sloan School of Management: "It's like an arms race, where you give a more powerful weapon to both sides."

As buyers and sellers do battle in the electronic world, the struggle should result in prices that more closely reflect their true market value. "The future of electronic commerce is an implicit one-to-one negotiation between buyer and seller," says Jerry Kaplan, founder of Onsale Inc., a Net auction site. "You will get an individual spot price on everything."

The notion of fixed costs is a relatively recent development. A couple of hundred years ago, when a person went to the cobbler to order a pair of shoes, they negotiated the price face-to-face. It wasn't until the arrival of railroads and canal systems, which allowed products to be distributed widely, that uniform prices came into being.

The Net brings us full circle. "We've suddenly made the interaction cost so cheap, there's no pragmatic reason not to have competitive bidding on everything," says Stuart I. Feldman, director of IBM's Institute for Advanced Commerce based in Hawthorne, N.Y. Someday, you might haggle over the price of just about anything, the way you would negotiate the price of a carpet in a Turkish bazaar. Except it's likely to take place on an electronic exchange, and it may be a computer bidding against another computer on your behalf.

WIN-WIN. For a preview of what's to come, just look to the financial markets. Take the NASDAQ stock market, or Instinet's even more automated system, after which many Net entrepreneurs are modeling their businesses. NASDAQ, for example, uses a system of dealers, or market makers, who trade shares of stock for brokers or individuals. The dealers are linked by an electronic network that matches buy orders with sell orders, arriving at the value of a stock for that moment in time.

Like NASDAQ dealers, the new Internet market makers must set up mechanisms for clearing transactions and for making sure that both buyers and sellers are satisfied. As electronic exchanges are established to trade everything from advertising space to spare parts, the true market value of products will emerge. "All of this brings you closer and closer to the efficient market," says Robert MacAvoy, president of Easton Consulting in Stamford, Conn.

The most widely used form of this today is online auctions. In the world of virtual gavels, Kaplan's Onsale is the kingpin. The Web site runs seven live auctions a week where people outbid one another for computer gear, electronics equipment, even steaks. Onsale buys surplus or distressed goods from companies at fire-sale prices so they can weather low bids. And customer love it. Grant Crowley, president of Crowley's Yacht Yard Inc. in Chicago, bought 14 old-model desktop PCs for his business via Onsale. He figures he saved 40% over what he would have paid in a store. "It's a great deal for people in small businesses like mine," Crowley says.

So far, the lure of a bargain has proved powerful: More than 4 million bids have been placed since Onsale opened its doors three years ago. It sold $115 million worth of goods last year, up nearly 300% from 1996. "Suddenly, consumers are active participants in price-setting," says Onsale founder Kaplan. "It's infinite economic democracy."

For every couple dozen online auctions, though, there is an entrepreneur applying the new Net economics in ways that will ultimately transform entire industries--from telecommunications to energy. These companies are setting up exchanges for trading things such as phone minutes, gas supplies, and electronic components, a market Forrester Research projects will grow to $52 billion by 2002. Their approach is such a departure from the past that analyst Vernon Keenan of Zona Research Inc. says they represent the "third wave" of commerce on the Net--companies that are moving beyond simple marketing and online order-taking to creating entirely new electronic marketplaces.

EQUAL FOOTING. Who are these trailblazers? Some are established companies, while others are born of the Net. But they all share a radical new vision of electronic commerce. "This is the model of the future," says Eric Baty, business-information manager at Southern California Gas Co.

You might not think of a stodgy utility as being in the vanguard of cyberspace, but that's exactly where Southern California Gas is. A couple of years ago, it saw an opportunity in the dovetailing of two sweeping trends--the deregulation of the energy industry, which lets customers shop for energy suppliers the way they shop for long-distance phone service, and the rise of the Web. So, last fall, it launched Energy Marketplace, a Web-based exchange that lets customers shop for the best gas prices.

The system has something for everyone. Small and midsize gas providers list their prices on the exchange. That lowers their marketing costs and gives them access to a broader market--putting them on equal footing with big energy suppliers. Customers, mostly businesses, save money by shopping for the best price, or locking in long-term deals when prices are low. And Southern California Gas, as a distributor, increases its volume of business and collects a subscription fee from gas providers that use the exchange. In coming months, SoCalGas will offer residential customers the same opportunity and expand the service to include electricity.

Does it work? Using Energy Marketplace, Sumiden Wire Products Corp. in Stockton, Calif., found a new supplier, Intermarket Trading Co., and now saves $500 a month--about 20% of its $3,000 a month energy bill. "They're cheaper than the other guys," says Wayne Manna, plant manager at Sumiden. "It's much simpler and easier than before."

Energy Marketplace is typical of the early electronic bazaars. Like the pork bellies or wheat traded in the financial markets, the first goods to be bartered in the new electronic markets are commodities. Whether No.2 steel or No.2 pencils, price--not features or how something looks, feels, or fits--is the determining factor in a sale. And if the commodity happens to be perishable--such as airline seats, oranges, or electricity--the Net is even more compelling: Suppliers have to get rid of their inventory fast or lose the sale.

Alex Mashinsky sees similar qualities in long-distance phone minutes. A former commodities trader, **Mashinsky's** New York-based ArbiNet (short for Arbitrage Networks) is building an exchange for routing phone calls over the lowest-cost networks--on the fly.

Most telecommunications carriers have built massive networks to handle peak loads. The problem is, much of the capacity goes unused. AT&T, for example, typically uses just 20% of its global network capacity. In a fiercely competitive market that has seen margins erode, "that excess capacity is becoming extremely sensitive," says **Mashinsky**. "It can be the difference between making money and losing money." ArbiNet's exchange lets carriers optimize their capacity by accepting lower-cost calls over their networks during off-peak hours. There are other companies that broker long-distance minutes. But ArbiNet is the only one attempting it in real time.

The ArbiNet Clearing Network works this way: Network carriers, such as AT&T, supply information about their network availability and price at a given time. Carrier customers send calls through ArbiNet's clearinghouse--say, a phone call from New York to Hong Kong that must travel over secure lines. ArbiNet's powerful computers and phone switches match the request with the lowest-cost carrier for that particular call, check to make sure the capacity is in fact available, and route the call--all in a millisecond. "We arbitrage the capacity available at any given time," says **Mashinsky**.

ArbiNet's focus today is on the wholesale, or carrier-to-carrier, business. But **Mashinsky** thinks that two years from now, the market will be ripe for consumers. A "smart" phone, for example, could automatically check for the lowest carrier on each call that is placed. Such a scenario could be unnerving to the giant phone companies. "The big carriers don't want to do this," says **Mashinsky**. "It would undercut their prices."

Indeed, big businesses are sensitive about falling prices. Some entrenched companies already are fighting the idea of electronic markets that make it easy for customers to compare products and prices. Houston-based energy giant Enron Corp., for example, last month filed suit against SoCalGas and its Energy Marketplace. Enron, which plans to enter the California market, alleges that Energy Marketplace unfairly favors local suppliers that are better known. SoCalGas calls the suit a blocking tactic.

BEYOND SURPLUS. Other big players are embracing the Net, but half-heartedly--using it to dispose of surplus goods while protecting margins on their core products. Not that surplus inventory is anything to sneeze at. Chicago-based FastParts Inc. and FairMarket Inc. in Woburn, Mass., operate thriving exchanges where computer electronics companies swap excess parts. All told, U.S. industries generate some $18 billion in excess inventory a year--around 10% of all finished goods, says Anne Perlman, CEO of Moai Technologies Inc., a Net startup that makes software for creating online bartering sites. "Excess and obsolete equipment is a big and painful problem," she says.

Or a huge opportunity. Perlman knows firsthand about surplus goods. Before joining Moai, she ran Tandem Computer Inc.'s personal computer business. When Intel Corp.'s 386 microprocessor came out, she found herself with a boatload of earlier-generation 286 chips that were instantly obsolete. Afraid that she might have to write off the inventory as a loss, Perlman made some calls and found a customer willing to buy the stock--though she was left with the nagging feeling that she could have gotten a better price. Now, at Moai, along with co-founders Deva Hazarika and Frank Kang, she sells a $100,000-plus package to companies that want to run their own auctions to generate revenue from aging merchandise.

Most of the Net pioneers had to build their own systems--a time-consuming and costly task. The availability of off-the-shelf software packages from Moai and others should help jump-start more electronic exchanges.

''THIRD WAVE.'' That could pave the way for fluid pricing to reach beyond commodity products and surplus goods to popular, even premium-priced items. Electronic markets could be just as effective selling unique items, such as a Van Gogh painting or a company's core product line. "The move away from surplus goods to primary goods will be the real thrust of the third wave," says Zona's Keenan.

There's just one snag: When anyone on the Net can easily compare prices and features, some high-margin products could fall in price. And a strong brand name alone may not be enough to make a premium price tag stick. Some branded products may even prove to be interchangeable. You might not trust your phone service to an outfit you have never heard of on the basis of price alone. But you might be willing to swap among AT&T, MCI, or Sprint for a better deal. And do you really care if your credit card is from MasterCard or Visa? "There's a commoditization at the top level of brands," contends Jay Walker, CEO of Priceline, a new Web service that lets consumers name their price.

One way companies can respond is by cooking up creative ploys to distinguish their products. That could include personalizing products or offering loyalty programs that reward frequent customers. "Inventiveness in marketing is going to be very important in this world where people can go out and compete on price," says IBM's Feldman. That's happening in online brokerage services, a cutthroat market. Thanks to Internet brokers, trading fees are already rock-bottom. Now, companies such as E*trade are mulling loyalty programs that reward frequent traders.

There are other ways to sidestep the effects of the ultra-efficient Net market. Just look at the airline industry. It was one of the first industries to go online, starting with American Airlines Inc.'s Sabre automated-reservation system in the 1960s. When other airlines followed suit, American introduced the frequent-flier program to keep customers loyal.

Three decades after Sabre, airlines still manage to get many passengers to pay rich fares. The secret: knowing whom to gouge--in this case, the business customer who has to get somewhere and is less price-sensitive. Airlines also have perfected the science of yield management, concocting complicated pricing schemes that defy comparison. The price for an airline seat can change several times an hour, making it virtually certain that the person sitting next to you paid a different fare. "Airlines are using the Internet to raise the average price of a fare," says Ken Orton, CEO of Preview Travel, an online ticketing site.

Now, airlines are tapping into the Net--but mainly as a way to sell unfilled seats. They routinely send out E-mail alerts of last-minute fare specials.

And several major airlines have signed up with Priceline, which lets consumers specify when and where they want to travel, and name their price. Priceline then forwards the bids to participating airlines, which can choose to accept the request or not. The company makes its money on the spread between the bid and the lower airline price. "It empowers the buyer," says Walker, "but also the seller. They can plug in demand to empty flights."

As long as Priceline is clearly targeted at the leisure--not the business--traveler, airlines are willing to go along. "It's not for frequent fliers but to get people out of cars without affecting the airlines' retail price structure," says Walker.

In the end, such tactics may simply delay the inevitable march of the Internet. And the truth is, Net-based markets may not be such a bad thing for sellers. They produce a price that fairly reflects demand. Some companies may be surprised by the results.

Look at AucNet, an online auction for used cars. Dealers and wholesalers flock to AucNet's Web site to buy and sell some 6,000 cars a month. Surprisingly, sellers fetch more for their used cars than they might on a physical lot. That's partly because of the larger audience they get on the Net. But dealers also have come to trust the quality ratings that AucNet inspectors assign to each car after physically examining them, and they are willing to pay more for that seal of approval. Moai's Perlman has seen similar results in other online marketplaces. Most of the time, she says, "the market will bid a better price than the vendor was expecting."

Or at least, the right price. So why fight the perfect market?

By Amy E. Cortese, with Marcia Stepanek in New York

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