Pricing & Market Making on the Internet
Robert Dolan, HBS Note 9-500-065, 2000

TakeAway Points
Pricing & Market Making on the Internet

• Many (most) observers see the internet as creating downward pressure on prices via info availability”

• “Like saying that because of global warming it will be hotter at the beach this coming August”

• “There is no conclusive evidence that prices on the internet are lower per se than prices in conventional outlets”

• Internet transforms niche segments into mainstream segments: global reach, reduced search costs

• Opportunity created to sell commodities that otherwise would have gone unsold

• Key is product differentiation and “creating the perception of value”
The Internet Facilitates …

• Information flow

• Market making

• Transactions processing
The Internet

- Facilitates a buyer’s acquisition of information
- Enables suppliers to update prices dynamically in response to demand
- Allows aggregation of potential buyers
- Allows price to be the outcome of real-time ‘auctions’
- Permits broad, real-time circulation of requests for specified bids
- Frees customer from unwanted persuasion efforts
Price Variants

• List (posted) price
• Bid / ask price
• Negotiated price
• Auction price
• Exchange price
Price Variants

• Set prices
  *Periodically updated, continually (dynamically) updated*
  *Take it or leave it*
  *High perceived fairness*

• Negotiated price
  *Sometimes starting off a pre-specified list price*

• Competitive price
  *Auction, reverse auction, exchange*
“Ignorance Premium”

• Majority of customers are unlikely to spend a large amount of time and effort comparison shopping

• So, most buyers lack full information regarding choices

• “Buyer ignorance is often the source of profit for companies”
Internet Comparison Shopping

- 3rd party comparison sites
- 3rd party comparison agents

(search agents, bots, spiders)
- Retailer price comparison agents
Price “Protectors”

- Branding and trust
  *Unknown sellers, delayed exchange, 1st time anxiety*

- Lock-in (stickiness)
  *Switching costs, personalization, community*

- Shopping experience
  *Specs, reviews, digital samples, fast check-out*
Dynamic Pricing

- Competitive actions
- Inventory balancing
  - Liquidation, rationing
- Systematic demand changes
  - Seasonality
Internet Price Customization

• Special offer clickstreams
  *Add-on items, services*

• Customized offers based on purchase history
  *“Razor blades”, progressive pricing*

• Alternative “”store fronts”
  *Personalization, community*

• Source based price-matching
  *Lower prices if coming from a comparison site*
Negotiated Prices

- Precisely customized to buyers value perception
- Typically takes longer than fixed price ("haggling time")
- **Focuses attention on price**
- May be ‘complicated’ with added services in lieu of price, alternate (derivative models)
- Aggregating demand builds buyer power
Classic Auctions

- Ascending prices based on buyer competition
  - Value difficult to determine, matter of individual taste, dependent on market conditions
  - Internet increases the economic efficiency of aggregating demand, i.e. getting access to the largest number of potential buyers and closing transactions
  - Do not necessarily lead to bargain prices since more buyers are drawn into competition
Reverse Auctions

Competitive Bidding

- Well defined specifications
- Sealed bids / open bids
- Shared or winner take all
Priceline

- Hyped as “the ultimate in consumer-driven commerce”

- “Actually sacrifices customer power in favor of solving a vendor’s problem of selling off inventory”
  - Unspecified source, broad terms, obligatory payment
  - Essentially an unbranded, unknown product that degrades the quality of the product supplied and depresses prices