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A New Retailing Model Will Increase Real Market Efficiency

Abstract

The Open Channels Project seeks to deploy new Internet commerce infrastructure that is open, secure, globally available, and extremely low-cost. One novel feature of this infrastructure is a retailing model in which retailers compete on their ability to provide reliable and useful product selection information to consumers, rather than on physical location, selection, or price. This model particularly suits the Internet, because the power of the Internet is information.

By making it possible for experts to earn a good living researching product characteristics and then retailing products based on their findings, the Open Channels Project (OCP) introduces an economic model that will change the very foundations of commerce.

In the new model, producers will have to compete on quality and value as determined by the best information available. What this means is that real markets will become significantly more efficient.

Traditional commerce operates on a “push” model, in which demand is created and managed primarily through advertising paid for by producers and retailers. Although the Internet is already shifting behavior more towards a “pull” model, in which consumers actively seek the product characteristics wanted, product comparison information remains for the most part hard to find, incomplete, unreliable, or out of date.

The new system creates economic incentive for gathering and validating information, and a means of making that information conveniently accessible within a consumer’s decision process, taking the pull model to its logical conclusion. As a result, product definition, design, and development must now be based not on what a TV spot can sell, but on what a trusted and well-paid expert recommends after extensive research and testing.

A second-order effect is that many products now treated as commodities will undergo differentiation driven by consumer preferences in the presence of better information. Such differentiation will often let smaller producers compete successfully against larger ones.

These changes promise to lower barriers to innovation and make the world economy more efficient, flexible, and stable.

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1. Introduction to the Open Channels Project

The Open Channels Project proposes a new, open public commerce layer on the Internet, created and managed by a nonprofit international consortium and supported by various governments around the world. OCP's premise is that this new model can take the positive changes already made through online commerce to their logical conclusion. By doing this, we can change the rules of commercial distribution at a fundamental level, to the benefit of most people in the world.

This change will reduce and alter the role of middlemen, resulting in significant savings. Although it's hard to predict where a standard equilibrium of retail pricing for tangible goods will settle under the new model, productivity gains could end up lowering prices as much as 40 percent.

Equally significant, however, is built-in support for a system under which retailers compete based on their expertise.

Currently, retailers compete with each other based on their ability to stock physical stores with a profitable range of items at the lowest cost. In the new model, retailers carry no inventory — goods ship directly from a producer's warehouse to the consumer, and retailers have a completely different function. In the new system:

- ❑ **Producers set price rules:** When offering a product for sale, the producer sets price rules that include shipping options and costs, a retail price, and the portion of that price that the producer claims for itself.
- ❑ **Retailers carry no inventory:** Retailers “stock” a product by offering it for sale in their online shops at the manufacturer's suggested retail price, or if they choose at a discount that comes out of their portion of the sales price.
- ❑ **Retailers become experts instead:** The value that retailers add to earn their portion of the sales price is to stock the best products in a category and to make good recommendations concerning products' design, suitability, ease of use, value, reliability, quality, and safety. A retail “store” is simply an online mechanism or interface designed for transmitting that information in a convenient way.

Retailers thus cease to be shopkeepers and become instead qualified experts in the products they stock. In essence, being a retailer means being a product evaluator.

- ❑ **Retailer reputation is key:** Consumers choose retailers based on their record and reputation for making good recommendations.
- ❑ **Retailers are aggregated by other retailers:** To find a retailer you want to buy from in a market you're not familiar with, you go to an aggregating retailer, whose business depends on knowing which specialized retailers in given product areas have the best information and are least biased toward individual producers. Amazon is already exploring this model, and it will become further refined in a more competitive environment.
- ❑ **Retailers make money from product evaluation:** Whether as a retailer you function as a product evaluator or an evaluator of other retailers, you make money based on the quality of your evaluations. In this situation, the retailers who are genuinely on the side of consumers will be successful.

This system is the logical outcome when discovery shifts from a push model based on small geographic market segments to a pull model in which markets are national or global.

2. Price vs. Information in Retailer Competition

Judging by consumer behavior in the current commercial model, it is not intuitively obvious that retailers will be able to compete on evaluation rather than price.

This is because the value proposition offered by a product is a function of both its cost and its benefits. In other words, a shopper generally has two distinct objectives:

- ❑ Buy the most satisfactory product possible.
- ❑ Pay as little for a product as possible.

Buying the kind of decision-support information that helps determine the most satisfactory product increases the cost of that product, which means that consumers have an incentive to avoid paying for such information. Several strategies for avoiding that cost are quite familiar within the context of bricks-and-mortar retailing:

- ❑ A consumer can go to the store of a product evaluator, shop there long enough to determine the best product, and then go on to purchase the selected product from a discounter who provides no evaluation support whatsoever and thus can sell for a lower price.
- ❑ Discounters can rely on the work of product evaluators and can then offer the same information and recommendations without having to pay the costs of research and testing.

These strategies undercut the ability of product evaluators to make money from their research, which is one reason good product evaluation is not widely available under the current commercial model.

However, under the new model being created by the Open Channels Project, the system tends to stabilize at a price equilibrium in which:

- ❑ The margins of retailers are low.
- ❑ There are relatively few retailers for any given product category.
- ❑ Retailing is profitable even with low margins because each retailer sells to so large a part of the market.

Decision-support information is protected in this equilibrium both by its status as intellectual property and by its relatively low price. Particularly in areas where product characteristics change frequently, buyers will be willing to pay the small differential between information providers and discounters in order to be sure of obtaining the best, most up-to-date information. Aggregators in particular will tend to prefer the reliability of experts over discounters whose interests are less likely to be aligned with those of customers.

3. First-Order Effects of Better Information

The effect of the new retail model on producers and product development strategies is dramatic. In this new world, producers can no longer rely on push advertising to create demand — instead, their products must satisfy the requirements of sophisticated critics in

order to sell. This requirement radically changes strategies for successful product development:

- ❑ Investment in research and development and identification of real customer needs become far more important to producers than marketing and sales campaigns, since quality and utility are what sell products.
- ❑ Introducing a new product becomes far less expensive, as long as it provides significant benefit to customers. A large advertising budget is no longer necessary. Instead, all the expert, trusted retailers whose livelihood depends on evaluating and recommending the latest and best products can be relied on to promote a product that offers significant new benefits.

Currently, if the benefits of a feature or level of quality cannot be perceived or easily understood by the average consumer, spending money to include them is pointless for a producer, however advantageous they might be for consumers in the long run. In fact, there is significant incentive for producers to build obsolescence into products, or design them to wear out sooner than necessary so as to shorten the buying cycle and sell more.

Under the eye of expert retailers, however, the interests of consumers can be much better represented in buying decisions, which gives producers much greater incentive to meet customer needs as well as possible. This translates into a more efficient economy with far less waste.

4. Differentiating Commodities

Currently, large-scale distribution systems based on geographic centralization make many products into commodities. This commoditization is especially true in agriculture but also applies to other kinds of products as well.

For example, a U.S. chain such as Pier One might contract in the Third World for baskets. The pattern for a particular basket is the same regardless of where it's produced, guaranteeing sufficient uniformity to satisfy bricks-and-mortar retail sales, but greatly limiting the creative variation that many artisans are capable of. There is no easy way for a U.S. consumer to have access to more interesting designs or innovative techniques.

Similarly, if you are a farmer selling produce to supermarkets, there is little incentive to produce a superior product, since one carrot cannot easily be distinguished from another, or one tomato from another. The widespread recognition of "organic" farming benefits has created a large-scale differentiation that favors small farmers by allowing them to charge a premium for organic produce, but many agricultural experts question that this is the best differentiation for a sustainable future.

Introducing a marketplace for product-selection information could produce dramatic changes that would break some commodity products into a variety of differentiated ones.

For example, if small artisans around the world could offer their wares directly to consumers, rather than having to go through large retail import-export chains, not only would the artisans be able to make more money for their work but also consumers would have access to a far broader selection of wares, and to a level of artistic creativity that is now difficult to find.

An example from the agricultural area could involve information about such things as pesticide levels in fruits and vegetables. A recent study by University of Washington

researchers found high levels of various insecticides in the blood of children fed on standard supermarket vegetables, and further found that these blood levels fell within a week once the family in question switched to organic produce. However, the politics of food production and distribution has defeated any regulatory recognition of this problem, much less any governmental program for monitoring pesticide residues. A market-driven solution informed by experts who make a living from such evaluation, using the mechanisms provided by the Open Channels Project, is much more likely to work for consumers, and to remain independent of chemical-company and other agribusiness influences. Furthermore, this is information of critical interest to many families who would not ordinarily consider paying a premium for organic produce. The result would be to provide incentive for nonorganic farmers to reduce pesticide use, and to create a new product category, namely low-pesticide nonorganic produce.

In a more general way, small farmers in the U.S. would have far more ability to market produce with special characteristics such as excellent flavor or high nutritional value, where now they are driven far more by the shelf-life and uniformity requirements of large supermarkets.

The new retail model would make such changes practical, by creating a marketplace for information that consumers can trust about the quality and reliability of producers and their products.

5. Economic Benefits

Under the Open Channels Project model, the world would no longer be forced into lockstep by the logistics required by today's large, centralized organizations. There is good reason to believe that the following benefits would accrue:

- ❑ Real markets would become more diverse and agile.
- ❑ The world would become more efficient in exploiting opportunities not worth the attention of large organizations.
- ❑ Barriers to innovation would be reduced.
- ❑ Small producers would be rewarded for ingenuity and attention to quality in a way that is difficult today.
- ❑ Per-capita productivity would increase significantly around the world.
- ❑ Market competition would serve consumers far more than it does today, rather than the interests of distributors and intermediaries.
- ❑ A good marketplace for information would increase people's appreciation of it, and increase demand for it. Science, research, and business ethics would all benefit, creating a feedback loop that would continue to produce economic efficiencies.

The Open Channels Project retailing model, in which retailers compete on their ability to provide product selection information in an open, secure, globally available, and extremely low-cost fashion, benefits not only producers but also consumers worldwide.