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Online markets are not for everyone!

FROM THE LAB

What are you telling your clients about using online "business to business" (B-to-B) markets? Will this latest e-commerce fad save them money? Or not?

There is no doubt that B-to-B markets are hot. Many companies want a piece of this action, and who can blame them? This idea taps into some of the most powerful forces in business today: cheap information (via the Internet), capitalist ideology (competition is the greatest thing since sliced bread!), and profitability. But is the current mania for B-to-B markets justified?

I, for one, don't think so. I'll show you why your clients might benefit by cutting against the grain on this trend, moving away from, not toward, B-to-B markets.

The Trend Observed

Everybody, it seems, is using B-to-B markets to enter someone else's strategic backyard. The resulting free-for-all is reshaping how business gets done.

B-to-B markets turn customers into competitors. When online market-maker Vetro Corp. and hospital chain Tenet Healthcare recently launched a B-to-B market to help other hospitals save money on their medical supplies, five medical-product manufacturers-Baxter, J&J, GE Medical Systems, Medtronic, and Abbot Labs (between them making about 70% of the products a typical hospital needs)-responded by announcing plans for their own B-to-B market in hospital supplies. This venture will offer one-stop shopping to buyers, hopefully preempting the rise of auctions for medical products.

B-to-B markets also turn competitors into collaborators in breaking through industry boundaries. Three petroleum giants-BP Amoco, Royal Dutch/Shell, and Totalfina Elf-have formed a B-to-B market for oil products and metals with four traders-Deutsche Bank, Goldman Sachs, Morgan Stanley Dean Witter, and Societe Generale. This venture is intended to both help the oil companies improve product pricing and help the traders challenge the New York Mercantile Exchange (NYMEX). Not to be left out, a consortium of 12 chemical companies, led by the Ethyl Corp., is building an industrywide B-to-B market. This venture will do more than match buyers with sellers; it will arrange shipping and trade financing for purchases too. It might even help the chemical companies maintain margins in the face of increasing petroleum feedstock prices!

The Trend Explained

B-to-B markets are a twist on the transaction cost economics of Ronald Coase (The Firm, the Market, and the Law). Coase asked why large enterprises coexist with free markets. Surely, he felt, such bureaucracies could only be sustained by anticompetitive tactics. What he found was

that, almost paradoxically, companies can be more efficient than "free" markets at coordinating resources. The reason: transaction costs.

"Free" markets are not actually free. Participants must spend in order to collect information on resource attributes (price, quality, quantity) and supplier attributes (credit quality, trustworthiness) from each other before transacting business. Meanwhile, corporate management is cheaper than it first appears as an instrument of coordination. A CEO need only issue orders for interaction; little additional investment in information is required because his or her subordinates are already known to each other.

If management is cheap, while markets are expensive, why do markets exist at all? Managers may be a relatively cheap means of coordination, but their individual capacities to coordinate are quite limited. So as companies add resources, they must also add layers of management; increasing operating costs. Once markets start, their operating costs remain stable, or fall, as participation in them grows.

It follows that, as companies keep growing, the costs of coordination by manager eventually exceed the costs of coordination by market. Executives find it cheaper to specialize their enterprises by keeping only some resources inhouse and contracting with other companies for the rest—using price competition to keep costs down. This institutional behavior creates extended value chains linking companies and markets. For example, firms specializing in raw materials compete to supply manufacturers, which compete for distributors, which in turn compete for retailers.

But what happens if the cost of starting markets plunges as cheap information becomes available online? The established equilibrium between the costs of managers and markets is upset. Traditional industrial value chains shatter as B-to-B markets proliferate.

Enter Unconventional Wisdom

The Internet may make it cheaper and easier to start markets. But what is not yet obvious to many is that using markets to coordinate resources transforms other operating practices too. For example, the market mechanism pushes participants into standardization in order to streamline the transaction process; effecting what is bought and sold, as well as how it is bought and sold. This side effect of markets creates opportunities for countertrend thinking by the savvy consultant.

What happens if you counsel your client not to buy or sell the "standard" product offered in a market? While it is still too early to spot specific examples of B-to-B markets being bypassed in this fashion, there are parallel examples from the commodity markets that suggest considerable economic value can result. Consider the case example of Cupric Mining, the Microtron Corp., and the NYMEX.²

The NYMEX is a classic commodity market; samples were once inspected on the floor prior to sale. Today, commodities almost never touch the floor; futures are used instead. This shift from physical materials to paper-based trading required significant investment to set and enforce strict standards of purity, form, and delivery point for commodities to ensure price transparency. Market participants—whether producers hedging against price volatility or speculators seeking profit through price volatility—use the same future. But these participants are not homogenous; their interests clash.

Speculators gain as price volatility increases. Hedgers lose as the insurance they seek rises in price. And, as our featured clients found, hedgers can do better by bridging the market with an alliance.

Cupric's effort to bridge the NYMEX began in the late 1980s when it literally could not write contracts to finance a new mine because copper prices were oscillating so sharply. Rather than

keep playing a losing game, management began sounding out customers about offmarket alternatives and eventually located Microtron, a maker of circuit board foil. Copper accounts for about 33% of Microtron's costs, making it more than willing to try new ideas for securing raw copper.

The two companies spent considerable time negotiating their alliance. They established a set time period over which they would collaborate, an effective price for the copper involved, a volume-purchase guarantee to support development of a new refining process, a technology transfer protocol, and clauses to prevent either one from leaving the arrangement for a similar deal with another company.

When they were done they had broken the speculators' hold on their respective cost structures by introducing a nonstandard product: copper dissolved in a proprietary acid solution for piping between refinery and foil plant. Copper in solution reduces costs all around; Cupric avoids casting and shipping bulky ingots, and Microtron avoids storing and redissolving ingots in acid before manufacturing copper foil. But why wasn't this ingenious concept applied years before?

As long as a trading mentality drove their relationship, the alliance partners were prisoners of the market makers. Traders need a standard—a physical ingot of set weight and purity—off which to price copper futures. It was only by adopting a user mentality that Cupric and Microtron could break free of this trading standard to take a considerable slice out of operating costs.

Copper is not the only commodity metal where a "bridge" over a troubled market has been built. In 1998, General Motors signed a 10-year contract with Alcan that prices aluminum off production costs rather than through market gyrations. It requires the partners to mutually staff a technical center for studying aluminum usage. And it commits GM to engineer more aluminum into every vehicle it builds.

The logic of this particular partnership is profound. Aluminum is several times lighter than steel, and weight reduction cuts vehicle pollution. But, as the Wall Street Journal suggests, "Aluminum's price volatility of as much as 30% or 40% within a single year, reflecting trading on commodity markets, has been a handicap in expanding its use in autos." So GM and Alcan have left the market behind. Why should they let commodity market-based speculators constrain their strategic opportunities?

In Conclusion

Rah-rah rhetoric aside, a B-to-B market may not always be the right strategic solution. Clients stampeding toward cost-cutting price transparency and auction-style pricing can end up with disruptive price volatility and strategically constraining product standardization instead. Good consultants must be aware of the vices as well as the virtues of this e-commerce fad and be ready to recommend cutting against the grain as they see it becoming appropriate.

More important perhaps is the general principle of bridging dysfunctional markets with alliances. You can apply it to any pair of companies working as buyer or seller on opposite sides of any market. As B-to-B markets proliferate, opportunities to build value-adding alliances will proliferate too.

Notes

1. For background on transaction costs, see Journal of Management Consulting, "The Logic of Management Consulting" by Staffan Canback, vol. 10, no. 2 (Part 1) and no. 3 (Part 2).
2. The author wishes to thank Robert Porter Lynch of the Warren Company, alliance consultants from Providence, Rhode Island, for this example, heavily disguised to protect client confidentiality.

3. Stimson, Robert L. 1998. GM Commits to Aluminum in Alcan Pact, The Wall Street Journal (Nov. 4), p. 3+.

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