

# ONLINE ABUSE OF POWER:

## Two Sided Markets, Third Party Payer Businesses, and Vertical Integration

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## Calibration of Your Beliefs





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- Is Google ever “*creepy*” — does Google ever stray too close to what Eric Schmidt calls “*the creepy line*”?
- Is it **unfair** to make companies pay for their own trademarks in a keyword auction?
  - Is it **illegal** to let one company pay to use the trademark of another?
  - Could paying for your own trademark add to consumers’ costs?
- Is it **deceptive** to have paid search?
  - Is it **deceptive** if paid search influences free search?
  - Is it **deceptive** if paid search gets you to a dangerous website?
- Is it **unfair** competition if Google now places its own businesses ahead of competitors while claiming to be unbiased?
  - Is it deceptive?
- Is it **illegal** if Google has a monopoly on search?
  - How would you know if it is a monopoly?
  - Could a monopoly on search possibly cost **you** anything?
  - Is it illegal if Google acts to extend its monopoly?

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# Calibration of Your Beliefs






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-  Is it **fair to taxi drivers** that Uber drivers don't need to purchase commercial insurance and don't need to purchase medallions?
-  Is it **fair to me** if my landlord won't renew my lease and wants to turn my apartment into an Airbnb luxury rental? Is it **efficient**?
-  Is it **fair to my neighbors** if I turn my apartment into an Airbnb rental?
-  Is it **fair** if Google doesn't provide the best free search it can offer, and does a better job with paid search? Is it **legal**?

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# Calibration of Your Beliefs

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-  Of course we don't agree on whether something is **fair** or not
-  **Fair** is **subjective**, and and a **societal** assessment, not purely economic
-  **Efficiency** is an **economic** assessment, which society can overrule
-  Is it fair for **governments to pay people to rebuild** in hurricane flood zones? Is it efficient?
-  Is it fair or efficient to allow **platform operators to be the sole decision makers** on how private and personal information is used?

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# Context and Motivation

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- We thought online businesses would be **transparent**
  - Abuse and misrepresentation would be **impossible**
- We thought online businesses would be **efficient**
  - Monopoly power, and abuse of monopoly power, would both be impossible
- We were **wrong**
  - We forgot the lessons of history

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# The Paper Towel Game

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- Scaring Lever's US Board about eChannels
- Version One
  - The first discount discussion, with Brawny
  - The second discount discussion Viva
  - Where does it end?
- Version Two
  - The first discount discussions, when neither Brawny nor Viva will break
  - And the power of deception and mistrust
- And this was not even an MP3PP

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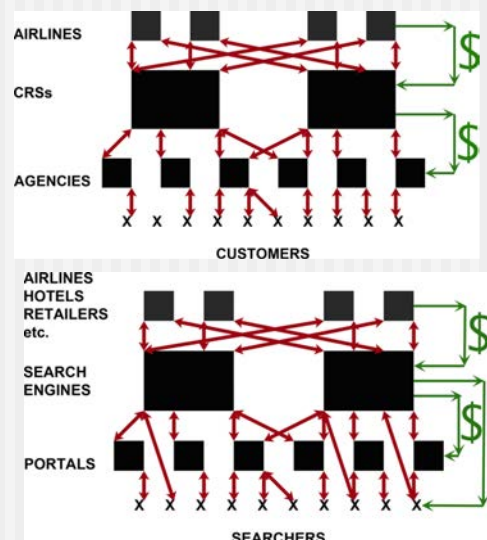
# Third Party Payer Models

- Questions about **Third Party Payer** business models
  - Do these business models possibly require a novel approach to regulation?
  - Can they be **as profoundly disruptive** as telecommunications was in the early 1900s?
  - (Remember role of network effects and limited interoperability; hasn't the net eliminated limited interoperability)
  - Can they possibly represent irresistible power, **decoupled from the pricing discipline** of the market?
  - Can they represent irresistible power, even **without appearing to be a traditional monopoly**?

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# Third Party Payer Models

- The critical importance of **single-homing**
- This is the source of **Parallel Monopolies** and their power
  - This is why auctions do not control prices
  - This is why reverse price wars are possible, and why the sellers cannot escape
- It is essential that consumers **cannot tell** or **do not care** when they are being misled
  - Transparency might end the ability to mislead
  - Lava had much less power!



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# Third Party Payer Models

## Are third party payer models *always* dangerous?

- AmEx and the first charge card
- Merchant paid significant discount
- In exchange for significant increase in impulse purchases and high value sales to high net worth customers

## Are third party payer models *always* dangerous?

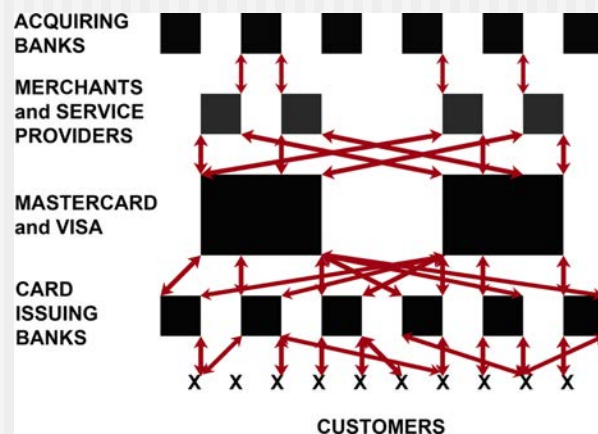
- MasterCard and Visa ... credit cards for the rest of us
- Very low discount rate paid by merchant
- Kept low by (1) competition between MasterCard and Visa and (2) competition among a large number of acquiring (merchant) banks
- Subsidized by first party payer annual fee and finance charges
- How has this been changed by consolidation of acquirers or of issuers? How do merchants feel about "airline miles cards"? How do consumers feel about them? How do airlines feel?

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# Danger Changes Over Time — Third Party Payer Models

## Are third party payer models always dangerous?

- Competition** between *MasterCard and Visa* kept their fees low to attract more merchants
- Competition** between large and small Issuer banks limited MasterCard and Visa's ability to provide complex, value-adding services
- Competition** among Acquiring Banks kept merchants' fees low



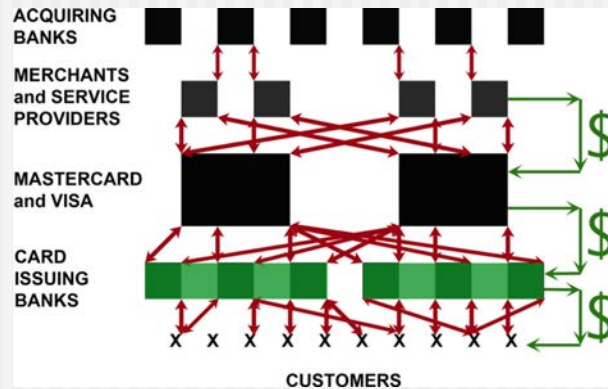
Initially credit card system looked like First Party Payer model, like CRSs did initially

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# Danger Changes Over Time — Third Party Payer Models

Are third party payer models **always** dangerous?

- Competition between **MasterCard and Visa** still keeps their fees low
- Competition between **Acquirers** still keeps their fees low
- But **Consolidation of Issuers, Competition for Customers, Technology to support Rewards Programs**, have changed the game!
- Merchants are **required** to accept **all** cards
- Issuers now compete for and **pay customers for usage**, with complex **reward** programs

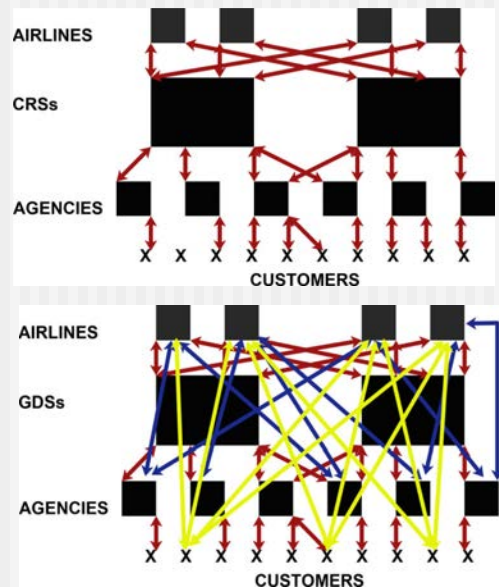


Now has also transitioned into Third Party Payer, at least on the issuer side, just like CRSs have

# Can They Still Be Dangerous? Third Party Payer Models

Can third party search still be dangerous?

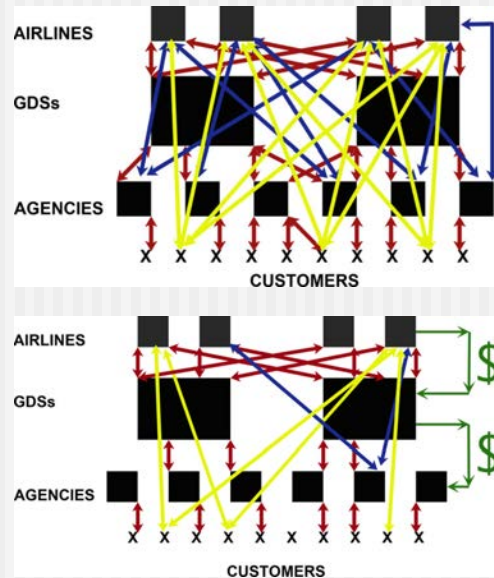
- Can there still be power in search?
- Expected evolution of air travel distribution argued against continued power
- Yes, third party payer model was dangerous in the 1980s
- But how could there be unfair distribution or abuse of power now?
- Global distribution systems (GDSs) were deregulated in 2004
- Look at all the new blue and yellow lines — we all expected that this brave new world would have no problems





# Can They Still Be Dangerous? Third Party Payer Models

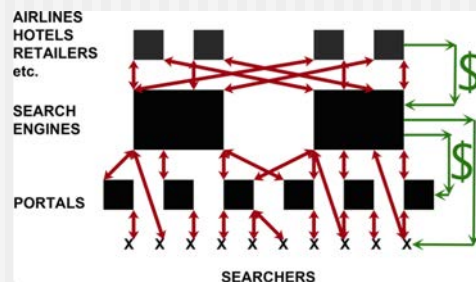
- Can third party search **still** be dangerous?
  - Actual evolution of air travel distribution did not match expectations
  - Current power looks much more like power in the 1980s than we expected
  - Far fewer blue and yellow lines than we expected
  - And current lawsuits look very much like lawsuits in the 1980s
  - Digital optimists** were wrong!



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# Third Party Payer Models — How Dangerous Can They Be?

- How** dangerous can MPP3PP business models be?
  - Value **creation** or value **harvesting**? Would we have search without Google?
  - What limits value harvesting?
    - Does **competition** with other search engines limit fees?
    - Does **advertising** limit fees for key words?
    - Does **total marginal contribution** to revenue limit fees for key words?



- What limits value harvesting?
  - Bankruptcy threshold**
  - Exit threshold**
  - Regulatory threshold**

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# The Recurring Pattern In Third Party Payer Models

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- There is a **recurring pattern** in third party payer systems
- Party three becomes **vulnerable**
  - Due to the parallel monopoly structure
  - How many CRS vendors can connect you to an agency that uses only Sabre?
  - How many credit card associations can connect you to a customer who is using a Visa card?
- Party two implements the **trick play** and **exploits the vulnerability**
  - Did airlines know how CRS pricing was going to change?
  - Did merchants know how credit card pricing was going to change?

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# Why Should You Care?

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











- Does competition between search vendors help limit cost of keywords?
- Does the use of quality scores make the manipulation of search in some way **stable**?
  - Is it good for Google in the short term?
  - Is it good for Google in the long term?
  - Does it produce better results for users than rank by bid used to produce
- So what problem could there possibly be with Google's use of quality scores?

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# Why Should You Care? — Understanding the Power











## Simplified Model of Bringle's Power

-  Customers' WTP for perfect product is Z500
-  Current promotional price is Z260
-  Sellers located at 0, 60, and 120 in PAS
-  Fit cost  $t = Z2$  per click
-  Brute force search costs Z100
-  Expected value for consumers from perfect brute force search  $Z500 - Z260 - Z100 = \mathbf{Z140}$
-  Expected value for consumers from perfect free Bringle search  $Z500 - Z260 = \mathbf{Z240}$
-  Now Bringle shows middle seller to all customers with no charge to consumers
  -  For 1/3 of the consumers the value is  $Z500 - Z260 = \mathbf{Z240}$
  -  For 2/3 of the consumers the value is  $Z500 - Z260 - Z120 = \mathbf{Z120}$
  -  So average value is  $\mathbf{Z160}$
  -  Not as good as perfect search, but consumers are still better off than before

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# Why Should You Care? — Understanding the Power













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-  Customers' WTP for perfect product is Z500
-  Current promotional price is Z260
-  Sellers located at 0, 60, and 120 in PAS
-  Fit cost  $t = Z2$  per click
-  Brute force search costs Z100
-  Expected value for consumers from perfect brute force search  $Z500 - Z260 - Z100 = \mathbf{Z140}$
-  Now Bringle decides to protect their reputation
  -  Bringle offers all sellers the right to be shown to their perfect consumers for Z50, and sellers pass this through to consumers
  -  Value to consumers is previous value of perfect search  $Z240 - Z50 = \mathbf{Z190}$
  -  Consumers are still better off, and merchants are unharmed

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



# Why Should You Care? — Understanding the Power

## **Simplified Model of Bringle's Power**

-  Customers' WTP for perfect product is Z500
-  Current promotional price is Z260
-  Sellers located at 0, 60, and 120 in PAS
-  Fit cost  $t = Z2$  per click
-  Brute force search costs Z100
-  Expected value for consumers from perfect brute force search  $Z500 - Z260 - Z100 = \mathbf{Z140}$
-  Now Bringle decides they are charging too little!
  -  Bringle offers all sellers the right to be shown to their perfect consumers for Z100, and sellers pass Z80 through to consumers and lose Z20 themselves
  -  Value to consumers is previous value of perfect search minus the pass through cost, that is,  $Z240 - Z80 = \mathbf{Z160}$
  -  Consumers are still better off than before the introduction of search
  -  Sellers are worse off
  -  And Bringle is harvesting far more value than they create

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# Why Should You Care?

-  **Is this a great business model, or what?** Consumers are better off than before search
-  The entire market is buying, which enhances consumer welfare as well.
-  Sellers also may have help when launching into a new market. Private information in this example is used only to benefit consumers. Why might this still constitute a regulatory conundrum?
-  Because in an MP3PP without regulation nothing limits what a search engine can charge except the possibility of seller bankruptcy. Market forces do not correct this. And, ultimately, it is expensive for consumers.

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# And now ... Platform Envelopment and Vertical Integration

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- Platform envelopment occurs when a vendor provides an increasing number of increasingly well integrated offerings
  - Can benefit the vendor with superior profitability while benefiting consumers with better offerings
  - When used to limit competition, and when this results in higher consumer prices, this can violate competition law
  - Basis of US Department of Justice Antitrust Litigation against Microsoft
- Platform envelopment in search today?
  - What makes Google so attractive to consumers?
  - What makes Android so attractive to consumers?
  - What search engine is the default on an Android?
  - Which social network integrates best into Google search?

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# And now ... Platform Envelopment and Vertical Integration

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- Vertical Integration in Search
  - Why use power only indirectly over party three?
  - Why not compete directly with party three?
  - Become a ticket agency — compete with Orbitz
  - Become a merchant — compete with Amazon market
  - Become a social network — compete with Facebook
  - Compete with Yelp and TripAdvisor
  - Earn commissions on **everything**
  - While increasing the effectiveness of your platform envelopment strategy

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# Conclusions: Why Should You Care?

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- Does free search cost you anything?
  - If the cost of fuel goes up, what happens to airfare?
  - If occupancy taxes go up, what happens to the cost of a night in a hotel?
- Are keywords somehow unique?
  - If the costs of keywords goes up, what happens to airfare?
  - If the cost of keywords goes up, what happens to the cost of a night in a hotel?
- What does this cost you?
- If no one can compete with Google Maps, or other services, what does this cost you?

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# Conclusions

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- The ***Paper Towel Game*** and the power of gateways
- The power of ***MP3PPs*** and the ability to ***harvest*** more value than is created
- Next class we will discuss ***Privacy Violations*** and ***Fake News***
- And we will discuss ***Regulation*** as a necessary last resort

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