

Online markets: discussion paper

A report for the Office of Fair Trading

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Executive Summary

Introduction to this paper

Trading and marketing online (e.g. companies advertising online or selling goods and services online) is growing in scale and changing rapidly. It involves activities which have network effects potentially leading to concentration in some markets that act as gateways for small and medium sized enterprises (SMEs¹) trading online. This independent research paper from Plum Consulting and Keplar LLP aims to help build the OFT's understanding of the dynamics of online markets by:

- Describing routes to market for SMEs wishing to trade online.
- Commenting on effects of the economics of these markets.

In doing this we aim to provide context for the consideration of any potential complaints.

The focus is on SMEs and online markets. Our findings are based on a literature review and on interviews with key industry participants and a small number of SMEs. This summary discusses findings by section of the value chain then by top-level theme.

Online markets are a large and growing opportunity for SMEs

Online markets have introduced new opportunities that did not previously exist and expanded significantly over recent years, with online sales accounting for 8.1% of total UK retail sales in April 2010² and internet advertising making up 24% of all advertising spend in H1 2009³. The majority of SMEs have internet access and a web presence. Their online sales approached £50 billion in 2008⁴. Many online businesses also operate offline, for example 23% of top eBay sellers in the UK also have a physical shop⁵. Online markets have also created new markets (e.g. for software applications on the Apple app store) in which SMEs may participate.

¹ Defined as companies with 1-249 employees.

² ONS. April 2010. Retail sales. <http://www.statistics.gov.uk/pdffdir/rs0510.pdf>

³ PricewaterhouseCoopers / Advertising Association / Internet Advertising Bureau / WARC. Fact Sheet: Online adspend – H1 2009. http://www.iabuk.net/media/images/iabresearch_adspend_adspendfctshth108_5253.pdf

⁴ ONS. E-commerce and ICT Activity. 2008 e-commerce Survey of Business datasets. http://www.statistics.gov.uk/downloads/theme_economy/e-commerce-2008/2008-datasets.pdf

(including business-to-business sales and exports)

10-249 employee companies had online sales of £48.5 billion in 2008. Data for 1-9 employee companies is not provided.

⁵ eBay Online Business Index Autumn 2009 – based on a survey of 508 online retailers selling on eBay, Aug/Sep 2009. <http://pages.ebay.co.uk/businesscentre/business.html>

Key findings by area of the value chain

Taxonomy of online markets

The sections below discuss our findings in the context of a framework of activities that SMEs may engage in to market or transact online. The key components of online trade that comprise this taxonomy are:

- Developing a web presence.
- Marketing or advertising online.
- Online payment (for SMEs that transact online).
- Fulfilment – the warehousing and delivery of goods (for online retailers).
- Access to a supply of goods (for online retailers).

Figure 1 illustrates this taxonomy and the set of suppliers in each area; some suppliers are specific to each area while online marketplaces fulfil more than one function and so provide a one-stop-shop.

Elements of the online market involve network effects and market concentration (search, online marketplaces and online payment gateways). However, innovation is ongoing, for example through the rise of the mobile internet and the social web.

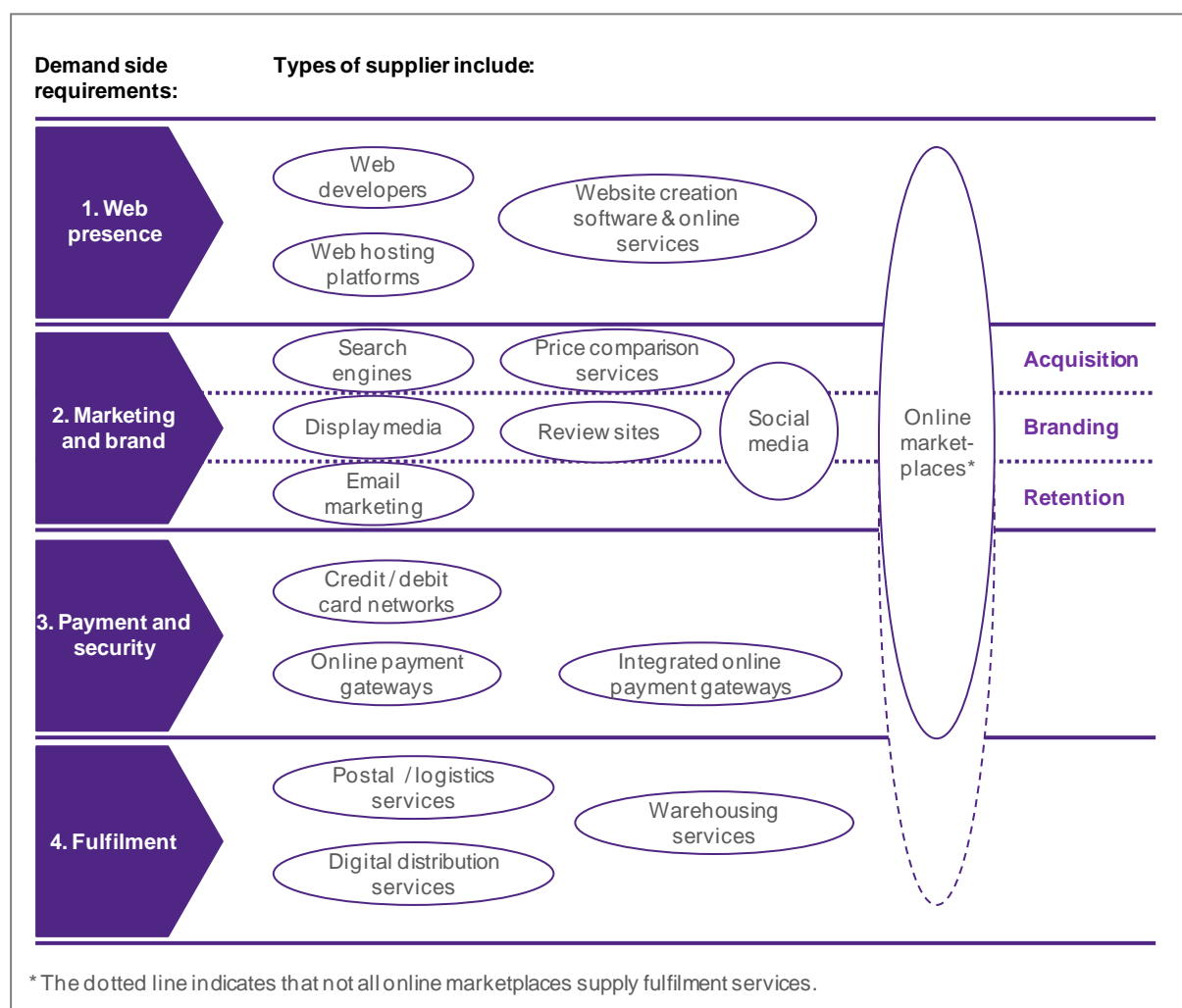
Online marketplaces: provide a ‘one-stop shop’ and lower barriers to entry

Online marketplaces such as eBay and Amazon Marketplace have significantly reduced financial and reputational barriers to entry for SMEs wishing to trade online. These marketplaces provide web presence, marketing and payment services and, in the case of Amazon, fulfilment. This allows SMEs to focus on their core competencies e.g. managing supplier relationships. We found that SMEs have choices online, as these marketplaces compete with each other (some retailers sell across several marketplaces) and retailers’ own websites. They also compete with paid search providers and others in providing marketing to SMEs. Customer ratings are a key element of the marketplaces, enabling SMEs to build a reputation at low cost relative to the offline environment. This element of reputation may be achieved quickly (just one piece of feedback generates a rating) and is tied to particular platforms (i.e. ratings are non-transferable).

Web presence: new services make it increasingly easy to develop a web presence

Barriers to SMEs seeking to develop a web presence, either independently or through marketplaces, are low and continuing to decrease. Developing a web presence is a necessary first step for SMEs wishing to benefit from the opportunities of trading online, just as bricks and mortar retailers, for example, require stores or concessions. Key developments have been the emergence of online website creation services (e.g. Wix.com) and online marketplaces (e.g. eBay) for which up-front costs for a basic level of service are negligible.

Figure 1: Taxonomy of services and services used by SMEs to trade online



Marketing: Google has a strong market position, but alternative options are developing

Online marketing is developing at a fast pace and has created new opportunities for SMEs that trade online (and offline). Specifically, the cost barriers to SMEs advertising to small niche and / or geographically dispersed audiences and people with a high propensity to buy have decreased dramatically, primarily due to search. Currently search is the form of online marketing that accounts for the largest amount of spend, though alternatives such as affiliate marketing share some of the characteristics of search and are increasingly viable for SMEs, depending on the business sector. Social networking offers new and different opportunities (e.g. engaging with 'fans').

Search marketing (paying for sponsored links in search results) provides a way for SMEs to acquire leads / customer intent that was not previously possible. Search marketing accounted for 61% of internet advertising spend in 2009⁶, and Google took 87.2% of search marketing spend in Q1 2010 in

⁶ PricewaterhouseCoopers / Advertising Association / Internet Advertising Bureau / WARC. Fact Sheet: Online adspend – Full Year 2009. http://www.iabuk.net/media/images/iabresearch_adspend_adspendfctshth2009_6332.pdf

the UK⁷. Costs of entry are minimal (e.g. bidding may start at 10p) and SMEs have control over the amount they spend (e.g. they can pre-set caps).

The ranking of page links in Google sponsored search results is determined by the product of the price an advertiser bids for a keyword and its quality score (an indication of a site's 'quality' that is determined by Google). The European Commission has launched a preliminary antitrust inquiry into the way that Google determines quality scores⁸. The three companies complaining provide search / comparison services in specific vertical segments (e.g. ejustice.fr - legal information). We note that the vast majority of SMEs do not provide search / comparison in vertical segments so would not be affected by this particular issue.

Natural search (appearing in free search results) is a crucial source of traffic (website visitors) for many SMEs. Google received and served 92% of UK search requests in January and February 2010⁹ so many SMEs are dependent on Google and are sensitive to any changes in its search algorithm (the software used to decide the ranking of web pages in search results).

Alternative online marketing channels to search are developing their capabilities, for example:

- Affiliate marketing (which includes price comparison websites) is accounting for increasing spend: £227 million of commissions and fees in 2008, growing at 22% per annum¹⁰. SMEs are making use of affiliate marketing e.g. price comparison site Kelkoo¹¹ lists products from SMEs alongside those of major retailers¹².
- Social networking enables SMEs to do new kinds of marketing, such as engaging with current and prospective customers to influence their attitudes towards brands. Use of social networking services may be free, though there are costs in terms of time input.
- Internet display advertising is becoming more targeted and sold through automated systems with lower minimum spend levels enabling SMEs to participate increasingly in this medium.

These channels may be used as alternatives to search though the viability of these options varies enormously by sector due to differences in consumers' shopping behaviour by product type. For example, review sites and social media may be effective substitutes to search for hotel operators and restaurants as people are likely to consult reviews and recommendations before making a booking. In contrast, affiliate marketing is effective for insurance providers.

Payment: Integrated payment gateways have significantly lowered barriers to entry

Online payment services, particularly integrated payment gateways (e.g. PayPal and Google Checkout), have lowered the cost and effort of setting up to take online payment enabling SMEs to sell

⁷ Efficient Frontier, UK Search Engine Performance Report : Q1 2010.

http://www.efrontier.com/sites/default/files/SearchEnginePerformance10Q1_UK.pdf

⁸ Google. European Public Policy Blog. "Committed to competing fairly."

<http://googlepublicpolicy.blogspot.com/2010/02/committed-to-competing-fairly.html>

⁹ StatCounter. Top 5 Search Engines in United Kingdom from Jan 09 to Feb 10. http://gs.statcounter.com/#search_engine-GB-monthly-200901-201002.

¹⁰ Econsultancy - Affiliate Marketing Buyer's Guide 2009, <http://blog.affiliatetip.com/archives/uk-affiliate-marketing-to-generate-4-billion-in-2009/>

¹¹ www.kelkoo.co.uk

¹² Not all price comparison sites operate in this way. Different business models exist in affiliate marketing.

goods and services online and to do so cross-border. Without integrated payment gateways, SMEs would experience cost and, more significantly, practical barriers to setting up to take payment online: they would have to have a merchant account with a bank (may cost £200 to set up¹³) and implement payment gateway technology (e.g. SagePay) on their websites (requires technical know-how). Though some SMEs use this latter option, particularly those that already have a merchant account for offline payments, 32% of SME retailers used the PayPal gateway in 2008¹⁴. It had higher uptake than other gateways. Though set-up costs are low, PayPal fees (as a proportion of transaction values) are higher than most merchant accounts / SagePay, though there is no monthly fee. Businesses that sell high value items may find PayPal more expensive, but this varies according to the interplay between volume and value of transactions.

Integrated payment gateways also provide a way for SMEs to overcome reputational / trust barriers. By allowing SMEs to take payment under the umbrella of their brands integrated payment gateways are lending SMEs the credibility and trust that these brands imply.

PayPal has opened its platform to third-parties to build applications which may stimulate innovation and extend the reach of the service to new areas (e.g. third party developers could create apps for consumers to pay a carpenter face-to-face using a mobile phone application rather than cash or a cheque). We found that some online discussion forums have reports of PayPal suspending accounts following disputed transactions. This is disruptive to the merchant, though the intention is likely to be fraud prevention. There are similarly priced alternatives to PayPal (e.g. Google Checkout).

Fulfilment and supply of goods: barriers remain but may have fallen

In the segments of the value chain that remain offline, namely the supply of goods and fulfilment, the barriers to SMEs setting up business or competing with larger retailers remain but may have fallen. Competition in the market for the distribution of small packages (e.g. DVDs and books) is sometimes more limited for SMEs relative to large retailers. However, absolute barriers to fulfilment have come down due to fulfilment services offered by Amazon. Online marketplaces may also have promoted choice and therefore competition in fulfilment.

Supply of goods is an issue for some online retailers due to attempts by manufacturers to limit online sales to approved sites or to stop online sales altogether and manufacturers have also made attempts to maintain prices online by preventing discounting. These practices are facilitated by the transparency of online retail services which makes it easy for manufacturers to monitor retailers and their pricing. A survey by eBay showed that 49% of its top sellers had experienced attempts to ban them from selling goods online.

¹³ Business Link. Accepting online payments.

<http://www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId=1073791013>

¹⁴ Actinic SME Retail Technology Report 2008. <http://downloads.actinic.com/docs/Actinic-SME-Retail-Technology-Report-2008.pdf>

Based on a survey of 277 SMEs

Top level findings

Innovation has led to significant decreases in cost barriers to SMEs setting up online

Barriers to SMEs setting up business have decreased across all areas of online markets except supply of goods. This has enabled a new set of SMEs to trade online. Online services used by businesses are characterised by relatively low unit costs which makes them very accessible to SMEs. Low cost innovations from major online service providers include:

- Amazon and eBay provide one-stop-shop online ‘marketplaces’ with little or no up-front costs for listings.
- Google AdWords enables SMEs to advertise in search results - no minimum spend.
- PayPal provides an online payment mechanism - no up-front costs.

Table 1 indicates the relative up-front costs for a retailer setting up in business online and offline.

Table 1: Comparison of online and offline up-front costs for a retailer setting up in business

Function	Online solution (All available at zero or negligible up-front cost ¹⁵)	Offline solution (Significant up-front costs ¹⁶)
Presence	Build a website using a free online website creation service e.g. Weebly ¹⁷ .	Lease retail premises.
Marketing	Set up an account with Google for search marketing.	Place advertising in local newspapers and directories.
Payment	Set up an account with PayPal and integrate it into the website.	Set up a merchant account and acquire a credit card terminal.
Fulfilment	Use Royal Mail for delivery, fulfilment by Amazon (Larger businesses may need to rent premises for storage of stock.)	Fulfilment from retail premises (Costs of holding stock and consumer costs in pick up.)

Reputational barriers have also decreased due to brand sheltering effects

The presence of major platforms and review sites has made it easier for SMEs to overcome reputational barriers to trading online. Trust and reputation are important to reassure consumers who are shopping online: a survey commissioned by the OFT found that 72% of online shoppers had concerns in January 2009, of which security issues (68%) and privacy issues (28%) were the most important¹⁸. Research commissioned by New Media Age found that 55% of UK online shoppers

¹⁵ Excluding the cost of time required to manage these activities.

¹⁶ These costs vary significantly by type of business and location, therefore we have not attempted to provide average costs.

¹⁷ <http://www.weebly.com/>

¹⁸ OFT Findings from consumer surveys on internet shopping, May 2009, http://www.of.gov.uk/shared_of/reports/Evaluating-OFTs-work/oft1079.pdf

“worry about fraud” when shopping online¹⁹, which may lead them to favour sites that use integrated payment gateways. This may lead to a preference for trusted brands online, though there is no up-to-date survey data to prove this. To independently establish a reputation online requires the expense of marketing and developing a professional-appearing website. Innovation has, however, provided alternative lower cost ways to build reputation online:

- Sheltering under the brands of platforms – platforms such as Amazon and PayPal to some extent lend their brands to the SMEs that use them, providing some consumer reassurance.
- Displaying customer feedback – online marketplaces show ratings for each sell based on customer feedback, and review sites (e.g. TripAdvisor for hotels) provide similar feedback mechanisms. These allow SMEs to quickly build a reputation.

The disadvantage for SMEs of marketplace-based ratings is that such ratings are not independent of the marketplace.

The major players driving innovation have achieved significant market positions

The success of some online service providers in leveraging economies of scale to reduce the costs of setting up businesses online has contributed to them achieving significant market positions. The businesses of these online service providers, which involve running large software platforms, have scale economies. The leading providers (e.g. Google in internet search marketing and PayPal in integrated online payments) have attracted large numbers of SMEs to use their platforms by offering service at a low and in some cases zero cost services.

Openness is creating competition in some areas but may reinforce leaders' market share

Some major platforms are opening parts of their value chain to third parties, leading to increased competition in some areas and reinforcing the market share of these platforms. The rationale for openness is to harness the capabilities of third parties to quickly improve the customer proposition, particularly where customers have diverse needs. Given the fast pace of change in online marketplaces openness is an attractive strategy to retain competitive advantage and meet consumer needs. Two types of openness, differentiated by the part of the business that is being opened, are:

- Open software interfaces – allowing complementary service providers / developers access to software that drives platforms so that they can build applications on top of the software e.g. PayPal opening its application programming interface (API) to third party developers. This is intended to increase the range of payment services / applications running on the underlying PayPal technology platform.
- Open marketplaces – allowing third-party sellers to participate in online marketplaces, with products listed alongside an established retailer e.g. Amazon. This grows the range of products available on Amazon, enabling the Amazon platform to serve a broader range of customer and meet a greater range of their needs.

¹⁹ NMA / Lightspeed research, Online Shopping survey, December 2009 - <http://www.nma.co.uk/data/online-shopping-survey-2010/3008738.article>

This approach leads to increasing competition and innovation in the parts of the business / value chain that have been opened. The low costs of using services means SMEs are incentivised to use a diversity of providers e.g. online retailers selling on established major marketplaces and new entrant marketplaces. However, openness also helps platforms to gain scale, so increasing the barriers to entry for competitors.

Some SMEs depend on particular market players and are sensitive to system changes

Some SMEs are currently dependent on particular providers and would be strongly affected by any 'system changes' or loss of service. SMEs experiencing this kind of dependence include small companies that lack the resources to diversify / explore new options. In these cases issues may arise if providers change the rules (e.g. changes to the Google search algorithm would benefit some and disadvantage others) or rates or cut off service.

Platforms' consumer protection activities may disadvantage some SMEs in some cases

Platform providers need to engage in consumer protection activities to meet end consumers' needs and maintain the reputation of the platform, thereby benefiting SMEs and other users. However, in some cases this may lead to disruption of some SMEs' businesses. One disadvantage of lowering costs of setting up in business online is that this facilitates entry of fraudulent traders as well as legitimate ones, with providers such as PayPal needing to 'police' their services in order to maintain consumer trust. SMEs' service may be suspended if there is suspicion that their activity is fraudulent / harmful (e.g. if consumer complaints are received or unusual trading patterns identified). An example is PayPal suspending accounts in cases of disputed transactions. This type of consumer protection may be disruptive to an SME that come under suspicion due to unfounded consumer complaints or mistaken analysis of trading patterns, but may serve the interests of users collectively.

The boundaries of online and offline markets are increasingly blurring

Initially, online may have been viewed as distinct from offline. However, online markets for physical goods have always depended on offline delivery, and consumers use online information in making offline purchases and vice-versa. The development of sophisticated mobile devices (e.g. smart phones) and mobile broadband will further blur the distinction. For example, consumers may in future discover products and services via mobile applications and local search rather than general search.

1 Introduction

1.1 About this paper

Trading and marketing online (e.g. companies advertising online or selling goods and services online) is growing in scale and changing rapidly. It involves activities which have network effects potentially leading to concentration in some markets that act as gateways for small and medium sized enterprises (SMEs²⁰) trading online. This independent research paper from Plum Consulting and Keplar aims to help build the OFT's understanding of the dynamics of online markets by:

- Describing routes to market for SMEs wishing to trade online.
- Commenting on effects of the economics of these markets.

In doing this we aim to provide context for the consideration of any potential complaints.

The focus is on small and medium sized enterprises (SMEs²¹) and the supply of services that facilitate them to trade or market online²², including the areas of web presence, online marketing and online payment. We also consider fulfilment services and the supply of goods to retailers inasmuch as these affect activity in online markets.

Our findings are based on a literature review and on interviews with key industry participants and a small number of SMEs. The latter provide illustration of actual market behaviour and are not intended to be representative of the total SME universe. Research was conducted in January and February 2010.

1.2 Market background: SMEs and the internet

Online markets have expanded significantly over recent years, with online sales accounting for 8.1% of total UK retail sales in April 2010²³ and internet advertising making up 24% of all advertising spend in H1 2009²⁴. The majority of SMEs have internet access and a web presence. Their online sales approached £50 billion in 2008²⁵. Many online businesses also operate offline, for example 23% of top eBay sellers in the UK also have a physical shop²⁶. However, online has also created new markets (e.g. for software applications on the Apple app store) in which SMEs may participate.

²⁰ Defined as companies with 1-249 employees.

²¹ Defined as companies with 1-249 employees.

²² The primary focus is web-based services. We have not covered proprietary B2B supply chain management and procurement systems for example.

²³ ONS. April 2010. Retail sales. <http://www.statistics.gov.uk/pdfdir/rs0510.pdf>

²⁴ PricewaterhouseCoopers / Advertising Association / Internet Advertising Bureau / WARC. Fact Sheet: Online adspend – H1 2009. http://www.iabuk.net/media/images/iabresearch_adspend_adspendfctshth108_5253.pdf

²⁵ ONS. E-commerce and ICT Activity. 2008 e-commerce Survey of Business datasets. http://www.statistics.gov.uk/downloads/theme_economy/ecommerce-2008/2008-datasets.pdf

10-249 employee companies had online sales of £48.5 billion in 2008. Data for 1-9 employee companies is not provided.

²⁶ eBay Online Business Index Autumn 2009 – based on a survey of 508 online retailers selling on eBay, Aug/Sep 2009. <http://pages.ebay.co.uk/businesscenter/business.html>

2 Analytical framework

The purpose of this section is to consider the published literature that addresses online markets and SMEs and to set out initial elements of a framework for understanding online markets.

2.1 Literature on online markets and SMEs

Specific literature on online markets and SMEs tends to be old and so not relevant given the pace of change in online markets or not focussed on the issue of how SMEs operate online. For example, the OECD report “ICT, E-business and SMEs” was published in 2004. Ofcom reported on SME engagement with communication services in 2006.²⁷ BIS conduct an SME survey, but this does not address online issues.²⁸ More recent work tends to focus on consumer issues as opposed to online market characteristics; for example, “OECD Conference on Empowering E-Consumers”, December 2009.²⁹ However, the OECD published a report on internet intermediaries in April 2010 which noted that:³⁰

“As to online e-commerce intermediaries, they have brought unprecedented user and consumer empowerment through greater information, facilitating product and price comparisons and creating downward pressure on prices or, in the case of auction platforms, meeting supply and demand and creating new markets.”

We therefore aim to set out a limited framework for beginning to understand online markets drawing on more general economic literature and observations and evidence presented elsewhere in this paper regarding the nature of online markets.

2.2 Dynamic character of online markets

We observe that online markets are “dynamic” in two senses.

- A measure of dynamic nature of a sector given by productivity growth estimates. Online markets are part of the ICT-intensive service sector which has exhibited an acceleration of labour productivity growth in many countries.³¹
- A qualitative indication of the dynamic character of online markets is given by evidence of the range of experimentation in terms of business models, the rate of growth of successful platforms and the level of ongoing innovation and “disruptive” change in areas such as cloud computing, growth of mobile internet and devices and of the social web.

²⁷ Ofcom. SME Engagement with Digital Communications Services.

<http://www.ofcom.org.uk/research/cm/smeengagement/smereport.pdf>

²⁸ BERR SME Business Barometer. <http://www.berr.gov.uk/files/file51016.doc>

²⁹ http://www.oecd.org/site/0,3407,en_21571361_43348316_1_1_1_1_1,00.html

See also OECD. April 2010. Summary of key points and conclusions. <http://www.oecd.org/dataoecd/32/10/45061590.pdf>

³⁰ OECD. April 2010. “The economic and social role of internet intermediaries”.

<http://www.oecd.org/dataoecd/49/4/44949023.pdf>

³¹ See EU KLEMS data for example. <http://www.euklems.net/>

The dynamic character of online markets may result in greater risk of failure for some start-ups but spectacular success for others. “Normal” returns for the market as a whole may therefore correspond to *ex post* returns that are high for successful firms.

Online markets are also very much *information intensive*. The very nature of many transactions places rich sources of information about consumers (and perhaps also other market participants) in conveniently digitized form, at the disposal of companies providing services such as search, payment and social network services. Collection of information about customers is not unique to online markets, but the scale under which it has become possible is unprecedented. The industry is undoubtedly very much alive to the value of information³² and is in process of implementing strategies to acquire it and use it profitably. We believe the formulation of strategies for profiting from the information explosion is very much in its infancy and, therefore, this is one major respect in which the market is ‘dynamic’.

As the quantity and quality of information companies have about their customers and about the customers of their competitor’s increases, there arises scope for provision of valuable new services but also for the exercise of market power. As purchase recommendations become well tailored to customers they become less like junk-mail and more like a personal shopping service. On the other hand, firms might be also able to use information to better price discriminate and extract surplus from customers, or to pre-empt putative rivals from entering a market. However, better informed consumers may also be more discriminating in their decisions, for example, in terms of price or quality.³³

Major platforms such as Amazon, PayPal, eBay, support and enforce a system of buyer and seller reputations which facilitates many valuable trades which otherwise could only take place in face-to-face markets. Hence, here is a vehicle for consumers and SMEs to benefit from the control of information by major platforms. However, there is also a possibility that an intermediary “certifies” parties to a transaction and extracts a large share of surplus whilst only minimally improving information flows in the market³⁴. Information will both create opportunities for adding value for customers and opportunities to extract value whilst adding little value if competition is limited.

A general implication of the highly dynamic nature of online markets is that the body of economics literature developed within a paradigm of static market analysis may fail to account for some of the observed characteristics of online markets and may be a poor guide to judging the efficiency of observed behaviour. For example, innovation can make defining relevant product markets difficult because business executives and government officials alike may not yet know what the future products will be³⁵.

2.3 Features of online markets

Online markets have the following characteristics which we have taken into account when assessing the way they impact on SMEs:

³² See e.g. “Information Rules” by Carl Shapiro and Hal Varian, Harvard Business School Press, 1999 for an early discussion.

³³ Goldmanis, Hortaçsu, Syverson and Emre. June 2010. “E-commerce and the Market Structure of Retail Industries”. *Economic Journal*, Volume 120, Number 545.

³⁴ Information revelation and certification intermediaries, Alessandro Lizzeri, The RAND Journal of Economics, 1999. <http://www.jstor.org/pss/2556078>

³⁵ G Sidak and D Teece. Dynamic competition in antitrust law, Journal of Competition Law and Economics, Vol 5(4), December 2009 <http://jcle.oxfordjournals.org/cgi/content/full/5/4/581?etoc>

- They have reduced the time and money costs to consumers of finding particular goods and services which open up new markets for niche products and services.
- They have lowered the transaction costs of doing business relative to the offline environment, in particular in relation to set-up and marketing costs for businesses.³⁶
- They are characterised by scale economies because many of the costs incurred in establishing services (e.g. software development costs) are fixed and because markets are often global not national or local.
- Many platforms are open to a wide range of users and, increasingly, are open to third party service providers. Incentives to discriminate may be decreasing with the range of services offered which may have risen with lower transaction costs and the opportunity to serve “long-tail” markets³⁷.
- Network effects often occur where additional users add value for existing users leading to concentration.³⁸
- There is greater transparency of information concerning price and sales activity which allows vendors to monitor retailers thereby potentially making practices such as denial of supply or resale price maintenance more likely to arise.³⁹

These factors affect competition within online markets and also impact on competition in offline markets as consumers now have easy access to price and product information (e.g. through comparison websites).

³⁶ The OECD note that internet intermediaries “...stimulate employment and entrepreneurship by lowering the barriers to starting and operating small businesses and by creating opportunities for ‘long-tail’ economic transactions to occur that were not previously possible, whereby businesses can sell a large number of unique items each in relatively small quantities.”

OECD. April 2010. “The economic and social role of internet intermediaries”.

<http://www.oecd.org/dataoecd/49/4/44949023.pdf>

³⁷ For example, Amazon opened their store to third party sellers in March 2002, Apple opened the iPhone to third party applications (subject to approval) in July 2008 and the PayPay platform opened up to third party applications in November 2009 (though eBay required UK sellers to offer PayPal in July 2008).

³⁸ Shapiro, Carl and Hal R. Varian. 1998. Information Rules. Boston, MA, Harvard Business School Press.

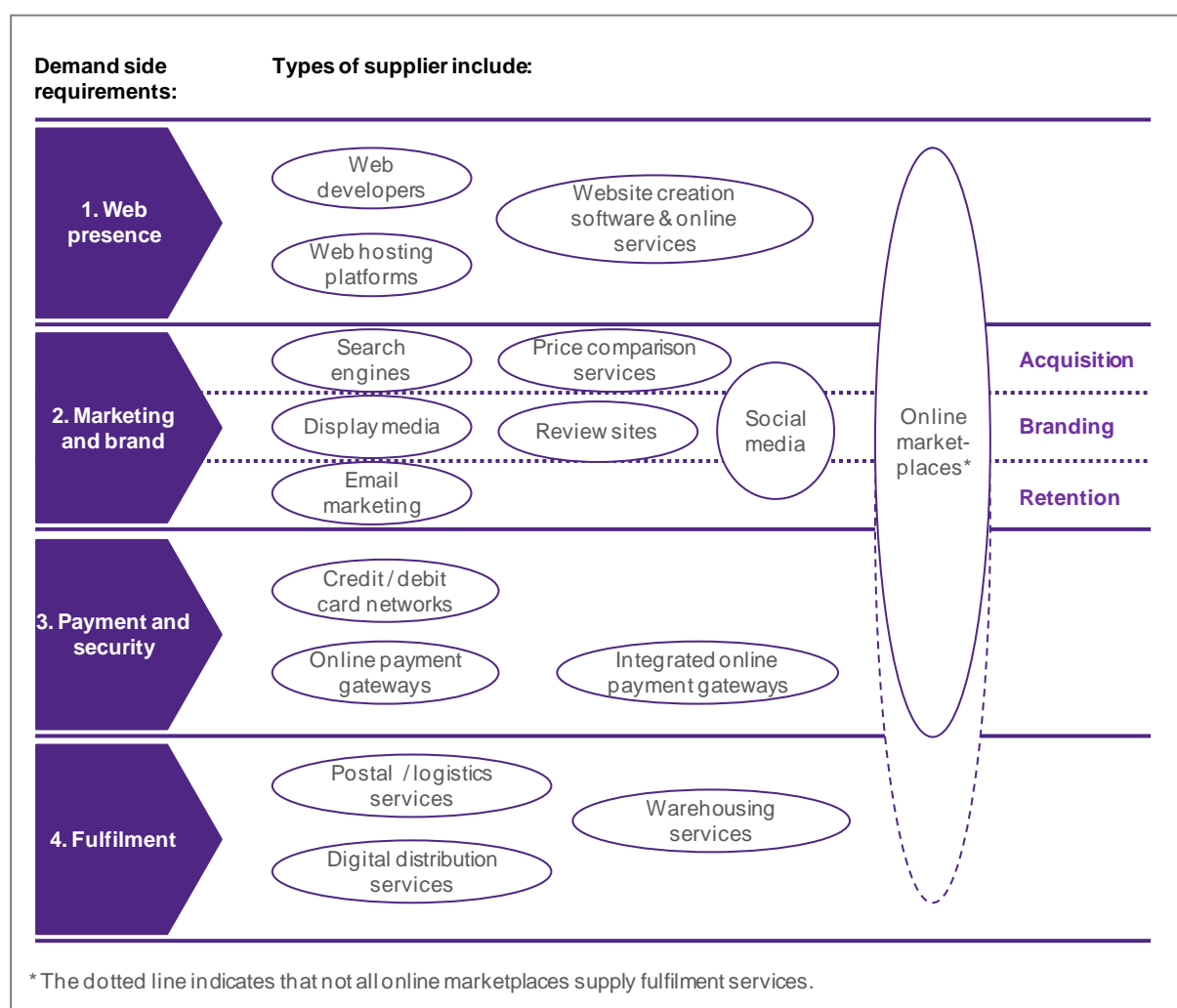
³⁹ eBay. Online Business Index: A quarterly survey of companies trading on the internet. Summer 2009.

http://pages.ebay.co.uk/businesscentre/OBI_Summer2009.pdf

3 Market practice

The opportunity for SMEs online differs according to the type of business: all SMEs can benefit from using online marketing to promote their businesses, and for SMEs that are retailers online also offers an opportunity to sell remotely. Figure 3-1 illustrates the generic needs / opportunities for SMEs online and the types of supplier that provide relevant services.

Figure 3-1: Taxonomy of services required by SMEs to trade online



All SMEs that seek to take advantage of online opportunities require a web presence, whether this is their own website or a listing / presence on a third-party site. SMEs also need to engage in some kind of marketing and brand activity to promote their services. There are numerous marketing mechanisms available online from search engine marketing through to the use of social networking. SMEs that transact online need to use payment services, which are provided by dedicated online payment providers. SME retailers also need to store stock and fulfil orders, most often via postal services. Each of these areas has a distinct set of suppliers. Online marketplaces provide a simple way for SMEs to trade online by providing web presence and marketing, and in some cases payment and fulfilment through a single customer relationship.

Sections 3.1 to 3.4 look at each of these areas in turn. Section 3.5 covers online marketplaces that supply more than one of these SME requirements. In section 3.6 we cover the issue of supply of goods which is important for those SMEs that sell goods online.

3.1 Web presence

Barriers to SMEs seeking to develop a web presence, either independently or through marketplaces, are low and continuing to decrease. Developing a web presence is a necessary first step for SMEs wishing to benefit from the opportunities of trading online, just as bricks and mortar retailers, for example, require stores or concessions. Key developments have been the emergence of online website creation services (e.g. Wix.com) and online marketplaces (e.g. eBay) for which up-front costs for a basic level of service are negligible or zero.

3.1.1 Web presence is essential for SMEs to access opportunities online

In order to access any of the opportunities that the internet presents SMEs need to develop a web presence. This may be a website and / or a listing in an online marketplace (the latter, which have no / low set up costs, is considered in section 3.5).

SMEs seeking to create their own website will need to design the site (layout, look and feel), develop it (write the software code) and host it (place the web pages on a web server that allows other users to access the content). Transactional websites require more complex development as these must support features such as secure online payment.

3.1.2 New developments allow SMEs to set up a web presence quickly and cheaply

Recent business innovations enable SMEs to set up a web presence quickly, cheaply/free and in-house, in some cases without the need for skilled staff or professional help. Key developments include:

- Free online website creation services (e.g. Wordpress.com, Wix.com, Weebly.com). These allow users to create websites using ready-made templates and provide web hosting.
- Getting British Business Online⁴⁰ - a joint initiative by Google, Enterprise UK, BT, e-skills UK and others that provides a free .co.uk domain name and website creation service to SMEs.
- Low-cost off-the-shelf “website in a box” software (e.g. Mr Site) that guides SMEs through the website creation process.
- Free / low cost solutions aimed at skilled IT users. These include open source “content management systems” (e.g. Joomla, Drupal) and e-commerce applications (e.g., Magento⁴¹).

Continued competition and innovation in the market for website building tools and online services is likely to further reduce the costs of setting up a web presence.

⁴⁰ <http://www.gbbo.co.uk/>

⁴¹ Drupal is an open source content management system, Magento is an open source ecommerce platform.

3.1.3 Professional providers are used in some cases – the market is competitive

Some SMEs may require professional web design and hosting services. Despite the competitive nature of the market there may be issues due to lack of buyer education enabling ‘cowboy operators’ to trade (though evidence is anecdotal).

SMEs may use professional web design and web development services if they require a complex site or lack the resources for in-house development. These services are often provided by web agencies. Similarly hosting services may be provided by professional web hosting companies.

The market of professional suppliers is competitive: there are of the order of thousands of web agencies⁴² in the UK and hundreds of web hosting companies⁴³. Overseas based hosting companies also supply the UK market. Due to the labour-intensive nature of web development the costs of custom solutions are high, from £1,000 to £15,000 depending on the level of functionality required. However, web hosting prices are relatively low, typically £10-£50 per month.

Our research found a perception among some industry stakeholders that some ‘cowboy’ web developers are present in the market for professional web services. This was seen to be a consequence of the unregulated nature of the web agency market (few barriers to entry), and a lack of education among SMEs when procuring services.

Case Study: Cookability⁴⁴

In 2001 Gareth & Kristy Kitchen bought a cookery shop in Wotton-under-Edge as a going concern with the deliberate intention of turning it into an e-commerce business. The website launched 18 months later and since then the online business has expanded; it now has three part-time employees, and the turnover of the online business far exceeds that of the store. *“If it hadn’t been for the website the shop would no longer exist”*.

Gareth, who has a background in IT, developed his own website, the sole channel to online markets. Online marketplaces are not used as the fees are seen as high relative to the cost of sale on the Cookability site. For the same reason the site uses Protx (SagePay) for payment rather than PayPal.

About 90% of the website’s traffic comes in via natural search. The site comes top of Google natural search listings for some specialist items / terms but much lower for more generic terms. *“That’s just the way that search engines work. Coming top on everything is the holy grail.”* Overall, the business is highly dependent on Google: *“If they switched off Google tomorrow we would be dead in the water. It is a worry.”* The business has looked at other online marketing options (paid search, price comparison sites) but found that it is difficult to make the economics work for low value items.

3.2 Marketing and brand

Online marketing is developing at a fast pace and has created new opportunities for SMEs that trade online (and offline). Specifically, the cost barriers to SMEs advertising to small niche and / or geographically dispersed audiences and people in the process of making a buying decision have decreased dramatically, primarily due to search. Currently search is the form of online marketing that

⁴² Examples of web agencies are listed at www.website-design-directory.co.uk and www.freeindex.co.uk

⁴³ Examples of web hosting companies are listed at www.hostfinder.co.uk and www.freeindex.co.uk

⁴⁴ www.cookability.biz

accounts for the largest amount of spend, though alternatives such as affiliate marketing share some of the characteristics of search and are increasingly viable for SMEs, depending on the business sector. Social networking offers new and different opportunities (e.g. engaging with 'fans').

Google is the market leader in search, and some SMEs are reliant on Google and are sensitive to changes in its system. SMEs may find it more difficult than larger businesses to achieve high natural (free) search rankings due to the relatively small size of their websites and their lack of resources available to generate original web content. Affiliate marketing and social networking are competitive and in most cases provide SMEs with the opportunity to achieve their marketing objectives (e.g. gain high visibility). Anecdotal evidence suggests that some SMEs are using these online marketing channels, potentially as a substitute to search.

3.2.1 Online marketing options

There is an increasing range of online marketing methods available to and accessible to SMEs. The implication is that any current reliance of SMEs on particular marketing mechanisms, particularly search, may decrease in future.

Table 3-1 compares the features and applications of the main types of online marketing at a simplified level. Different mechanisms tend to play different roles, but there is a degree of substitution between them, though this varies by product / service type.

Table 3-1: Comparison of online marketing methods

Marketing method	Applications (simplified)		
	Acquiring new customers	Building brand and reputation	Communicating with customers
Search marketing	●	○	○
Affiliate marketing	●	◐	○
Display advertising	◐	◐	◐
Social networking	◐	●	●
Classified advertising	●	○	○
Email marketing	○	◐	●

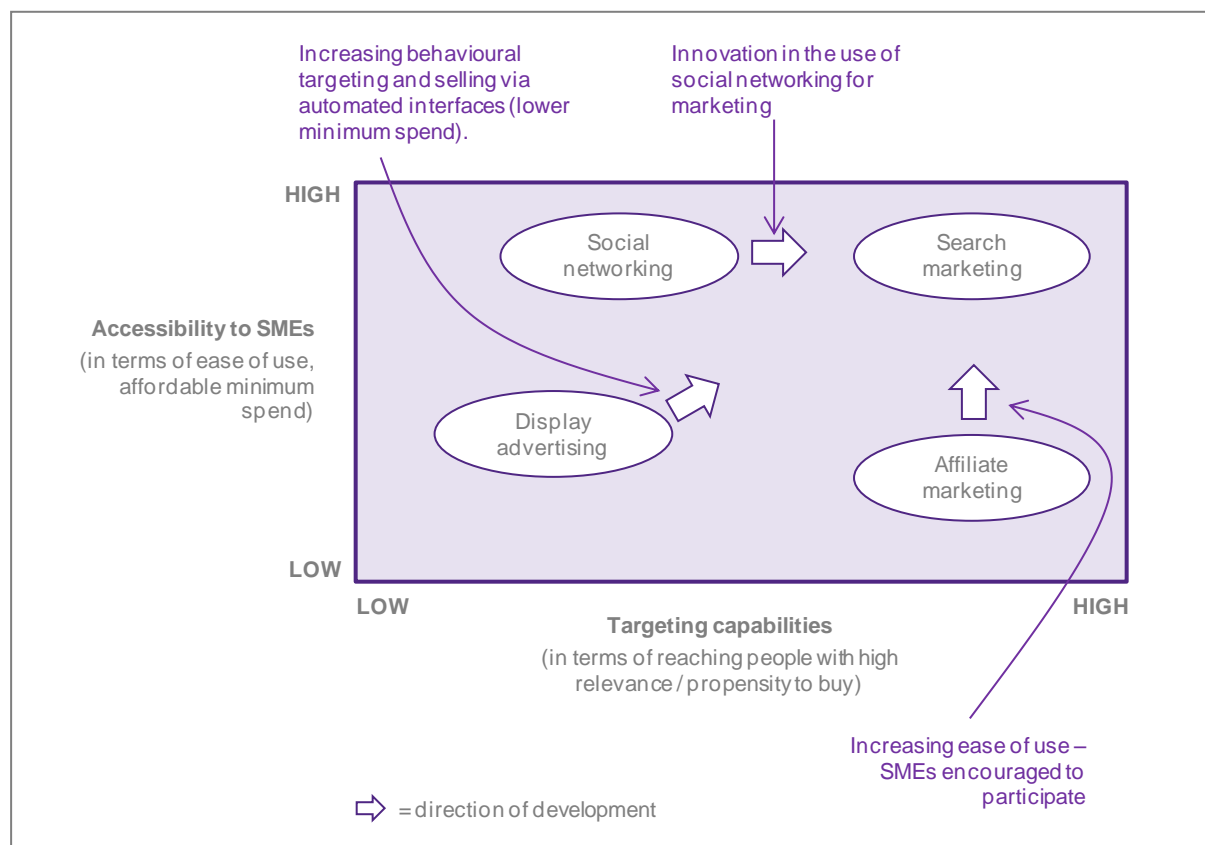
Key: ○ = low suitability, ● = high suitability. **Source:** Plum Consulting.

SMEs' websites also fulfil all three of the marketing applications listed above. However, these sites must first attract consumers which may rely on natural search, search marketing or other ways of acquiring traffic.

One of the key developments is the increasing range of marketing mechanisms that SMEs can use to acquire customers. Figure 3-2 shows how social networking, display advertising and affiliate marketing are increasingly developing characteristics that make them alternatives to search for online

customer acquisition. The oval shapes show the current position of each marketing mechanism on a matrix of accessibility to SMEs vs. targeting capabilities. The arrows show the direction in which these mechanisms are developing.

Figure 3-2: Development of online marketing mechanisms used for customer acquisition



The following sections discuss four areas: search marketing, affiliate marketing (including price comparison), display media and social networking. Online classified advertising and email marketing are also significant opportunities for SMEs. We found that there are not significant barriers to SMEs using them or other issues in these areas, so these are not considered further.

3.2.2 Search engine marketing

Search marketing (paying for sponsored links in search results) provides a way for SMEs to acquire leads / customer intent that was not previously possible. Search marketing accounted for 61% of internet advertising spend in 2009⁴⁵. Costs of entry are minimal (e.g. bidding may start at 10p) and SMEs have control over the amount they spend (e.g. they can pre-set caps). Google is the market leader, and some SMEs are reliant on Google and are sensitive to changes in its system. SMEs may

⁴⁵ PricewaterhouseCoopers / Advertising Association / Internet Advertising Bureau / WARC. Fact Sheet: Online adspend – Full Year 2009. http://www.iabuk.net/media/images/iabresearch_adspend_adspendfctshth2009_6332.pdf

find it more difficult than larger businesses to achieve high natural (free) search rankings due to the relatively small size of their websites.

Search engines are automated systems that match website links to keywords

Search engines are systems that match website links to users' search terms according to a set of rules. Search engine businesses make money from selling sponsored links on search results pages on a per-click basis. They are incentivised to provide highly relevant results as these maximise the number of search requests (users will make more searches if the results are relevant and useful) and the proportion of links that consumers click on (they will be more likely to click on relevant links).

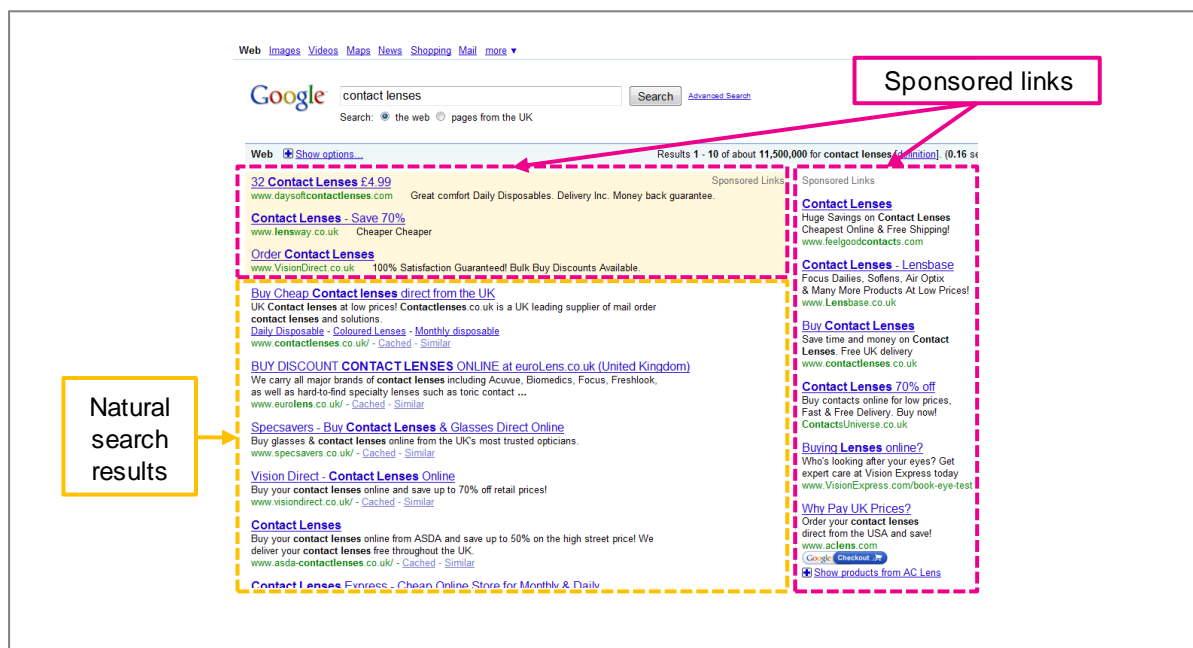
Figure 3-3 illustrates the two kinds of search results that are shown in response to a Google search query. Two systems determine the listings in two parallel sets of results:

- Natural search listings that follow a ranking determined by the Google search algorithm which is proprietary and constantly evolving. This algorithm aims to identify pages that are relevant and authoritative. It uses criteria such as relevance of a page's contents to a search term and the number of web pages that link to a particular page (inbound links). Indexing of websites is automatic and free to the website. SMEs may take technical steps to make their sites perform better in the algorithm – this is known as “search engine optimisation”.
- Sponsored search listings that are purchased by advertisers through an auction-type model. Advertisers ‘bid’ an amount they are willing to pay for a click on a particular search term. The ranking of page links in Google sponsored search results is determined by the product of the bid price and a site's quality score (an indication of a site's ‘quality’ that is determined by Google). Advertisers pay the bid price for each click on their website listing.

Prominent position in the results page is important: a study of consumer behaviour showed that 40% click the first listing in the results, 16% the second, 10% third and 5-6% positions 4-6⁴⁶. There is a more detailed explanation of how search works in Appendix B.

⁴⁶ Search Engine Guide/Cornell University, September 2005

Figure 3-3: Example of Google natural and sponsored search results



Search engine marketing has created distinct new opportunities for SMEs

Search engine marketing (the use of sponsored links) has distinct features relative to other forms of marketing. Key points include:

- It delivers intent i.e. by entering a search term consumers are, in most cases, revealing something about their current activity or intention (e.g. the search term “LCD TV” is linked to a high probability that someone is researching the purchase of a new television set).
- Advertisers pay for actual website visitors rather than paying each time an ad is shown.
- There is no minimum spend e.g. advertisers can start bidding at 10p.

Some SMEs are reliant on Google and are sensitive to changes in its algorithm

Due to Google’s high market share, those SMEs that depend on search for traffic also depend on Google. They will be sensitive to changes in the search algorithm and may find it more difficult than larger companies to achieve a high ranking in natural search listings.

Google is the market leader in search: it received and served 92% of UK search requests in January and February 2010⁴⁷ and took 87.2% of search marketing spend in Q1 2010⁴⁸. Yahoo! and Bing (Microsoft’s search engine) are the main challengers, each with a 3% share.

Small businesses are relatively more dependent on search than larger ones as indicated by the fact that a larger proportion of their traffic comes from search⁴⁹. In our view this is because larger

⁴⁷ StatCounter Top 5 Search Engines in United Kingdom from Jan 09 to Feb 10. http://gs.statcounter.com/#search_engine-GB-monthly-200901-201002.

⁴⁸ Efficient Frontier, UK Search Engine Performance Report : Q1 2010.

companies have larger marketing budgets that enable them to use more marketing channels than an SME e.g. press, television, radio and internet display. This large scale of marketing will drive traffic to websites in addition to the traffic delivered by search. Similarly, consumers may be more likely to recall the URL of a big brand and access it directly without using search.

SMEs may find it more difficult than larger businesses to achieve high natural search rankings as the relatively small size of their websites means they will perform less well on search criteria such as frequency of update and number of inbound links. In our view this is not a form of discrimination against SMEs but a feature of the system in which they operate, analogous to the difficulty of SMEs achieving visibility in the physical world.

SMEs are also sensitive to any changes in the way that Google's algorithms work. Specific issues may arise due to changes in the criteria / algorithm used to determine:

- Page rank (natural search) – changes may lead to higher / lower rankings.
- Quality score (search marketing) – changes affect the cost of acquiring clicks.

SMEs are able to respond to these changes by adapting their sites: search engine optimisation (SEO). However, SMEs will have fewer resources for SEO than larger competitors which may put them at a relative disadvantage.

In relation to the second point, the European Commission has launched a preliminary antitrust inquiry into the way that Google determines quality scores⁵⁰. The three companies complaining provide search / comparison services in specific vertical segments (e.g. ejustice.fr - legal information). We note that the vast majority of SMEs do not provide search / comparison in vertical segments so would not be affected by this particular issue.

Local search may become more important in future

Local search is becoming increasingly important, is closely associated with the development of the mobile internet and provides new marketing opportunities for SMEs that address local markets online or offline. The market is currently competitive, and services are often provided for free.

Local search is increasing in importance, particularly due to the take up of smart phones. Google first launched a local search service in 2004, and later integrated it with its Google maps product (which was launched in 2005). Local search results may appear within standard Google search results. Recently, local search has grown in importance due to uptake of smart phones, some of which may enable individuals to be located by GPS. Search results appear in order of proximity, often with supplementary data (e.g. maps). On the iPhone, for example, there are already tens of applications with this functionality including *Yelp*, *AroundMe* and *Yell.com*.

The implications of local search for SMEs include:

- SMEs that address local markets online or offline may find it easier to achieve prominence in local search results than in general search results as the relevant competitive set is smaller.

⁴⁹ Econsultancy blog : Small businesses rely more on search engines. <http://econsultancy.com/blog/1814-small-businesses-rely-more-on-search-engines-hitwise>

⁵⁰ Google. European Public Policy Blog. "Committed to competing fairly." <http://googlepublicpolicy.blogspot.com/2010/02/committed-to-competing-fairly.html>

- SMEs that trade offline have the opportunity to reach consumers at an appropriate point in the buying process (e.g. as people are in the high street).

Due to the competitive nature of the market it is currently very cheap (or even free) for local businesses to list using these services e.g. there is no cost for local businesses to register with Google. However, this reflects a stage in market development in which search providers are aiming to develop comprehensive listings, and may change as the market consolidates.

3.2.3 Affiliate marketing (including price comparison)

Affiliate marketing (which includes price comparison websites) is accounting for increasing spend: £227 million of commissions and fees in 2008, growing at 22% per annum⁵¹. SMEs are participating and affiliate marketing may in some cases provide an alternative to search. Most affiliate marketing services are objective, giving SMEs the opportunity to gain prominence.

Affiliate marketing includes various models in which advertisers pay per customer acquisition

In an affiliate marketing model advertisers pay only for leads that result in a purchase: they pay per “acquisition”. Third-parties conduct marketing activity to attract these leads which are then passed on to the advertiser, and payment is made for results.

The affiliate model flourishes in product areas in which the per-acquisition fee is high, providing a strong incentive for affiliates. Typically, affiliates aim to insert themselves in the customer buying process, maybe by assisting customers compare prices (e.g. on car insurance) or providing details of different financial services products.

There are various different types of affiliate:

- Price comparison sites – where users can quickly compare prices across different providers of the same commodity item (e.g. televisions), or compare the features of more complicated products.
- Review sites and content sites - aggregate opinions submitted by past buyers / users; important for experience goods, for example the hotel and restaurant sector.
- Voucher code, cash back and rewards sites – incentivise purchase via discounts or other benefits, analogous to a supermarket loyalty card programme.
- Shopping directories / vertical search / product listing sites - list different providers of a product / service.

In future new types of affiliate may emerge that do not fit neatly into the above classification, either because they offer a new type of service, or because they combine multiple elements (e.g. price comparison with user reviews). As barriers to entry are low we would expect new services to launch in this area, particularly in underserved segments (e.g. niche product areas) that will increase the opportunities available to SMEs.

⁵¹ Econsultancy - Affiliate Marketing Buyer's Guide 2009, <http://blog.affiliatetip.com/archives/uk-affiliate-marketing-to-generate-4-billion-in-2009/>

Affiliate marketing is increasingly viable for SMEs and may substitute for search

Affiliate marketing is accessible to SMEs. It enables them to compete with larger advertisers and may provide an alternative to search marketing in some cases. For SMEs setting up on affiliate marketing services ranges from straightforward (e.g. Google Product search) to requiring technical capability and the provision of advertisements in graphical form (e.g. affiliate networks).

As in search results, some listings on affiliate sites have a higher ranking / more prominence than others. In our view there is pressure from consumers for prominence to be objective i.e. determined by objective criteria such as price (price comparison sites), ratings (review sites) or relevance (other sites). Sites that have given paying advertisers prominence in a non-transparent way have suffered from bad publicity which may have affected consumer trust in them. For example, lawsuits have been filed in the US against Yelp.com, a review site⁵². It has been accused of deleting favourable reviews of companies that refused to take paid advertising on the site, thereby giving more prominence to sites that did advertise.

Affiliate marketing can form part of the marketing mix for SMEs, and may complement search marketing or provide an alternative to it in some cases. Examples of SMEs making use of affiliate marketing include:

- Price comparison site Kelkoo⁵³ lists products from SMEs alongside those of major retailers⁵⁴.
- Spa listing / review site Wahanda⁵⁵ does not charge for basic listings, encouraging SMEs to sign up. Listings include many SMEs.

Illustrative example: Price comparison sites are being used by SMEs

Price comparison sites provide SMEs with a way of acquiring customers that may substitute for search in some cases. Price comparison sites aggregate data from participating retailers / service providers and show users prices from different providers in response to searching for / browsing to a category / item. SMEs are able to participate in price comparison services by providing relevant data. Price comparison sites offer SMEs a level playing field as listings are in order of price, not company size. Provided that SMEs can compete on price they can achieve prominence. For example, SMEs rate achieve high rankings in the following cases:

- On Kelkoo the search term “sony vaio power supply” gives results⁵⁶ that include two SME retailers (Smart-Parts.net and Toppower.co.uk), eBay and Amazon Marketplace.
- On Pricerunner the search term “contact lenses” gives results⁵⁷ that include only SMEs.

⁵² TechCrunch blog. “Class Action Lawyers Declare Victory Over Yelp, Still Want Damages.”

<http://techcrunch.com/2010/04/06/yelp-class-action/>

⁵³ www.kelkoo.co.uk

⁵⁴ Not all price comparison sites operate in this way. Different business models exist in affiliate marketing,

⁵⁵ www.wahanda.com

⁵⁶ <http://shopping.kelkoo.co.uk/ctl/do/search?siteSearchQuery=sony+vaio+power+supply&fromform=true>

⁵⁷ http://www.pricerunner.co.uk/cl/334/Contact-lenses?ref=redirect&q=contact+lenses&other_hits=346:contact+lenses|200:contact+lenses|361:contact+lenses|456:contact+lenses|x:::&sort=4&search=1+day+acuvue+moist

3.2.4 Display media

Internet display advertising is not currently widely used by SMEs due to high minimum spend levels as is the case with offline display media (e.g. newspapers), but accessibility will increase due the use of automated systems to sell inventory in smaller quantities (with lower minimum spend levels). Display advertising is also becoming more targeted (capable of reaching specific groups with a high propensity to buy) making it an alternative to search marketing in some situations.

There is currently limited use of internet display advertising by SMEs

Display advertising is the sale of online “ad space” on a tenancy or per view basis: it is the online equivalent of advertising in print in which ads are placed alongside content. Display ad space is offered directly by web publishers (e.g. newspaper websites) and indirectly by ad networks that aggregate space across multiple websites.

There is limited use of display advertising by SMEs due to high minimum spend levels. Display advertising on major publishers’ sites is relatively inaccessible to SMEs, as publishers (or ad networks representing them) insist on a minimum level of spend (e.g. £5,000 on MSN⁵⁸). Display advertising on niche audience publications such as trade journals and local media may be more accessible, but this depends on advertisers being able to make deals with individual publication owners.

In future display advertising could become an increasingly viable option for SMEs

In future, display advertising could become an increasingly viable option for SMEs. Key developments include:

- Further improvement of behavioural targeting systems so that advertisers can target ads at audiences with particular characteristics (inferred from their browsing history or other data).
- The use of online interfaces to sell advertising - Google, Microsoft and Yahoo! are increasingly selling display ads through online interfaces at low spend levels, enabling SMEs to participate more easily. Google, for example, has explicitly said that it wishes to do for display advertising what it has already done for search engine marketing with AdWords.⁵⁹

3.2.5 Social networking

Social networking offers SMEs new marketing tools

The recent growth of social networking services including Facebook and Twitter offers SMEs a toolset to attract and retain customers and build brand visibility and loyalty. Consumers are spending an increasing amount of time on social networking sites, globally an average of five and a half hours per

⁵⁸ <https://advertising.microsoft.com/uk/advertise-on-Microsoft-Advertising>

⁵⁹ Business Week. “Google’s Display-Ad Sales Should Top \$1 Billion.”
http://www.businessweek.com/technology/content/feb2010/tc2010027_356976.htm

user in December 2009, 82% more than a year earlier.⁶⁰ These services and their use for marketing is an area of constant innovation. The main marketing applications to-date include:

- Businesses monitoring what their customers are saying about them.
- Connecting and engaging with (prospective) customers discussing related products and services, with a view to improving their view of a company / products.
- Nurturing and encouraging “brand advocates” who will then use their own social networks to promote the SME’s products and services.

Examples include creating “fan pages” on Facebook and the development of Facebook apps. Facebook also sells display advertising which is considered in the preceding section. On Twitter SMEs can broadcast directly to a set of self-selected followers. SMEs can also add social features to their own websites and engage with their prospective customer base on niche social networking sites e.g. Mumsnet⁶¹.

Entry costs are low and social networking may substitute for other forms of marketing

Barriers to the use of some forms of social networking for marketing are effectively zero. We found that many of the SMEs interviewed are using social networking (e.g. they are active on Twitter). However, developing applications for Facebook and creating videos for viral campaigns involve substantial up-front costs that would deter SMEs from participating. At this stage it is unclear to what extent social networking has become a substitute for other forms of marketing.

Though it is uncertain how social networking will evolve it is likely that it will lead to more and different marketing opportunities for SMEs that may complement or provide alternatives to other forms of marketing.

Case study: Olivia Rubin⁶²

Olivia Rubin is an independent fashion designer who set up her own label in September 2007. She launched a basic website in September 2008 and updated version including an online shop in February 2009.

The website has proved to be a key enabler for the business. It helped to secure a growing number of online stockists including Asos, Coconut Alley, and Amelie Boutique. Previously most of her stockists were independent boutiques. In addition, having a website meant that press articles on Olivia’s designs could link directly through to her own website, rather than one of her stockists). Lastly, it provided a sales channel she could use to sell at retail rather than wholesale prices.

Her business has gained an enormous amount of momentum, and her clothing has been worn by a number of high profile celebrities including Cheryl Cole and Ferne Cotton. Online and social media in particular has been important in building that momentum: Olivia blogs daily, uses Twitter and Facebook extensively as well as more traditional PR, catwalk and fashion shows. Twitter has been useful in building up relationships with stockists and press, as well as being a cost-effective channel to advertise promotions directly to Olivia’s fan base.

⁶⁰ Sfnblog.com “Nielsen: Global time spent on social networking sites up 82% year on year.”

http://www.sfnblog.com/industry_trends/2010/01/nielsen_global_time_spent_on_social_netw.php

⁶¹ <http://www.mumsnet.com/>

⁶² <http://www.oliviarubinlondon.com/>

3.3 Payment and security

Online payment services, particularly integrated payment gateways (e.g. PayPal and Google Checkout), have lowered the cost of setting up to take online payment enabling SMEs to sell goods and services online and to do so cross-border. Integrated payment gateways also provide a way for SMEs to overcome reputational / trust barriers.

PayPal is the leading integrated payment gateway and has a strong market position. We found that some online discussion forums have reports of PayPal suspending accounts following disputed transactions. This is disruptive to the merchant, though the intention is likely to be fraud prevention. There are similarly priced alternatives to PayPal (e.g. Google Checkout).

PayPal has opened its platform to third-parties to build applications which may stimulate innovation and extend the reach of the service to new areas (e.g. consumers paying a carpenter face-to-face using a mobile phone application rather than cash or a cheque).

3.3.1 Secure online payment requires a complex set of systems

To benefit from the opportunities of online transactions, SMEs need a system to take payment from credit / debit cards, security in order to protect both the buyer and seller from fraud, and in some cases the ability to transact cross-border. The systems involved in doing this are complex, but in a simplified model the key elements are:

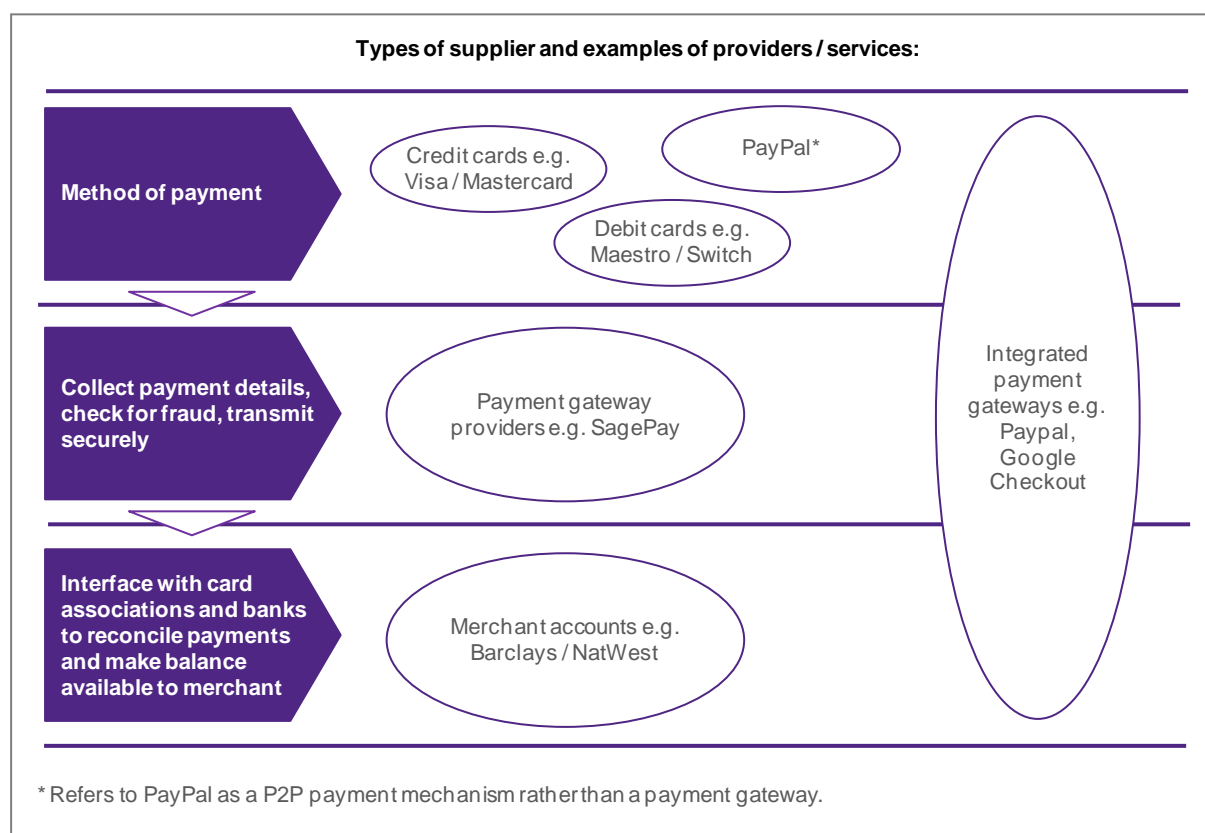
- Method of payment – typically a credit card or debit card.
- Way to collect details and transmit them securely – systems that provide secure forms and secure connections with relevant parties (e.g. card associations).
- Reconciliation with banks and card associations and transfer of money to merchants – accounts that can interface with card associations and banks in order to take payment.

There are two main options to put this capability in place, as

Figure 3-4 shows a simplified form. SMEs also have the option of using online marketplaces which handle payment (see section 3.6). Some SMEs may also take customer details using a web form and enter these manually into a credit card terminal (not shown on the diagram). The level of security of this method is low, which is likely to discourage use by merchants and consumers. However, many consumers may not be aware of the difference between a web form and a secure payment mechanism despite attempts by browsers to highlight sites with poor security⁶³.

⁶³ In theory consumers can identify the difference by (i) the address bar reading https:// rather than http://, (ii) a small padlock that appears on most browsers (e.g. bottom right on Firefox). (iii) warnings / advice from the browser in the event that a website tries to establish a “secure” connection (i.e. https) without a valid certificate.

Figure 3-4: Online payment options for SMEs⁶⁴



3.3.2 Integrated payment gateways have lowered the costs of setting up to take payment online

Online payment services, particularly integrated payment gateways (e.g. PayPal and Google Checkout), have lowered the cost of setting up to take online payment enabling SMEs to sell goods and services online and to do so cross-border. They also help SMEs to overcome reputational / trust barriers.

Without integrated payment gateways, SMEs would experience cost and, more significantly, practical barriers to setting up to take payment online. They would have to use a payment gateway (a service to securely take card details and interface with card associations e.g. SagePay and Worldpay) and a merchant account (to accept payment from card associations). This is shown on the left hand side of Figure 3-4. There are some practical barriers to obtaining a merchant account: the SME needs to be a registered business and the business and its directors need to have a good credit history.⁶⁵ Some technology know-how is required to integrate the website and payment technology. Overall, the technology and form filling effort may act as a barrier for some SMEs. There are also costs: a

⁶⁴ In addition, SMEs may take payment using non-secure online forms or by email but we have assumed that very few SMEs will do so in future.

⁶⁵ An outline of all the requirements for opening a merchant account can be found at Business Link: Practical advice for businesses: Accepting online payments.

<http://www.businesslink.gov.uk/bdotg/action/detail?r.s=m&r.l1=1073861169&r.lc=en&r.l3=1073920405&r.l2=1079589261&type=RESOURCES&itemId=1073791017>

merchant account at a typical UK high street bank might cost £200 to set up⁶⁶ and charge a minimum £20 a month: this is more than PayPal but affordable for most SMEs.

The innovation came from PayPal which provides an integrated payment gateway (right hand side of diagram). Sellers that use PayPal's gateway do not need a merchant account, which is effectively a part of the PayPal service. There are no setup costs and no minimum monthly fees, though PayPal charges transaction fees (the percentage depends on the volume and value of sales processed). . PayPal fees (as a proportion of transaction values) are higher than most merchant accounts / SagePay, though there is no monthly fee. Businesses that sell high value items may find PayPal more expensive, but this varies according to the interplay between volume and value of transactions. PayPal also simplifies cross-border payment, which enables SMEs to export: for example, 25% of PayPal total payment volume was cross-border in 2009⁶⁷. Google Checkout offers a similar service to PayPal.

Integrated payment gateways also provide a way for SMEs to overcome reputational / trust barriers. 55% of UK online shoppers "worry about fraud" when shopping online⁶⁸, which may lead them to favour sites that use integrated payment gateways. By allowing SMEs to take payment under the umbrella of their brands integrated payment gateways are lending SMEs the credibility and trust that these brands imply.

PayPal also provides a peer-to-peer payment system. Participants set up permanent PayPal accounts that link to their cards / bank accounts. Payments are authorised by the buyer entering a username and password on the PayPal site and funds are transferred to the seller's PayPal account without card details being shared with the seller. SMEs using the PayPal integrated payment gateway are able to accept payment from consumers' PayPal accounts. Other payment gateways (e.g. SagePay) may also accept payment from PayPal accounts.

Online marketplaces (e.g. Amazon) that typically take payment directly from consumers and distribute the appropriate share to merchants provide a third option. The UK eBay marketplace requires sellers to offer PayPal payment (potentially though it does not restrict the use of other payment options in addition to PayPal). For the merchant the entry cost of the marketplace approach to payment is zero. This is discussed in more detail in section 3.5.

3.3.3 Market structure and conduct

Online payment gateway services are offered by several companies including SagePay, RBS WorldPay and 2Checkout. PayPal (owned by eBay) and Google Checkout offer integrated payment gateways. PayPal was used by 32% of SME retailers in 2008, RBS WorldPay (16%) and SagePay 15% in 2008⁶⁹.

⁶⁶ Business Link: Practical advice for businesses: Accepting online payments.

<http://www.businesslink.gov.uk/bdotg/action/detail?type=RESOURCES&itemId=1073791013>

⁶⁷ eBay. Annual Report 2009. http://files.shareholder.com/downloads/eBay/937102382x0x361552/b45137ee-aa41-4c2c-94ca-d72d5b0844be/eBay_77655_BANNERLESS.pdf

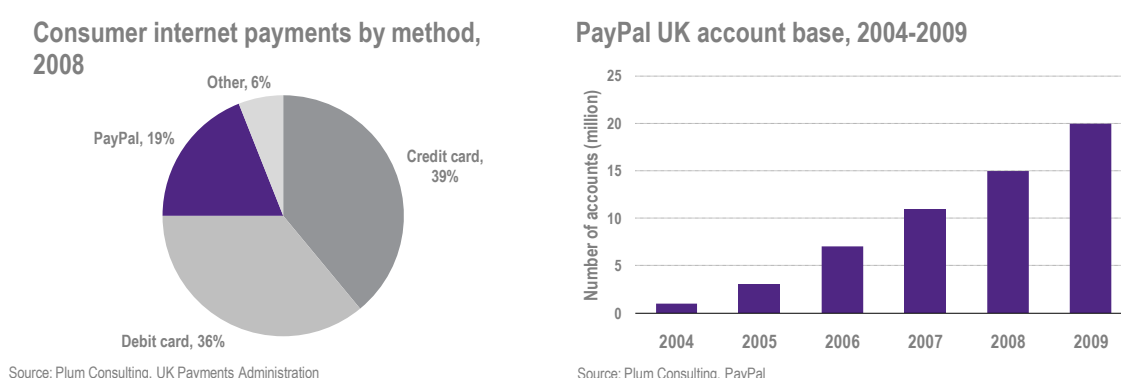
⁶⁸ NMA / Lightspeed research, Online Shopping Survey, December 2009 - <http://www.nma.co.uk/data/online-shopping-survey-2010/3008738.article>

⁶⁹ Actinic SME Retail Technology Report 2008. <http://downloads.actinic.com/docs/Actinic-SME-Retail-Technology-Report-2008.pdf> Based on survey of 277 SMEs

PayPal is currently the most widely used peer-to-peer payment system: Figure 3-5 illustrates its historic growth and current share. Google Checkout launched in June 2006 and has not yet published results.

Pricing on the PayPal and Google Checkout gateways is currently almost identical, set at 20p per transaction plus a commission fee which varies from 3.4% for sales for monthly revenues below £1,500 to 1.4% for revenues above £55,000. PayPal offers an additional subscription fee of £20 per month for its 'Website payment pro' service that allows SMEs to host payment on their websites without redirection to the PayPal site⁷⁰.

Figure 3-5: PayPal share of payments and UK peer-to-peer account base



Consumer protection activities may disrupt some businesses

PayPal engages in consumer protection activities that provide benefits for SMEs but may disrupt some businesses. PayPal offers consumers protection against unscrupulous sellers⁷¹ (e.g. those that take payment for an item and never deliver it). Buyers who pay via PayPal may complain to PayPal in cases of non-delivery, initiating "dispute resolution" that may result in a refund. In order to ensure that sufficient cash is available for refunds, PayPal sometimes holds payments. In these cases merchants are provided with access to the funds either after the buyer leaves positive feedback (if they have purchased via eBay), or after 21 days if the buyer has not complained (if the buyer bought on either eBay or an independent website). PayPal employ a statistical / algorithmic approach to work out where claims are likely to occur and hence when to hold money: sellers with a long history of trading without provoking customer disputes are less likely to have funds held than new businesses with shorter trading histories, or those selling high risk items. Though affected businesses may be temporarily disrupted if funds are held, on the whole businesses benefit from the confidence that PayPal inspires in their customers.

⁷⁰ For Paypal pricing structure see <https://www.paypal-business.co.uk/website-payments-standard-what-it-costs.asp> and <https://www.paypal-business.co.uk/website-payments-pro.asp>. For Google Checkout pricing structure see <https://checkout.google.com/seller/fees.html?hl=en&gl=GB>.

⁷¹ <http://www.paypalwarning.com/>
<https://www.paypal-marketing.co.uk/safetyadvice/BuyerProtectionOffEbay.htm>

Some online forums report PayPal suspending accounts following disputed transactions⁷² which the sellers concerned perceived as unfair. Our interviews with SMEs did not reveal any complaints about the conduct of PayPal

Both PayPal and Google Checkout cross-promote with services in adjacent sectors. eBay in the UK requires that sellers offer a PayPal payment option, though not to the exclusion of other payment methods. Similarly use of Google Checkout is incentivised through offers of free Google Adwords.

PayPal has opened its platform to third party developers

The nature and dynamics of the online payments market are likely to change due to PayPal opening its platform to third party developers in late 2009⁷³. This enables developers to create innovative new applications that make use of PayPal's back-end payment gateway capability. We speculate that new developments could include, among others, peer-to-peer payment on mobiles and "Tweeting" money. The key consequence is that the reach of the service could extend to new areas e.g. a plumber taking payment through peer-to-peer mobile payment after completing a job or a publisher receiving micropayments for content. Whilst PayPal today is a main payment processing technology in ecommerce, the opening up of the PayPal platform is likely to mean PayPal is used to process payment in a much broader range of businesses and sectors.

The opening of the platform also alters market dynamics. If successful, it would increase innovation and enable a set of payment providers that use the PayPal platform, but at the same time may embed the market position of the underlying platform.

3.4 Fulfilment

Fulfilment for online retailers and wholesalers involves warehousing and physical delivery services (e.g. postal services), while for businesses with a digital product (e.g. online publishers, software vendors) it involves distribution over the internet. Some SMEs and online service companies interviewed for this project raised concerns over dependence on the Royal Mail for physical delivery, so we have included the issue despite services being provided offline.

3.4.1 There may be limited competition in distribution

Some SME retailers are dependent on distribution services in which competition is perceived to be limited. However, online services may stimulate increased competition in future.

Online retailers are highly dependent on delivery services, particularly as consumers attach a high value to timely delivery. One online retailer that we interviewed believed that the customer ratings of sellers that appear in online marketplaces (see section 3.5) are sensitive to the quality of delivery services, so the latter will have an impact on future sales. Better postal / delivery services were the

⁷² <http://www.nopaypal.co.uk/forum/>

⁷³ "Paypal to become first truly global payment platform open to third-party developers" <https://www.paypal-media.com/releasedetail.cfm?ReleaseID=398758>

second highest priority for online retailers selling on eBay, 42% rated this as a priority⁷⁴. Distribution is typically carried out by specialists (e.g. Royal Mail, TNT) with the exception of some local firms (e.g. florists) which make their own deliveries.

Several industry participants and SMEs that we interviewed believed that there is limited competition in the market for the distribution of small packages (e.g. DVDs and books), with a high level of dependence on the Royal Mail. The strike action at the end of 2009 was disruptive to their businesses. One SME retailer we interviewed was aware of alternative providers, but hesitant to use them due to a perception of slower delivery than the Royal Mail due to the need for alternative providers to use the Royal Mail for the 'last mile'.

Online retail may, however, stimulate increased competition in the provision of delivery services. Some online retailers (mainly larger ones at present) offer consumers a choice of delivery provider at checkout, showing a comparison of delivery providers, their times and prices. Technology from Metapack⁷⁵, for example, enables retailers to support multiple delivery providers. In future these or similar services may be more widely used by SMEs, enabling them to give consumers choice which may stimulate increased competition in delivery services in future.

3.4.2 Warehousing is not a significant barrier to setting up retail businesses online

Anecdotally we found that warehousing is not a significant barrier to setting up SME retail businesses online as the smallest firms were able to store goods at home or in retail premises, with the option to invest in warehousing as their business scales. Barriers to setting up warehousing on a larger scale have decreased due to the Fulfilment from Amazon, a service that enables online retailers to store goods in the Amazon warehouse, and dispatch from it, for a fee (see section 3.5). There are other companies offering comparable services e.g. Lynx Fulfilment⁷⁶.

3.5 Online marketplaces

Online marketplaces have significantly reduced barriers to entry for SMEs wishing to retail online and now enable a tier of small online retailers to operate, as well as supporting larger retailers. eBay and Amazon Marketplace are the major online marketplaces. These companies are dependent on SMEs to serve the range of needs of their customers, and there is competition between marketplaces for the business of SMEs (and consumers). Marketplaces also compete with paid search and online classified sites in the provision of marketing services.

3.5.1 Marketplaces have made it easier to set up to sell online

Online marketplaces have made it easier for SMEs to set up to sell online by reducing costs and helping SMEs to overcome reputational barriers.

⁷⁴ eBay Online Business Index, Autumn 2009. Survey of 508 top eBay sellers.

http://pages.ebay.co.uk/businesscentre/OBI_Autumn2009.pdf

⁷⁵ <http://www.metapack.com/>

⁷⁶ <http://www.lynxfulfillment.com>

3.5.2 Marketplaces have reduced the cost of setting up to sell online

Online marketplaces have significantly reduced the cost of setting up to sell online by providing web presence, marketing, payment, and, in some cases, fulfilment. Online marketplaces benefit from economies of scale, so they can offer these services at a relatively low cost. SMEs using marketplaces can sell online through a single supplier relationship instead of creating their own website, doing their own marketing and managing their own payments.

3.5.3 Marketplaces help SMEs to overcome reputational barriers

Online marketplaces have also made it easier for SMEs to overcome reputational barriers to trading online. Trust and reputation are important to reassure consumers who are shopping online: 72% of online shoppers had concerns in January 2009, of which security issues (68%) and privacy issues (28%) were the most important⁷⁷. This may lead to a preference for trusted brands online, though there is no up-to-date survey data to prove this. To independently establish a reputation online requires the expense of marketing and developing a professional-appearing website. Online marketplaces have, however, provided alternative lower cost ways to build reputation online:

- Sheltering under the brands of marketplaces which to some extent lend their brands to the SMEs that use them, providing some consumer reassurance.
- Displaying customer feedback – online marketplaces show ratings for each seller based on customer feedback. These allow SMEs to quickly build a reputation.

The disadvantage for SMEs of marketplace-based ratings is that the rating is not independent of the marketplace.

3.5.4 eBay and Amazon are the main online marketplaces

eBay and Amazon Marketplace are the largest online marketplaces. The following sections describe their services. Other online marketplaces are found in specific vertical sectors, with examples including: PlayTrade⁷⁸ hosted by Play.com (books, CDs, DVDs and games), PixMania (cameras and electrical items) and Abe.com (second-hand books).

eBay

eBay is an auction platform and a fixed-price marketplace, with the latter accounting for a growing share of its business: increasing from 49% of gross merchandise volume in Q4 2008 to 56% in Q4 2009⁷⁹. The marketplace covers a large range of product categories, from 'motors' to 'home and garden'. There were 120,000 registered businesses on eBay⁸⁰ in the UK in 2009, with 178,000 sellers

⁷⁷ OFT Findings from consumer surveys on internet shopping, May 2009, http://www.of.gov.uk/shared_of/reports/Evaluating-OFTs-work/oft1079.pdf

⁷⁸ <http://www.play.com/HOME/HOME/6-/LandingPage.html?page=playtradealt>

⁷⁹ eBay <http://www.ebayinc.com/page/search?query=fixed-price+sales#20100120006819>

⁸⁰ eBay. Defined as those sellers that voluntarily register as businesses or those that exceed a threshold for gross merchandise value and number of items sold – not a true measure of registered / VAT registered companies.

depending on eBay for some or all of their income. Table 3-2 lists eBay's marketplace services and pricing.

Table 3-2: Summary of eBay's services⁸¹

Service	Description	Pricing
Sell an item	Standard selling process used by businesses and individuals to list items on eBay. Option to sell at a fixed price or at auction. Finite listing time period.	Insertion (listing) fee from £0.40, or £0.20 for books, CDs, DVDs and video games. Final value fee (commission) varies by product category: <ul style="list-style-type: none"> • Media (books, CDs, DVDs, video games): 9% • Technology: 5.25% • Other – 9.9%
eBay shop	A shop within eBay. Retailers can bring their own look and feel to the shop and have a custom URL e.g. www.ebay.co.uk/yourshop Marketing tools to help retailers drive traffic e.g. XML file to link to price comparison sites / search engines.	Monthly fee: £14.99 (basic), £49.99 (featured), £349.99 (anchored). Reduced insertion and final value fees.

Sellers with sufficient monthly sales qualify for "Top Rated Seller" status which gives them a personal account manager and a discount on final value fees.⁸²

Items listed on eBay are seen by users as they browse, or in search results. The ranking of items in search results depends on relevance to the search term and the seller's rating as determined by buyers' feedback. The ranking depends on the average rating, so the system does not discriminate against small or new sellers that have not accumulated ratings from a large number of buyers⁸³. In addition to influencing rankings, ratings influence consumers buying decisions: shoppers tend to trust higher rated sellers. The effect of this feedback mechanism is to encourage sellers to offer good service. eBay sellers have to offer PayPal as a payment option, although they can also offer alternatives.⁸⁴ Though some sellers may complain about this, in our view it gives buyers greater protection which in turn benefits sellers.

Amazon

Amazon is an online retailer and marketplace, covering a range of product categories. It had 1.8 million third-party sellers on the platform worldwide in Q3 2009 of which some were businesses. These third-party businesses accounted for 31% of unit sales⁸⁵. (Amazon does not release UK-specific figures.) Table 3-3 summarises the main services that Amazon offers SMEs.

⁸¹ Prices listed in <http://pages.ebay.co.uk/help/sell/fees.html#BIN>

⁸² The discount is increasing in sales volume. <http://pages.ebay.co.uk/services/buyandsell/powerseller/criteria.html#a1>

⁸³ For details of eBay's "Best Match" ranking algorithm see <http://pages.ebay.co.uk/sell/sellerupdate/bestmatch.html>

⁸⁴ <http://tamebay.com/2008/03/paypal-made-compulsory-on-all-ebay-uk-listings.html>

⁸⁵ Personal communication, Amazon.

Table 3-3: Summary of Amazon's services

Service	Description	Pricing
Sell on Amazon	Sellers list items on Amazon which appear under the seller's name. Amazon processes customers' orders that are immediately passed on to sellers, and takes payment which sellers receive within 14 days.	Fees of 17.25% of sale price (less for consumer electronics, tools, car and motorbike parts) per item plus flat fee of £0.16 to £1.31 per item depending on item type and country item is dispatched to ⁸⁶
Fulfilment by Amazon	Sellers send labelled stock to Amazon which is stored in the Amazon warehouse. When an order is made Amazon picks, packs and delivers the item. Retailers may also use this service for orders taken through sites other than Amazon.	Amazon charges for inventory storage and on a volume per month basis. Separately, Amazon charges handling, picking and packing and weight handling fees per order which vary according to the size of the item. ⁸⁷
Amazon advantage	Amazon manages the entire listings and fulfilment process including pricing, storage and delivery. Items appear under the Amazon brand.	£25 per month excluding VAT

Like eBay Amazon has a customer ratings system. Some key features of the Amazon service, which differentiate it from eBay, include:

- Amazon.com lists side-by-side items (on what Amazon calls the "single detail page") from Amazon the retailer and items from third-party sellers which appear under either the third-party seller's name or the Amazon brand. Amazon therefore competes with third-party sellers in some cases.
- Amazon offers fulfilment services to third-party sellers.
- Amazon handles payment for all items on the site and passes on the balance to third-party sellers.

On 1 May 2010 Amazon UK introduced general terms and conditions that restrict third party sellers on Amazon marketplace from selling items on Amazon at higher prices than the same items on sellers' alternative online channels e.g. eBay or their own websites (such terms and conditions already existed in the UK for certain product categories and sellers)⁸⁸. The stated intention of the rule is to "increase customer trust" in Amazon's pricing i.e. to ensure that consumers get the lowest prices on Amazon. However, it may also limit the ability of online retailers to vary prices across channels in order to maximise profitability (though retailers they have the option of not listing on Amazon). SMEs may wish to offer lower prices on their own websites than on Amazon if:

- The absence of marketplace commission fees allows them to price lower than on marketplaces and retain an attractive margin.
- They believe that consumers using marketplaces have a higher willingness to pay than consumers using retailers' own websites.

One of the Amazon sellers that we interviewed varied prices by channel to reflect these factors.

⁸⁶ <http://www.amazon.co.uk/gp/seller-account/mm-product-page.html?topic=200314080>, last checked 11 June 2010

⁸⁷ http://www.amazon.co.uk/gp/seller/fba/fba_pricing.html last checked on 11 June 2010

⁸⁸ <http://www.amazon.co.uk/gp/help/customer/display.html?ie=UTF8&nodeId=200458310>

3.5.5 Dynamics of online marketplaces

The market is competitive and SMEs often use more than one marketplace

The market is competitive. Due to the low costs of setting up on marketplaces SMEs often use multiple marketplaces, effectively treating each as a separate marketing channel, though some smaller SMEs may use just one marketplace.

There is competition for online shoppers between different online marketplaces and retailers' own websites. The relative shares will vary by product segment: for example, it can be seen from the eBay and Amazon websites that eBay has a higher market share in collectable items and Amazon in second-hand books.

Larger SME retailers often diversify by distributing on more than one marketplace and their own websites. Of the top retailers on eBay, an average 37% of income comes from eBay and 10% from Amazon⁸⁹. Strategically it makes sense for retailers to maximise distribution outlets; barriers to entry are sufficiently low for them to do so with ease. The case study below illustrates this point well: Goldstone Books now distributes second-hand books on 12 different marketplaces.

Some small retailers and new entrants trade on only one marketplace as this is where they started and their businesses have not yet grown.

Marketplaces are dependent on SMEs so they are incentivised to support them

Online marketplaces are currently dependent on SME retailers for their success so it is in their interest to support them. We found that the position of sellers in listings is unrelated to company size and volume of transactions (depends on customer ratings) and that barriers to SMEs switching marketplace may not be an issue in practice. However, eBay, for example does offer discounted fees to sellers with high transaction volumes and good ratings through its 'Powerseller' programme⁹⁰.

Marketplaces are dependent on SMEs to extend their product range in order to serve a greater range of customers and meet an increasing range of their needs. For example third-party sellers (which include SMEs) accounted for 31% of Amazon's unit sales in Q3 2009⁹¹.

The pricing structure of eBay and Amazon does not appear to discriminate against sellers in categories in which either may have a strong position: the product categories used to determine pricing are too broad to single out particular product types (see Table 3-2: and Table 3-3:) for higher fees.

There are barriers to SMEs switching from one marketplace to another as customer ratings are not transferable and the seller may not have the right to contact customers except in relation to fulfilling an order (e.g. Amazon does not allow such contact⁹²). However, in our view the reality is that businesses could start afresh on new marketplaces with minimal effort so diversification rather than switching is likely to be the dynamic seen in practice, and any nominal lock-in is limited in its effect.

⁸⁹ eBay Online Business Index report, Summer 2009. Survey of 458 eBay retailers.

http://pages.ebay.co.uk/businesscentre/OBI_Summer2009.pdf

⁹⁰ <http://pages.ebay.co.uk/services/buyandsell/powerseller/benefits.html>

⁹¹ Amazon Q3 2009 conference call: <http://phx.corporate-ir.net/phoenix.zhtml?c=97664&p=irol-audioarchives>

⁹² Amazon Marketplace Participation Agreement - <http://www.amazon.co.uk/gp/help/customer/display.html?nodeId=3216781>

In future SMEs may take more services from marketplaces

In future SMEs using marketplaces may have to become more 'professional' to compete, but marketplaces are offering new services to help them do so.

Our interviews with SMEs and online marketplaces suggest that large-scale retailers are playing an increasing role in marketplaces, and that SMEs increasingly need to match their quality of service. A small number of major retailers are now present on marketplaces (e.g. Debenhams and Tesco on eBay Outlet⁹³), though the proportion of sales that these retailers account for is not reported. Successful SME retailers have grown in scale. There was a perception among interviewees that SME retailers need to match the scale and customer service of these larger retailers in order to compete.

The range of services offered by marketplaces is increasing e.g. Amazon is now able to offer SMEs fulfilment services, enabling them to provide a high standard of customer service with a low barrier to entry in terms of warehousing or distribution.

Case study: Goldstone Books⁹⁴

The founder of Goldstone Books started selling spare books on Amazon five years ago. Sales quickly grew and after two years he went into business full-time. Since then growth has been rapid. The company now employs 17 people, has 14,000ft² of warehousing space and turns over about £1 million. *"Amazon has enabled me to build a thriving business."*

After initially listing items on Amazon the business has diversified across various marketplaces, now listing second-hand books on 12 different sites. Goldstone also has its own website but marketplaces account for the vast majority of sales: *"Consumers trust the main sites and tend not to shop around."*

Goldstone is able to work around the different fee structures and rules of each site and has not experienced any problems with them. *"You play by the rules and if you don't want to no one is forcing you to sell via their website."*

Customer feedback and ratings have an important influence on sales. Part of the role of Goldstone's customer service staff is to check feedback on the marketplaces and seek to change it if in error. The Royal Mail is used for delivery as *"Customers expect delivery within a couple of days"* and customer ratings are sensitive to quality of delivery services.

Goldstone is operating in an increasingly competitive market with decreasing selling prices. Recently the business has started to use Fulfilment by Amazon: it warehouses stock with Amazon which is listed as Amazon items on the site, alongside Goldstone's own items. The benefit is the flexibility to price below postage (the minimum effective price possible as a third-party seller) and so undercut competitors.

3.6 Supply of goods

An industry participant who we spoke to described a "concerted push by manufacturers to control distribution". This includes attempts to limit online sales to approved sites or to stop online sales altogether, and attempts to maintain prices online by preventing discounting. These practices are facilitated by the transparency of online retail which makes it easy for manufacturers to monitor retailers and their pricing.

⁹³ <http://deals.ebay.co.uk/outlet/>

⁹⁴ <http://www.goldstonebooks.co.uk/>

3.6.1 Restrictive practices

There are various anecdotal cases of restrictive practices occurring. Quantitative data is more limited, with a survey from eBay providing the best insight into the extent of attempts to restrict supply in the UK: Figure 3-6 summarises the results. However, we note that the survey covers only large eBay sellers and may not be representative of online retailers more widely. It is possible that manufacturers are more (or less) resistant to sales of their products on the eBay marketplace than retailers' own sites, which could skew the results.

Figure 3-6: Supply restrictions reported by eBay sellers⁹⁵



The most common restriction experienced was being *banned from selling online*, referring to suppliers trying to prevent sale of their goods on the internet e.g. by inserting clauses into contracts explicitly banning such sales. Also common was being *restricted from selling online* due to the supplier or manufacturer imposing specific requirements on online sellers. Examples include manufacturers allowing sale of their goods only through dedicated websites, thereby excluding marketplaces, or restricting sales to 'customers with webcams' which is first difficult to establish and second often irrelevant to an online sales process. *Display restrictions* also hinder the ability of retailers to sell online. These are conditions on how goods are displayed e.g. stipulating how many pixels there must be in each image of a product.

Retailers being *prevented from discounting goods* was also common in eBay's survey, referring to manufacturers and suppliers only allowing online businesses to sell their products if they do so at a price stipulated by the supplier. *Other unexplained problems* refers to supply drying up for unexplained reasons after a retailer began to sell online, with the retailer suspecting a link. In about a quarter of cases online retailers had *problems when shipping abroad*, meaning that suppliers do not allow them to sell to customers abroad.

⁹⁵ The survey covered 458 eBay sellers that were registered with eBay as businesses. The average revenue distribution of these sellers is 37% from eBay, 32% from other websites including 10% from Amazon, and 20% from bricks and mortar businesses. Annual turnover on eBay was in the range £100,000 to £3.4m with an average of £242,000.

3.6.2 Impacts on SME retailers and on consumers

We have found no quantitative assessment of the impact of these restrictions, but in our view some impacts on SMEs and on consumers are likely. Restriction of supply may act as a barrier to entry for SME retailers in sectors where access to particular goods is a necessity. Restrictions on discounting may effectively discriminate against SME retailers as price is in some cases their main differentiator compared to larger competitors. Both supply and price effects would impact on consumers.

The transparency of online is an important factor which may explain the predominance of allegations of refusal to supply, resale price maintenance and other practices in relation to online markets. Such practices may involve both social costs and benefits⁹⁶. However, we note in the following section that market dynamics are changing and the balance of social costs and benefits associated with retail restrictions is also likely to change. In particular, the mobile internet is likely to blur the distinction between online and offline with people using online search and marketplaces to make a purchase which is then collected physically, thereby avoiding the need to be at home to take delivery for example) or to support a physical purchase when shopping in a bricks and mortar environment.

⁹⁶ Centre for Competition Policy at University of East Anglia. OFT. An evaluation of the impact upon productivity of ending resale price maintenance on books. February 2008. http://www.oft.gov.uk/shared_of/economic_research/oft981.pdf
Mathewson F and Winter R, (1998) 'The law and economics of resale price maintenance' Review of Industrial Organization, 13, 57-84.

4 Market dynamics

We expect to see significant change over the next few years: existing developments will continue to be adopted causing further transformation to online markets, while new technology and business innovation will also occur.

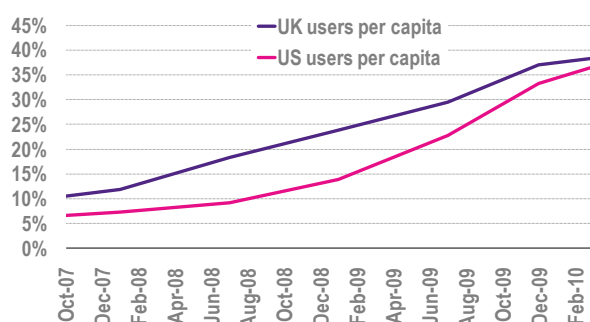
Even without further technological and business innovation, online markets would likely prove dynamic as the impact of existing technology and business innovation seems most unlikely to have reached a steady state. We envisage innovation in two areas to prove disruptive for every aspect of online markets, namely the rise of the social web and mobile internet use and applications. Whilst the precise impact of these changes is difficult to foresee, the likelihood of significant impact appears high. We base this conclusion on the fact that the social and mobile web are growing very fast and because they appear to touch every aspect of online markets from web presence to fulfilment.

4.1 The social web may facilitate more business activities

By the social web we mean not just social sites such as Facebook, but also the numerous sites that allow consumers to interact and feedback on products, services and merchants.⁹⁷ (The growth in the Facebook platform is shown in Figure 4-1.) Such feedback is at the core of a platform such as eBay, but also facilitates online review sites such as TripAdvisor.com. These feedback mechanisms may make it easier for SMEs to gain a good reputation online. Platforms that started life as purely social, such as Facebook, may also become important platforms for web presence, marketing and brand and potentially transactions.

Figure 4-1

Facebook penetration over time in the US and UK



Source: Plum Consulting, Facebook, various websites

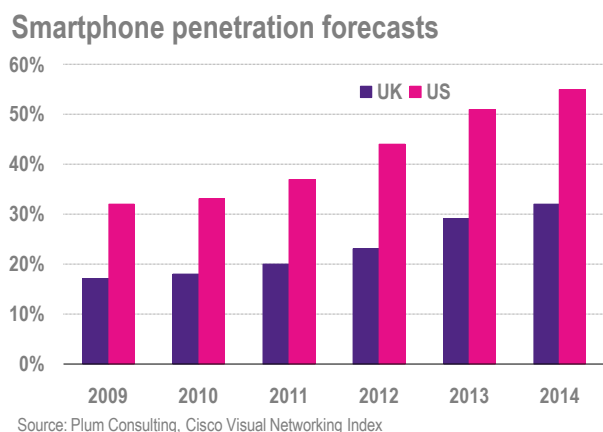
4.2 Mobile internet will open up new opportunities

The rapid growth of mobile internet use, increasing sophistication of smartphones and the exploding range of “apps” for smartphones and, in the near future, for other portable devices such as tablets is

⁹⁷ For an overview of the social web see The Economist. 28 January 2010. “A world of connections.” http://www.economist.com/specialreports/displaystory.cfm?story_id=15351002

also driving a number of fundamental changes. Figure 4.2, below, shows forecast smartphone ownership in the UK and US.⁹⁸

Figure 4-2⁹⁹



A further indication of change is the growth in sales by eBay via mobile apps which were more than \$600 million in 2009 and are expected to increase to \$1.5 billion in 2010.¹⁰⁰

Mobile devices coupled to the internet enable a number of applications which differ fundamentally from internet use at home or in the office which may impact on online markets, for example:

- It enables access to online information wherever an individual is, including in a bricks and mortar retail environment. Further, location information can be used to search for goods and services near the user, and potentially to target advertising to the user.
- Mapping applications and augmented reality applications allow online information, including socially generated information, to be overlaid on the physical environment. Online ratings, feedback and reviews could be layered onto a representation of the bricks and mortar retail environment.
- Specialist apps may substitute for generic search. Cameras and other sensors will also enable information about real things to be obtained “directly” without having to enter search terms, for example, bar code recognition, visual search and identification of music.
- A more speculative possibility would be for online pricing to replace offline pricing, even in-store. This would allow the possibility of individually tailored pricing to replace posted prices in a bricks and mortar environment (though this would be constrained by opportunities for arbitrage).

⁹⁸ Smartphones are defined by Cisco as: mobile phones offering advanced capabilities such as the ability to run applications beyond a basic mobile phone, often with PC-like functionality. Smartphones run complete operating system software and provide a standardized interface and platform for application developers.

⁹⁹ Cisco Visual Networking Index: Global Mobile Data Traffic Forecast Update, 2009-2014.

http://www.cisco.com/en/US/solutions/collateral/ns341/ns525/ns537/ns705/ns827/white_paper_c11-520862.html

¹⁰⁰ eBay. 23 June 2010. “eBay acquires RedLaser.” <http://www.ebayinc.com/news#20100623006637>

4.3 These developments blur the online-offline distinction

A key implication of these developments would appear to be a blurring of the online-offline distinction with online information available and even overlaid on the real world and online applications able to process “sensory” inputs from the real world directly. Possible impacts on online value chains might include:

- Discovery and marketing via an app or local search rather than general search.
- Comparison search online followed by local in-store purchase.
- Use of online payment systems to pay in-store.
- Fulfilment of an online purchase locally and almost immediately.

These developments appear probable to change the likelihoods that information obtained offline leads to an online purchase and that information obtained online leads to an offline purchase. It may also encourage more integrated online-offline business models.

5 Conclusions

5.1 Barriers to entry have decreased, stimulating market entry

Entry costs in online markets are low and often zero (excluding time costs), as a result of innovation and competition in the provision of services. Some of the main developments include:

- Web presence – online web creation services and open source software.
- Marketing – search marketing, affiliate marketing models including price comparison, sales of display advertising through automated interfaces and social network marketing.
- Payment – integrated payment gateways, particularly PayPal.
- Marketplaces – eBay and Amazon marketplaces.

The exceptions are the segments of the value chain that remain offline: the supply of goods and fulfilment. In these areas barriers remain and may in fact be higher for online traders, for example restriction of supply. However, online has facilitated ease of access to services, choice and competition in relation to fulfilment.

Reputational barriers to entry have also decreased owing to the presence of major platforms and review sites. Major platforms such as Amazon and PayPal to some extent lend their brands to the SMEs that use them, providing some consumer reassurance.

The overall impact has been to stimulate the entry of a large number of small businesses. For example, eBay supports 120,000 businesses in the UK, some of which we can assume would not have been trading online were it not for eBay. However, SME's share of aggregate private sector turnover in the UK does not show any discernable trend up or down in the last 5 years (see Appendix A).

5.2 Some aspects of the market are concentrated

Competition in online markets varies by segment of the value chain. Some segments are concentrated and have providers with a large share: Google in internet search marketing and PayPal in integrated online payments are prime examples. Nevertheless, our research found that in most segments of the value chain SMEs have choice of provider. For example, in online marketing the growth of affiliate marketing (including price comparison services) and social networking are providing increasingly viable alternatives to search marketing for some types of marketing activity. There is, however, considerable variation by business segment, particularly in the online marketing segment of the value chain.

Leading providers depend on SMEs for a large part of their business, encouraging them to support SMEs. Likewise, some SMEs may be reliant on leading providers and they are sensitive to system changes in the services offered by these providers (e.g. changes to the Google search algorithm).

Furthermore online markets are highly dynamic. We have identified evolutionary changes within particular segments of the value chain (e.g. increasing capabilities of online marketplaces, growth of online website creation services) and bigger picture disruptive changes that will affect all aspects of online markets (e.g. growth of internet services on mobile and social networking). This means that

strong market positions in the present may not imply strong positions in the future, and that being a large player in the market will not necessarily be associated with harmful practices.

We also found that some online players with a strong market position are opening their platforms to enable third parties to develop services (e.g. PayPal). The rationale for openness is to harness the capabilities of third parties to quickly improve the customer proposition; this strategy is driven by the fast pace of change and high level of competition in online markets. Types of openness include open software interfaces (allowing complementary service providers / developers to build applications) and open marketplaces (allowing third-party sellers to participate in marketplaces). This approach leads to increasing competition and innovation in the parts of the business / value chain that have been opened. However, openness helps platforms to gain scale, so increasing the barriers to entry for competitors.

5.3 The boundaries of online and offline markets are increasingly blurring

Though this paper has looked at online markets, there is an increasing blurring of boundaries between online and offline markets. Some of the more interesting dynamics include:

- Activity in online markets directly stimulating competition by lowering barriers to trade and lowering entry costs (with possible spill over from online to offline presence).
- Provision of online and offline services as complements to one another rather than purely as substitutes (this might include an online retailer offering physical collection points or a bricks and mortar retailer offering online as another channel).
- Online search and comparison leading to an offline purchase (for reasons of immediacy and elimination of need to coordinate delivery) in addition to offline search leading to an online purchase. We anticipate that mobile internet use may accentuate this development.

This suggests that a more holistic view of markets may be of value in future analyses.

Appendix A: Online markets and SME data

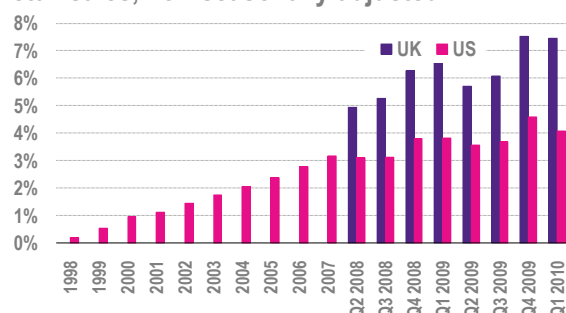
Growth in internet access has been the key enabler of online market development. The penetration of individual internet use increased from 56% in 2002 to 82% in 2009¹⁰¹, while the penetration of broadband to households increased from negligible levels to 70% over the same period. The increasing number of people online has stimulated a proliferation of online services.

E-commerce has been present in the UK market for over 10 years: Amazon and eBay entered the UK market in 1998 and 1999 respectively. Online sales have since grown substantially, accounting for 7.5% of total retail sales by Q1 2010¹⁰². The growth of e-commerce has been a driver for growth in internet advertising, which has increased from 8% of total advertising spend in 2005 to 24% in 2009¹⁰³, of which search engine marketing made up 63%. A large proportion of SMEs are online: 90% of businesses with 10-49 employees had internet access in 2008, and 98.8% of those in the 50-249 employee size band¹⁰⁴. Many have also developed a web presence: of SMEs with fewer than 10 employees 48% had a web presence in July 2009, 39% of companies selling goods, 54% of service companies¹⁰⁵.

E-commerce data is available for SMEs with 10-249 employees which had online sales of £48.5 billion in 2008. Online markets also generate considerable value for SMEs that is not captured in the ecommerce data. Consumers may discover SMEs online, through search or advertising for example, and go on to pay for goods and services offline. This is particularly true of service companies such as plumbers, builders and accountants. Figure A-1 illustrates growth in online retail sales, with US data shown to indicate the historic pattern in the absence of UK data before 2008.

Figure A-1¹⁰⁶

Quarterly & annual US & UK online retail sales, non-seasonally adjusted



Source: Plum Consulting, ONS, Census

¹⁰¹ Eurostat (http://epp.eurostat.ec.europa.eu/portal/page/portal/information_society/data/database)

¹⁰² ONS. Retail Sales Statistical Bulletin. April 2010. <http://www.statistics.gov.uk/pdfdir/rs0510.pdf>

¹⁰³ PwC, IAB, WARC. Fact Sheets: Online adspend. <http://www.iabuk.net/en/1/iabknowledgebankadspend.html>

¹⁰⁴ ONS, 2008 E-commerce survey of business datasets. <http://www.statistics.gov.uk/statbase/product.asp?vlnk=6645>

¹⁰⁵ <https://www.paypal-press.co.uk/Latest-News/UK-SMALL-BUSINESSES-WITHOUT-A-WEBSITE-MISS-OUT-ON-235-BILLION-IN-TURNOVER-ac.aspx>

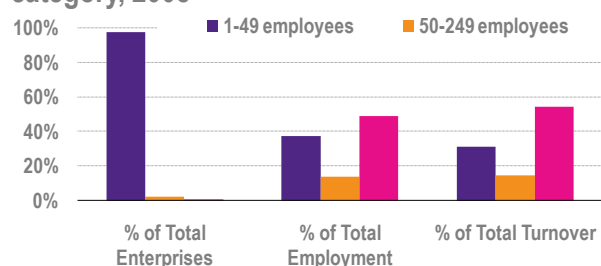
¹⁰⁶ ONS. Retail Sales Statistical Bulletin. April 2010. <http://www.statistics.gov.uk/pdfdir/rs0510.pdf>

US Census Bureau. Quarterly Retail E-Commerce Sales. 1st Quarter 2010. <http://www.census.gov/retail/mrts/www/data/pdf/10Q1.pdf>

Taking a wider measure (including business-to-business sales and exports) ecommerce accounted for 9.8% of all sales in 2008, a nominal increase of 36.6% on 2007 levels.¹⁰⁷ SMEs (which we define here as companies with 1 to 249 employees) account for around 51% of employment and 46% of turnover of the totals for private sector enterprises as shown on Figure A-2

Figure A-2¹⁰⁸

Percentage of UK private sector enterprises, employment, and turnover in each enterprise size category, 2008



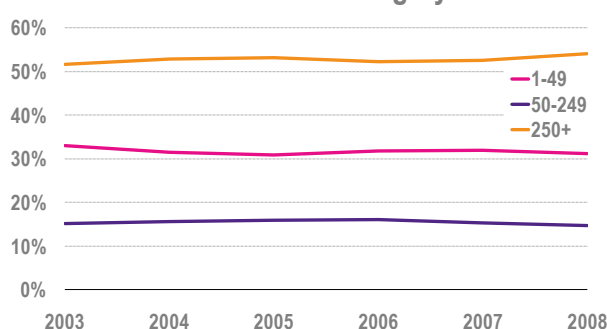
Source: Plum Consulting, BIS

SMEs are distributed across a range of industry sectors with the significant being retail and wholesale (34.7% of turnover of all SMEs in 2008), real estate, renting and business activities (22.8%), construction (12.7%) and manufacturing (8.7%)¹⁰⁹. The key implication is that SMEs will have a range of very different objectives for their activity in online markets.

While new SMEs may have started as a result of the easy of operating online the net impact on turnover of SMEs in aggregate would appear to be roughly neutral (see Figure A-3).

Figure A-3¹¹⁰

Percentage of total UK private sector turnover in each firm size category



Source: Plum Consulting, BIS

¹⁰⁷ ONS. November 2009. "E-commerce and information and communications technology (ICT) activity, 2008."

<http://www.statistics.gov.uk/pdfdir/ecom1109.pdf>

¹⁰⁸ BIS. Enterprise Directorate: Small and Medium Enterprise Statistics for the UK and Regions. <http://stats.berr.gov.uk/ed/sme/>

¹⁰⁹ BIS Enterprise Directorate Analytical Unit

¹¹⁰ BIS. Enterprise Directorate: Small and Medium Enterprise Statistics for the UK and Regions. <http://stats.berr.gov.uk/ed/sme/>

Appendix B: How search engines work

B.1.1 Search marketing

Google sells sponsored links on a pay-per-click model via its AdWords product. The system works as follows:

- Advertisers sign up with AdWords for free. They then bid for keywords (search terms) on an automated interface by specifying a price that they are willing to pay for each click-through from that keyword, and the text and URL (link to a webpage) that will appear in the sponsored link.
- Google assigns each advertiser a “quality score” from 1 to 10, based on a proprietary algorithm that determines to what extent the advertiser is relevant to / suitable for the keyword. The intention is to ensure that relevant sites (that are most likely to generate click through and thus revenue for Google) are prioritised and sites that may disappoint the user (e.g. a parked domain page with nothing but affiliate links) are not (to ensure consumers continue to value the service).¹¹¹
- When someone performs a search for a specific set of keywords, Google looks up all the advertisers that wish to bid on those keywords. For each advertiser, it takes the product of the bid price and the quality score, and ranks them. It then displays the highest ranking advertisers in the sponsored link area: if their quality scores exceed a certain threshold, the top 3 advertisers will get ads that appear at the top of the search page (above the natural search results), lower ranking advertisers will be listed on the right hand side.
- The individual performing the keyword search may then click on one of these ads. If a sponsored ad is clicked, the advertiser pays the bid price to Google

The features that differentiate search marketing from other forms of marketing include:

- It enables targeting on specific search terms
- Advertisers pay for actual website visitors (clicks) rather than paying each time an ad is shown
- It is easy to monitor return on investment via web analytics tools on the Google site
- There is no minimum spend - advertisers can start bidding with 10p and do not need to commit to spending a minimum per day or per month. Google does not prioritise or give preferential treatment to advertisers that spend more: each auction is considered independently, with the ranking of an advertiser determined entirely by the advertiser’s bid price and quality score.¹¹²

Search marketing has thus enabled new business models predicated on customer acquisition (e.g. a company selling replacement laptop batteries). However, these businesses are highly reliant on Google; one SME that we interviewed suffered as a result of a change in its quality score.

¹¹¹ For a full description of Quality Scores from Google see <http://adwords.google.com/support/aw/bin/answer.py?hl=en&answer=10215>

¹¹² Google’s biggest spending advertisers do get a dedicated account manager

B.1.2 Natural search

Many SMEs rely on “natural” search results rather than pay for traffic. The ranking of natural search results is determined by a proprietary Google search algorithm, which aims to identify those web pages that are most relevant and authoritative. Though the Google algorithm is not in the public domain and is constantly evolving, it is known to consider factors including the:

- Relevance of the page’s contents to the search term, as evidenced by the number of times the keyword appears on the web page, particularly in the page or section titles, and the label names for inbound links¹¹³
- Number and authority of other web pages that link in to a particular page - this function, called “PageRank”, was modelled on the idea of academic citation¹¹⁴
- Frequency with which the content of a page is updated, favouring sites like blogs and social networking sites where new content is added frequently over time¹¹⁵
- Originality of content i.e. extent to which textual content on a site is unique / unavailable elsewhere on the internet. Google gives a lower ranking to sites that reproduce content from other sites.¹¹⁶

Google has also started experimenting with personalising search results (i.e. showing different results to different individuals based on their search history¹¹⁷) and using information from social networking sites (e.g. Twitter) to inform results¹¹⁸.

SMEs may find it more difficult than larger businesses to achieve high natural search rankings as due to the relatively small size of their websites they will perform less well on frequency of update and links. In our view this is not a form of discrimination against SMEs but a feature of the system in which they operate, analogous to the difficulty of SMEs achieving visibility in the physical world.

There are limited opportunities for advertisers to “buy” their way up the search rankings. There are technical steps an SME can take to make its website more “attractive” in the eyes of the search algorithm (e.g. providing site maps and tidy URL structures) and ensuring that content is updated regularly. This process is called “search engine optimisation”. Nearly all the SMEs we interviewed made some effort to optimise their sites. Spending on third-party services to assist with search engine optimisation market in the UK accounted for an estimated at £330m in 2008 compared to £2,420m spent on paid search.¹¹⁹

¹¹³ For detailed examination see “Search Engine 2009 Ranking Factors.” <http://www.seomoz.org/article/search-ranking-factors#overview>

¹¹⁴ <http://en.wikipedia.org/wiki/PageRank>

¹¹⁵ Econsultancy SEO Best Practice Guide 2009

¹¹⁶ Econsultancy SEO best practice guide April 2009

¹¹⁷ “Personalized Search for everyone.” <http://googleblog.blogspot.com/2009/12/personalized-search-for-everyone.html>

¹¹⁸ “Google links Facebook, Twitter, MySpace in real-time search.” <http://www.techradar.com/news/internet/google-links-facebook-twitter-myspace-in-real-time-search-656483>

¹¹⁹ Econsultancy <http://econsultancy.com/blog/2759-seo-losing-out-to-paid-search-budgets-3>

Appendix C: How price comparison services work

Price comparison sites are a large and relatively fast growing category. Moneysupermarket.com launched in 1999, focusing on financial products but has since branched into multiple product areas¹²⁰. More recent entrants include *CompareTheMarket.com* (insurance, launched in 2005¹²¹), *Confused.com* (insurance products, launched in 2002¹²²) and *GoCompare.com* (car insurance, launched in 2006¹²³).

Like other affiliate sites, price comparison sites earn money by referring prospective customers to businesses seeking to acquire customers, taking an affiliate fee for any purchases these customers make. Fees vary by product type and the market power of the price comparison site.

Smaller comparison sites (e.g. SingleView which compares dating sites) typically interface with businesses (which may include SMEs) via affiliate networks that aggregate offers from businesses seeking to acquire customers: these offers include rates set by the businesses.

Larger price comparison sites may be in a position to demand their own fee structure. This may be in the consumer interest if it ensures that all affiliates listed on the site pay the same fee, so that the “objectivity” of the comparison site is not compromised. This is the model adopted by Kelkoo, for example¹²⁴. Lastly, a price comparison site may choose not to charge advertisers at all. This is the case for Google Product search.¹²⁵

¹²⁰ http://en.wikipedia.org/wiki/Money_Supermarket

¹²¹ http://en.wikipedia.org/wiki/Compare_the_Market

¹²² <http://www.confused.com/corporate/about-us>

¹²³ <http://en.wikipedia.org/wiki/Gocompare.com>

¹²⁴ http://www.kelkoo.co.uk/co_4292-online-merchants-and-stores-partner-with-kelkoo.html

¹²⁵ http://www.google.com/intl/en_us/products/submit.html