

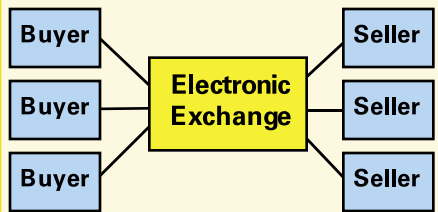
# THE FUTURE OF MARKETS

## Successful exchanges will mirror behavior in the underlying markets.

By E. Russell (Rusty) Brazier

**T**he development of B2B exchanges certainly has not worked out the way the hype from last year would have us all believe. Every few days it seems there is another announcement of a failed B2B exchange. Clearly many of the new electronic markets have been unsuccessful in building more than a trivial number of transactions. A variety of factors have been blamed. "Sellers don't want to participate because it commoditizes their products." "Buyers want to leverage their buying power directly, instead of becoming merely one face among many in an electronic market." "Both buyers and sellers formed their own coalitions and took the momentum away from the independent exchanges." Or the most common excuse, "We just couldn't get the buyers and sellers to give up the phone and fax."

*The butterfly or center-based exchange, sitting at the center of the universe was supposed to wring inefficiencies out of traditional market relationships. Well, those inefficiencies didn't want to be wrung out.*



However, some exchanges have achieved excellent results. For example, Altra has achieved solid liquidity in gas, power and liquids markets. CheMatch has carved out a notable electronic marketplace for trading chemicals, and is linking that marketplace with futures contracts from the Chicago Mercantile Exchange. E-marketplaces such as DoveBid and SalvageSale.com fill another niche, providing auctions for used, excess, or damaged goods.

But that begs the question...What is responsible for the significant difference between performance of various B2B exchanges? Why has it worked for energy and chemicals, but struggled in industrial equipment and the food and beverage industry?

Buyers and sellers did not wake up one morning and change the way

they had done business for years. They correctly perceived that B2B exchanges would change the way information would be disseminated, how transactions would be consummated, even who has the authority to conduct transactions. They concluded that B2B exchanges would result in significant shifts in market power, often "leveling the playing field," which by definition means a transfer of marketpower from the powerful to the not-so-powerful. And even more important, the individuals involved in buying and selling activities on the front line recognized that the evolution of B2B exchanges would likely result in significant changes in their own jobs, impacting personal rewards, compensation issues, and job satisfaction (such as pounding away on a screen versus chatting on the telephone). This turned out to be a formidable barrier to successful adoption of B2B exchange technologies.

The other important constituency that pushed back was the intermediaries; the brokers, trading companies and distributors that perceived that B2B exchanges could put them out of business, or at the very least dramatically reduce their revenue-generating opportunities. One of the basic tenants of the early butterfly model was that traditional intermediaries are inherently inefficient. They were said to make money based on lack of trustworthy, real-time information about the marketplace. An electronic exchange could presumably remedy this problem by providing a means for buyer and seller to find each other and transact business directly, eliminating the middleman and providing new, Internet-enabled technologies to manage the transaction process. Intermediaries providing a service of simply matching buyers and sellers would melt away under the harsh light of market transparency. It was not lost on the intermediaries that their demise was expected to drive much of the economic value to be generated by B2B exchanges.

The bottom line is that many independent B2B exchanges ran into trouble due to these very fundamental issues—not because coalitions formed in their industries. Most coalitions still have little traction

themselves. And not because Internet funding dried up. Lack of funding did not cause markets to reject the new technologies. Instead, many independent B2B exchanges ran into trouble because their prospective customers—the people that buy, sell and trade—did not use their products. And the fundamental reason was because their business models did not fit their target markets. And that is the kiss of death, in any economy—old or new.

### Spot Market Dynamics

The dynamics of spot market behavior are quite different from longer term, contractual relationships between companies. Generally speaking, term markets represent extended, corporate level direct relationships between companies. In contrast, spot markets are focused on negotiation and deal-making in relatively short-term deals. Transactions are conducted by a wide variety of participants, including individual buyers, sellers, brokers, traders and so on.

Spot markets are diverse, rich, and complex. These markets are characterized by many unique transactions. While they are certainly based on long-term relationships, each deal or individual transaction stands on its own. Typically they are self-organizing and consist of multiple participants with competing interests. Think of a spot market as a living, breathing organism with a life of its own. Just like a person is a collection of many different types of cells, a marketplace is a collection of many different participants, each with roles and responsibilities.

These participants are conducting transactions, sharing information, handling documentation, and all other aspects of the buying and selling process. These processes may not be the most efficient way of doing business, but they are the de facto standards in any given industry. Spot market processes are a reflection of deep-seated tradition in the industry, the market power of different players in the market, and practices that provide personal reward, value and job satisfaction for individual decision-makers. It's not surprising that market participants with a vested interest in the status quo would resist changes to these processes.

So there were three fatal flaws in the butterfly model that

proved to be the major barriers to adoption of B2B exchange technologies in certain vertical markets. First, most of the butterflies neglected the significant role played by market intermediaries in the creation and maintenance of liquidity. Second, the butterflies glossed over the importance of different spot market structures, assuming one size (the center-based exchange) would fit all. Third, the butterflies tried to do everything at once, short-circuiting the transition of network, peer-to-peer markets to center-based exchanges.

### The Next Generation of B2B Markets

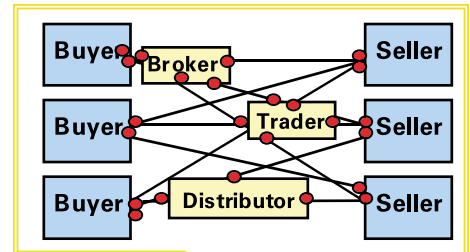
Today many analysts have written off all but a few independent exchanges and now extol the virtues of coalition markets, where participating companies can presumably deem success of the exchange by committing a certain level of "spend" to the coalition entity, and focusing on term market relationships between companies. In some markets, these coalition exchanges will prove very successful.

However, this is not the only path to success in B2B markets. In a number of fragmented spot markets, the key to success will be an approach which mirrors existing spot market processes. If spot markets are naturally self-organizing, peer-to-peer webs then the business models of exchanges in these markets should support this way of conducting business, rather than attempting to force it into a radically new structure. Over time, a new structure can evolve naturally as the marketplace becomes accustomed to new tools and new ways of doing business.

Center-based exchange technologies, whether auction, reverse-auction, bid-ask or any of the popular business models miss the mark in these markets.

The answer is technology and functionality that is designed from the ground up to fit the requirements of these web-like, product-based markets. Peer-to-peer markets must be mapped to the functionality of peer-to-peer technologies.

This does not suggest that all B2B exchanges should plan to use Napster-like functionality to conduct million-dollar transactions for



*In their natural state, spot markets are not butterflies, with all transactions flowing through a single point of contact, they are webs—peer-to-peer webs. And they are not about to change into butterflies overnight.*



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See [Future of Markets](#)

*Continued on page 30*

## The Future of Markets

*Continued from page 17*

industrial products. (For those of you who have been living in a cave for the past year, Napster is the incredibly popular and highly controversial online music trading service. Napster's peer-to-peer technology lets users trade MP3 files directly from hard drive to hard drive, instead of downloading them from a Web site. With almost 40 million copies in circulation, it may be the most ubiquitous piece of non-Microsoft desktop software ever.) But the approach to the functionality in B2B electronic markets must support behaviors in the underlying spot markets, which

are predominately peer-to-peer.

There is a huge untapped potential for this approach across a broad spectrum of vertical markets. As this approach is implemented, a new wave of B2B exchanges will emerge to assume a prominent role in the evolution of Internet technologies in vertical markets.

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