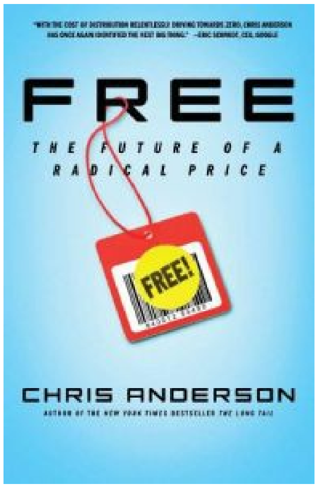

Book Free

The Future of a Radical Price

Chris Anderson
Hyperion, 2009
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Recommendation

Economists swear there is no such thing as a free lunch. Someone always pays. That may be true in the "atoms" world of physical things, but Chris Anderson explains why it does not apply in the "bits" world of the Internet, where "free" is the ruling paradigm. If, as Stewart Brand (founder of the Whole Earth Catalogue and the Whole Earth 'Lectronic Link) said, "Information wants to be free," now it is, at least in many instances, particularly online. While the idea of giving things away as a promotion or loss leader isn't new, Anderson's fresh insight is that giveaways are becoming a business imperative that companies are going to have to accept and use. Actually, companies online and off can become immensely profitable when they give products or services away for free to bring customers in and to create the need for future ancillary product sales (in other words, take the printer and buy the ink). Anderson, author of *The Long Tail* and editor of *Wired* magazine, tells you how to make money by providing most of your offerings for free and charging for just a few of them. *BooksInShort* recommends this perceptive, innovative, idiosyncratic book to all marketers.

Take-Aways

- Giving things away for free is the newest successful sales strategy.
- "Free" can mean many different things, all of them enticing to the buying public, but "almost free" has virtually no magic with customers.
- In the offline world, "free" often is merely a marketing gimmick. But online, it is real.
- With almost no marginal costs, the Internet is the classic $0.00-pricing medium.
- Google, the immensely profitable online search company, gives most of its products away for free.
- Many online firms, including gaming companies, boldly pursue inventive new free marketing strategies.
- Giving consumers something free can be a great money-making business model.
- Free stuff always represents some variant of "cross-subsidies," an economic term implying that costs are always present, even though often subtle and paid by others.
- Anything digital is on a direct glide path to being free.
- Free Web services, like Craigslist classified ads and Wikipedia, have taken revenue away from print businesses and given it to the public, but at great cost.

Summary

The Fortune in "Free"

Google, the online search behemoth, became a highly successful company by giving away most of its products and services. Google supplies online visitors with almost

100 products, mostly free, from "photo editing software to word processors and spreadsheets." To many, particularly those rooted in a traditional business model, giving away products makes no economic sense. But it works for Google. Indeed, it is a $20 billion firm, more profitable than all U.S. car firms and airlines combined.

> "In many instances, businesses can profit more from giving things away than they can by charging for them."

So how does Google actually make money? Primarily, it earns massive advertising revenues from its core products, most notably its famous search engine. Companies pay Google to place their ads next to relevant search results. The revenue potential is tremendous. Google has become the "flag bearer of Free" among online businesses. Thousands of companies are feverishly attempting to emulate its free-services business model, which it developed in three distinct phases. From 1999 to 2001, it built a better search system. From 2001 to 2003, it offered advertisers an innovative self-service method for aligning their ads with specific "keywords or contents." Additionally, it got advertisers to outbid each other for the best ad positions. Since 2003, to increase its online reach and cement users' loyalty, Google has developed and provided numerous free services. Where feasible, it sells accompanying ads.

> "Google offers nearly a hundred products...almost all of them are free of charge. Really free – no trick. It does it the way any modern digital company should: by handing out a lot of things to make money on a few."

"Take whatever it is you are doing, and do it to the max in terms of distribution," says Google CEO Eric Schmidt. "Since the marginal cost of distribution is free [online], you might as well put things everywhere." By offering free services, Google can "reach the biggest possible market and achieve mass adoption." Most online activity complements Google's primary business. Every time a blogger posts something online, Google's Web crawler indexes it, thus increasing the value of its search results. Every time an online user clicks Google Maps, the company's database of consumer behavior becomes slightly more comprehensive. The e-mails sent via Google Gmail adds to the company's basic understanding of its Internet network connections. Google parses this information for statistics it can use to enhance ad sales and to develop new Internet products. What is good for the Internet is good for Google and vice versa. The more time people spend online, the more Google profits – and its abundant, free Web services make users more inclined to spend that time online. For Google, this represents perfect commercial synergy.

Online Gaming

Online gaming firms also use the Web's zero-cost pricing model to salutary effect. Online gaming was a $1 billion industry in the U.S. in 2008. In China in 2010, it will be worth $2.67 billion. "A Petri dish of new forms of free," this industry offers most games for free, but it makes money five different ways.

> "People are making lots of money charging nothing."

Here's how:

1. **"Selling virtual items"** – More than 60 million people worldwide are registered users on Maple Story, an online game for young children. Participants don't have to spend money to play the game, but the small gamers can purchase "teleportation stones" that enable them to play faster. Virtual items for sale include a "guardian angel," and "new outfits, hairstyles and faces." Online gaming firms such as Maple Story sell virtual items (that is, bits of nonphysical information in the Internet ether), or they charge transaction fees for such purchases. World of Warcraft is another popular online game. Membership is not free, but the game enables players to earn online "virtual assets" which they can sell outside the game for real money. Facebook uses a similar revenue-generation enhancement model when it sells "digital gifts."
2. **"Subscriptions"** – Club Penguin was an online community with more than 12 million child members when Disney bought it in 2007 for $700 million. Since then, it has become even more popular. Children do not have to pay to play and many don't. However, many users ask their parents for the $6 monthly subscription fee so they can enhance their online igloos (more Internet ether) or purchase virtual pets for their virtual penguins. RuneScape, an online game of "orcs and elves," has six million users. One million of them pay $5 each month for an enhanced gaming experience making RuneScape a profitable business.
3. **"Advertising"** – Many companies cleverly blend paid ads into online gaming environments so they seem to be a part of the virtual landscape. Before the 2008 U.S. presidential election, the xBox Live Burnout Paradise racing game featured a billboard near the tracks showing Barack Obama urging gamers to vote for him. Other paid ads appear on the virtual racers' clothes and as posters on virtual buildings.
4. **"Real estate"** – Second Life isn't really a game; it is a virtual world where users meet each other and interact. Currently, half a million people have free Second Life accounts. They can explore its virtual world and associate in novel ways. However, to build your own "in-world" house, you need virtual land. Linden Labs, which owns and runs Second Life, offers monthly land leases for $5 to $195. The land-leasing business is so good that some people now make their livings as Second Life real estate brokers. One broker claims to have become a millionaire reselling virtual land in Second Life.
5. **"Merchandise"** – Webkinz is a "clever combination of free and paid." Parents buy their children stuffed Webkinz animals which come with a code. The kids then register their new toys with that code on the Webkinz Web site, where they can play with virtual simulations of their toys. Lego and Mattel use this "online/offline model" for their free Web games.

> "For the music industry and much of the software industry...Free has become the de facto price regardless of every effort to stop it."

Numerous other online companies, in the gaming industry and outside of it, now use the partially free business model to make money. These include Skype, the Web phone service; and LinkedIn, the professional social network.

Offline for Free

The free (or almost free) pricing model works as well offline as on the Web, here are some examples:

- **Air travel** – Dublin-based Ryanair will fly you from London to Barcelona for $20. Its actual cost for the flight is $70 per passenger, which it recovers through various extra or optional fees, like $30 to check two bags. Eventually, the company plans to fly passengers for free, perhaps paying for the flights with "in-air gambling."
- **DVRs** – Comcast, the U.S. cable company, gave free digital video recorders to approximately nine million customers. It immediately recovered part of the cost through a $20 installation fee and it charges a $14 monthly fee to use the device. In effect, users pay for the boxes over time. Finally, Comcast hopes that new

customers will subscribe to its other, more profitable services, such as high-speed Internet and pay-per-view movies.

- **Silverware** – In 2008, the Portuguese media company Controlinveste gave 60-piece silverware sets away to boost sales of its newspapers. Inventively, it bundled one utensil in each day's edition. Thus, customers had to buy 60 different issues of the paper to get a full set. If they missed one edition, their sets would be incomplete. That same year, it also gave away tool boxes with tools, dinner place sets and other premiums.

A Primer on Free

The free merchandising approach has many forms. Sometimes, free things are not truly free. "Free gift inside" means your price includes the cost of the gift. "Buy one, get one free" means that when you buy two products, you get a 50% discount. Ad-supported media, like TV and radio, claims to be free, but you must tolerate commercials to get to the content. But online, "free really is free," most of the time. Wikipedia, the most comprehensive encyclopedia ever designed, is free.

> "The Web has become the biggest store in history, and everything is 100% off."

Most people intuitively regard "almost free" as substantially different from free. People have no barriers against getting something free, but they will refuse to pay even a minor amount.

Free or almost free offers involve certain variations on the same basic "cross-subsidies" formula: "shifting money from product to product, person to person...now and later, or into nonmonetary markets and back out again."

> "The pursuit of Free can be a bruising business for those who don't do the calculations right."

Four cross-subsidies categories support the free business model:

1. **"Direct cross-subsidies"** – You get a free product, which motivates you, or requires someone else, to pay for a different product. Example: You get a credit card free, if you pay your bill on time, but sellers pay every time you use it.
2. **"Three-party market"** – The third party pays to use a market that you and some other entity create. Advertisers (third parties) subsidize the heavy production costs of newspapers (second parties). The papers "sell" their readership base (first parties) to advertisers.
3. **"Freemium"** – You can use the limited-in-scope version for free or at nominal cost. But to upgrade, you must pay for the premium version. Flickr is free, but Flickr Pro is $25.
4. **"Nonmonetary markets"** – Cash payments are never a factor, as with Wikipedia.

When Costs Don't Count, Free Is Only a Matter of Time

The Web is "all about scale." While Internet companies pay for large, costly banks of powerful servers to send content over the Web, the immense number of users is growing almost exponentially. Thus, the actual per-user costs of reaching millions of people are miniscule. Further, the Web's three basic components – "computer processing power, digital storage and bandwidth" – are becoming almost "too cheap to meter." As their capabilities increase and their costs drop, the Web itself – the "bits" world – becomes a medium where cost is not a factor.

Free Fall Losses

The downside of free is what it does to paid content. Craigslist free classified ads cost newspapers $30 billion dollars, destroying jobs and forcing some papers into grave financial straits. Craigslist made $40 million in 2006, so where did the rest of the money go? It went into the pockets of the site's users, who no longer pay for classified ads. Wikipedia is "decimating" physical encyclopedias. Without charging for its service, it dried up the industry's revenues and gave online users free access to information. In that way, "free...turns billion-dollar industries into million-dollar industries." With the Web, some things that were scarce (like TV channels) become plentiful instead. This "de-monetization" is the impact of "marketplace efficiency," "liquidity" and infinite capacity. In the face of this trend, according to Jeff Zucker, head of NBC Universal, the TV industry is scared of "trading analog dollars for digital pennies."

How to Be Free

Keep 10 rules in mind as you assemble your company's free business model:

1. **"If it's digital, sooner or later it's going to be free"** – Marginal costs are the ultimate price points for competitive markets. On the Web, marginal costs are near zero. Thus, free will soon be the default (not optional) position online. "Bits want to be free."
2. **"Atoms would like to be free, too"** – But they never will be, yet, brick-and-mortar companies are discovering inventive ways to put the free approach to work.
3. **"You can't stop free"** – It's impossible in a world of hackers and intellectual pirates.
4. **"You can make money from free"** – It just takes imagination and savvy marketing.
5. **"Redefine your market"** – Better Place makes battery-driven cars. So, it produces cars but, in its niche, it is not competing with other automobile manufacturers.
6. **"Round down"** – When costs are going to zero, be the first one to charge nothing.
7. **"Sooner or later you will compete with free"** – Prepare a plan so your company can survive – and even thrive – when a competitor offers a 100% discount.
8. **"Embrace waste"** – Overuse makes sense when basic business components, such as processing power, digital storage and bandwidth, become too cheap to meter.
9. **"Free makes other things more valuable"** – Contrast premium services with free online offerings.
10. **"Manage for abundance, not scarcity"** – In a digital age, where costs are near zero, your marketing can be far more bold and experimental. You also have less to lose if you don't win. Just try and then, try again – for free.

About the Author

Chris Anderson is editor-in-chief of *Wired* magazine. He received the *BooksInShort* International Book Award for his book *The Long Tail*.