
Photograph by Graham MacIndoe

Jay Walker: The Thought Leader Interview

Priceline.com's founder and vice chairman bet his fortune on the power of ideas. But he still believes e-business is full of patent nonsense.

Thought Leader
by Randall Rothenberg

For many Americans, the first inkling that the Internet was something larger than a toy was the 1998 television advertising of Priceline.com Inc. Starring former *Star Trek* actor William Shatner, the commercials invited consumers to access the World Wide Web and name their own prices for airline tickets. It was absurd — unheard of — although it's a fair bet that few were able to articulate the economist's reasoning for the miracle at hand: An independent company had just rendered the opacity of airline yield management startlingly transparent.

Such was the inspiration of Jay S. Walker, then 42 years old. The Queens, N.Y. native, a Cornell University alumnus and born salesman, had bounced through entrepreneurial ventures — newspaper publishing, catalog marketing, art vending — before scoring a triumph with a startup service that automated readers' magazine subscription renewals. The company made Mr. Walker wealthy. Having stumbled on the fact that business models could be patented as readily as a pharmaceutical company's molecules, Mr. Walker then started a laboratory for the sole purpose of developing strategic theo-

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ries and concepts that could be turned into businesses, thanks to the Internet, and patented.

Priceline.com, one of the first enterprises to emerge from the Walker Digital Corporation lab, developed from a system that allows companies to dispose of excess inventory at optimal prices, using a double-blind methodology that doesn't diminish the provider's brand or its ability to charge full fare for its non-surplus goods. The idea was so attractive, so original, that upon Priceline.com's IPO in March 1999, investors accorded the company a value of some $13 billion — with nearly half belonging to Mr. Walker.

Priceline.com, which recorded first-year revenues of $35 million, has extended its price-distribution system beyond transportation into hard goods. Embodying the Berkeley economist Hal Varian's premise that "yield management is where it's at" (see "To Hal Varian, the Price is Always Right," *S+B,* First Quarter 2000), the company started Priceline WebHouse Club, a name-your-own-price grocery purchasing service. In February, it began selling gasoline under a similar procedure. Meanwhile, Walker Digital continues to file new patents, even as it challenges — and is challenged by — others in what many see as a developing patent free-for-all over Internet business models.

The corporate family Mr. Walker has built atop his assets seems a long distance from the Alley-and-Valley culture one associates with e-commerce. Spread across low-rise buildings in several Connecticut suburbs, Priceline.com and its sister companies are sober, professional, and adult. Mr. Walker makes decisions from a large, wood-paneled office that is lined with leather-bound Franklin Library editions, and hung with memorabilia, some political (including Richard Nixon's terse resignation letter), and some related to America's space race.

Behind Mr. Walker's desk are four full shelves of thin, unidentified volumes. One-half-shelf's worth are bound in red — patents granted; the rest are bound in blue — patents pending. But if these are the cards he is playing in the New Economy sweepstakes, Mr. Walker resists the notion that this is a game of chance. He was reminded by his interviewer that, just out of college, they played together in an occasional card game that also featured the now-prominent hotelier Andre Balasz and the corporate restructuring expert Thomas Epstein. Asked if he remembered how he fared, Mr. Walker responded: "I never considered myself a very good gambler."

S+B: While people around the country are familiar with Priceline.com, by virtue of its advertising, few, I suspect, realize that this grew out of a company you created earlier, Walker Digital, whose raison d'etre was the development of commercially viable ideas. What moved you in a direction others would consider esoteric?

WALKER: I'm a theorist who is interested in how people think about issues, who wants to understand the abstract levels at which things operate, and then reintegrate those abstractions back into real commercial value.

S+B: Had this always been a motivating vision of yours?

WALKER: I didn't spend most of my career in intellectual property. I spent most of my career as a marketer developing value-added systems, without any hope of creating property around those systems, because I didn't understand I could.

S+B: How did the epiphany occur?

WALKER: It wasn't a moment; it was

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just a general process. I was reading an article about encryption technology one day, and I had an insight that all gambling would change ultimately because encryption technology made it possible to have a hand-held casino that couldn't be cheated or lied to. Then I began to wonder how I might benefit commercially from the idea. Since I wasn't going to open a casino, I thought maybe I could own the idea. That led me to patent law. I hired some lawyers and said, "Let me see if I've got this right. If I invented the credit card and was able to describe it as a 'periodic billing system for transaction charges,' I would have been able to own the credit card?" And the patent lawyers said, "Yeah." I said, "If I invented the frequent-flyer program as a 'rewards points tracking system,' I could have owned any frequent-flyer program?" "Sure, of course," they said.

And I said, "Does it strike any of you as odd that nobody owns those things?" And they said, "Business does that all the time. They invent things and they don't realize they could own them." Only a group of lawyers could possibly look that kind of incredible wealth loss in the face, and not see that there was something odd that nobody owns those ideas.

S+B: Did it occur to you at this point that maybe you were reading it wrong?

WALKER: Sure. I went to businesspeople I knew and said, "I could have owned the ATM machine." "You're kidding! You must be wrong." "I could have owned the travelers' check." "You're kidding! You must be wrong." Every business person I asked said, "What are you talking about? You can't patent that."

S+B: What convinced you otherwise?

WALKER: Every patent attorney I asked said I was asking stupid questions. Of course those things were patentable. It was clear the business people were all wrong, and the patent attorneys were all right, because it was a matter of law. So I started raising and investing millions of dollars on the basis that I could invent new solutions that were indeed ownable. If they were useful, they'd be valuable. And if they weren't useful, I would just own something useless. The only question was: Was I going to own land in Montana or own land on Park Avenue. That's about the quality of invention, not the quality of patents. It turns out I can own land on Park Avenue.

S+B: The notion of theory-based, ownable business models has taken the New Economy by storm.

WALKER: Outside of the consulting world, academia, and a handful of large corporate players that use strategy as a discipline, almost nobody would think that it's worth their time and effort. I've got to tell you, that's still largely true even on the Internet. I can't tell you the number of times that I meet with Internet entrepreneurs or executives, and how little theory they have, and how little cognitive behavior they seem to exhibit about what it is they're doing.

S+B: There is an argument that says that managers can get sidetracked by theory.

WALKER: You can be bothered by anything that requires you to take time out to think. But the mantra of "execute, execute, execute, speed, speed, speed" seems to preclude any consideration of what we are speeding toward. That's sort of like saying, "Don't bother me with the facts — I'm busy executing them."

S+B: You might look on this as the flip side of the eternally evolving business model — it's the lack of a business model, the unwillingness to grapple strategically with a new idea.

There's a battle taking place in the New Economy that pits convenience as a central theory against savings.

WALKER: It's not that Amazon isn't trying to incorporate radical thinking of a sort. It's simply that they're not starting with the thinking. They're starting with the result and reengineering what they can, and then if there's thinking there, so much the better. If you talked to [Amazon.com CEO] Jeff Bezos, he would tell you that that's correct. He would say — and I've talked to him at length about this — his theory is, "I'm going to delight the customer, and have a lot of them before anybody else. Everything else will sort of take care of itself." That's Nordstrom on the Net. He basically says, "If I constantly over-deliver on customer expectations, and horizontally expand as fast as I can so that I can maximize my customer base, I get a network effect with my customers" — he doesn't call it that, but that's what it is — "and the delight becomes my value-added advantage in the Net world where price can't be a value-added advantage."

S+B: Sounds like a theory to me.
WALKER: I believe all those theories are wrong, every last one of them.

S+B: In what way?
WALKER: There's a battle taking place over commerce in the New Economy, especially consumer commerce, which pits convenience as a central theory against savings. There are only four ways to create value in the New Economy, and they're really simple: information, entertainment, convenience, and savings. Every business in an electronic network takes those four elements and blends them in some proportion. But information and entertainment don't provide for good business models. So the real battle taking place has to do with the balance between convenience and savings.

S+B: Can you elaborate?
WALKER: Inasmuch as you base your business on information, there's almost no business there, because information gets reduced to a very low, almost commodity, level. There's very little edge; if information is your product you can't control its redistribution on a network.

S+B: That was a central, early argument made by Esther Dyson.
WALKER: Right. What about entertainment? Tough. Entertainment per unit time is very expensive to create; you'd better have at least $50,000 per minute for programming if you're going up against network television. If you can't compete against television and movies, it's very hard to entertain in our society. Worse, there are so many entertainment choices right now that consumers are not willing to pay that much more for your allegedly better entertainment. Meanwhile, there's a bandwidth issue — an extraordinary problem at this stage of the game. So you've got problems if you're going into the Internet entertainment business.

Convenience turns out to be the first of the major drivers that actually can be ported to the Web. Shop in your slippers, infinite inventory, bank at home, trade stocks at home — those things are really conveniences. Doing them on the Net doesn't add that much quality to the experience. They're primarily improvements in kind. They're not revolutions.

S+B: But why have these "convenience" businesses, as you define them, gained so much prominence, in the media and on Wall Street?
WALKER: Convenience happens to be perfectly aligned with the early adopters, the "rich white boys on the Net," as well as journalists, who are not necessarily affluent, but are time-poor, and are also early adopters. Journalists and other early adopters

are very likely to buy books; very likely to have software shipped to them; very likely to buy toys on the Internet; and very likely to trade stocks at E-Trade. So the outsize apparent impact of convenience has created what we call a "7-Eleven effect." The 7-Eleven effect says, "I don't know why everyone doesn't shop at 7-Eleven — it's so convenient!" For most of the country, the answer is: "Because the prices are too damn high!" But if you're a 7-Eleven customer, a supermarket doesn't make sense to you, a warehouse club makes even less, and an outlet mall is alien. Why would anybody drive 50 miles to save $6 on a sweater? That question makes no sense to anyone who shops at a 7-Eleven.

This explains why such people don't understand WebHouse Club. WebHouse Club is just Costco reinvented. Journalists and early adopters have never been in a Costco or a Wal-Mart. So convenience, to them, seems to be the ultimate driver of Internet commerce. And if your commercial interpretation of value is a convenience model, then Jeff's Amazon approach, driven by convenience, makes sense.

S+B: But it sounds to me like a catalog shopping model — which could be a good business, but it isn't terribly earth-shaking.

WALKER: It's a richer catalog-shopping model. But it has a terrible flaw: No business revolution in the history of our country, no commercial revolution in the history of our country, has ever taken absorbed costs and put them into the non-absorbed sector. None.

An absorbed cost is when I drive to the store and use my own gas, labor, and car depreciation. I absorb that cost. When UPS, on the other hand, has to drive in the other direction to my house, it's an explicit cost — gas, Teamsters, and depreciation. Guess what? None of those things scale. Not only that, there now have to be, explicitly stated in the transaction, shipping and handling costs. Convenience-based businesses are transforming costs that were once absorbed into explicit costs. They play against the mass customer desire for savings.

S+B: So you're saying that the best businesses are built on the fourth of the value-creation sources you enumerated before: savings? Or to put it another way, are you suggesting that profitability in this new medium is predicated on figuring out how to take the costs out of an industry's value chain?

WALKER: Not at all. It's about a balance among those sources of value creation. The opportunity of the Internet is to reinvent the value equation around an information movement. It's not about taking costs out of the system. Putting costs in the system could turn out be more valuable. Disney didn't take costs out of Disneyland. It revolutionized the theme-park business by injecting costs into the business. Network television didn't take costs out of programming; it injected costs into making an entirely new model. Business is about sustainable value; it's not about cost reduction. Don't fall into the engineering trap. Engineers take costs out of things. Businesspeople engineer value equations. And they don't care whether it's about more or less cost: They only care about whether there's more or less value. And if they can charge for the value they create, that's where the successful business lies.

We don't look back and recognize as heroes people who took costs out of the electric distribution system. We recognize as heroes people who understood that electricity had the power to change our lives in every possible way, and figured out how to bring it to everybody at a cost everybody can afford. The real value creators are rarely engineers. You've been tricked into thinking that the Internet is an ERP model of pulling costs out of an economy that somehow is bloated. The economy is actually massively efficient. Cutting costs is a trap. It is a limited-thinking trap.

S+B: But cost-cutting underlies this year's infatuation with reintermediating the business-to-business marketplace.

WALKER: That represents a total misunderstanding of business principles. There is no long-term sustainable value in getting between a professional buyer and a professional seller. They are incredibly good at making sure nobody between them makes any money. I don't care if you're trading T-bills or steel, nobody gets rich between professional buyers. You may for a period of time make money while you help depress their costs, because you have some advantages. But, very quickly, professional buyers and professional sellers don't need your help. And unless you've got a proprietary system in the middle, you can't possibly add value long-term.

S+B: So you think the B2B focus is very much missing the point?
WALKER: I think 95 percent of it is nuts.

S+B: But if the advantage is not in cost-cutting, and the advantage is not in convenience…
WALKER: The real issue is value. Americans drive to Wal-Mart to buy their things. Why? Is it convenient? No, it's on the outskirts of town. Sam Walton reinvented value. He did it in part by cutting costs; his primary way to deliver value was to give you lower prices. But the result was that he could offer value that nobody else could offer. He had a greeter at the door that added costs. That is not cheap. But it added value. He gave stock options to all of his people who worked for him. Why? It cost him money to give stock options. But it added value, because the employee-shareholder would behave. He installed large MIS systems, not a cost-cutting move at all. But ultimately he realized he could replace inventory with information. He was only cutting costs because he had to do that as his way of delivering his value to the customer. He never took more margin over more value. Never.

If you sit down and you ask, "Where is the value center, where is the economic engine for e-commerce?" I guarantee you it is not in cost reduction. Not even close. The economic engine is always in value.

S+B: But low price, as in the Wal-Mart equation, can serve as a magnet.
WALKER: Low price is the driver that gets the behavior you want. The customers will establish price/value tradeoffs. This is why Priceline exists. Priceline is all about personal elasticity. If I provide sustainable price/value, people are smart, they'll get it, and they'll come back. They'll know that I'm not trying to trick them; they can sense it.

S+B: So in the Priceline environment, auction pricing…
WALKER: Don't say auction. We're not an auction. An auction is a price competition among buyers for the benefit of the seller. We are price distributors. We are a pricing system. We are essentially the sixth pricing system in the history of the world.

S+B: The other five would be?
WALKER: Retail price. Auction pricing. Barter. Market price. And RFP, a request for a proposal.

S+B: That's not an auction?
WALKER: No, an auction would set them off against each other. An RFP just says, "Everybody give me a price, I'll pick one."

S+B: In what way is Priceline the sixth system?
WALKER: The sixth way to set price is to let all the buyers set every possible price, and let the sellers decide which ones to take. That's what we do.

S+B: And you figure that value proposition alone is enough to drive the Priceline brand across flanker services, such as the new WebHouse Club, the grocery pricing service; and Perfect Yard Sale, the used-goods site?
WALKER: It's a $100 billion value. Probably bigger.

S+B: Did you know that at the beginning?
WALKER: I knew it day one. It's like saying, if you had discovered the cure to a terrible disease, the minute you discovered it, would you have known you had it? We discovered the cure for a terrible disease, a disease that has existed for hundreds of years. Sellers always have inventory that they could sell at a lower price. And there are always more buyers willing to buy at the lower price, but the seller can't afford to reduce price without destroying his rate card. The seller therefore was forced to hide the discount in some way. In the airline case, for example, if you didn't sell the seats, you'd just let them perish. The seller had no choice. His best interest was to never chase the last sale at the lower price.

We figured out how the seller can have his cake and eat it, too. By injecting uncertainty into the process, the buyer wouldn't know exactly what he was getting, but would know enough of what he was getting that his price would be very attractive — as long as he could name it. He could name his own elasticity for uncertainty. The seller, on the other hand, could say, "Well, if they don't know it's me, I can now sell. Because I can tell the people on the rate card, 'Your price includes certainty. These other people are buying uncertainty.'"

S+B: Starting with the airlines as your suppliers made sense, because they have a history with yield management.

In the Information Economy, pricing data is actually detached from the product. Managed separately, it becomes its own source of value.

WALKER: The airline industry understood it better. We helped them — and others — broaden their yield curve.

S+B: Given that airlines have been operating in this way for years, in what way does this describe a dramatically different approach to doing business?

WALKER: Here's the difference. In the Information Economy, the information component of the economic activity is handled separately from the physical component. In the Industrial Economy, they're inextricably merged. So when you used to print the price on the can of coffee, the knowledge of price was printed on the product; it could not move free. The retailer couldn't adjust it, nobody could move it. In the Information Economy, the information is actually detached from the product and it's treated as a separate element: managed separately, manipulated separately. It becomes its own separate source of value.

S+B: Give me an example of a company where information and product are decoupled.

WALKER: Inasmuch as Federal Express delivers packages physically, it is an industrial company. Inasmuch as FedEx allows you to track the package, know where it is, know your discount, know your billing, can tell you where it's located, then it's an information company. What is worth more to you: the information layer of the FedEx process or the industrial layer? Obviously I want FedEx to industrially deliver my product, so I have an industrial component I pay for. But I pay more for FedEx than UPS service...

S+B: Because of the information component in it.

WALKER: Because of the information value-add. And since the information is typically much higher margin than the industrial element, and because information can be scaled so much faster, the real profit for FedEx is in the information layer and not the industrial layer. The difference between the Knowledge Economy and the Industrial Economy has to do with the detaching of such information. Once you've detached the information, everything changes. Those are the types of ideas we are patenting, and turning into businesses.

S+B: At a luncheon on patent reform at this year's World Economic Forum in Davos, you said the Knowledge Economy will transform the patent system, update it while retaining its advantages.

WALKER: Patents' Industrial Age length in the Information Age appears to be one thing that needs to change within a total package of patent reform. Industrial systems are linked. They were all created as part of the same recipe. The trade laws, the consumer protection laws, the notion of competition — these things are all industrial creatures. They've grown up for the last 100 or 200 years, so what we're looking at today is a very highly evolved set of checks and balances, and systems of decreasing relevance.

Consider capital formation time, which is embedded in the patent system. In the Industrial Economy, it took a great deal of time to amass the capital to finance a business, so patents were granted for 17 years, to cover that period. But the Internet proved that capital formation doesn't take years and years. Capital formation is not a problem, because once you can demonstrate your scalability, capital chases you.

S+B: There are those, like Harvard Law School Professor Larry Lessig, who argue we are allowing too much patenting, especially of business systems, and that this threatens ulti-

mately to inhibit, not promote, innovation. By way of example, he says the Internet was not built on proprietary technology.

WALKER: Intellectual property has stood the test of time in every business revolution. The burden of proof that this revolution would not benefit from strong intellectual property has to be extraordinarily high. Our society benefited massively in the Agricultural Revolution, the Industrial Revolution, in every revolution prior where underlying technology played a role in protecting inventors for limited periods, in return for them taking risk to create. There is no evidence that I can see that this time, it's different. I'm not saying that patents as existing are a universal, perfect answer. Occasionally the Patent Office makes an error. It grants an overly broad patent, and people license it instead of challenging it, as they should. However, to argue that this time it's different, and that protected intellectual property in the Internet space hinders innovation, is totally wrong, unsupported by any evidence, and self-centered.

S+B: To the untutored eye, there does seem to be a fair share of litigiousness in this space. Amazon has sued to protect what it says is its patent for one-click shopping. You've sued Expedia to protect your pricing system.

WALKER: The patent system self-balances against abuse. The patent owner only benefits by as much economic value as he can extract from his limited monopoly — either by building something himself, and/or by licensing what he has invented to others. If he licenses it and tries to extract a price that's too high, the others immediately ask two questions. First, how do I get around your property? If they can get around it, as in "click twice," they do. Therefore, the economic cost is extremely low, the patent holder gets nothing. If they can't get around it, then they ask: "What is the cost to litigate against it, and perhaps overturn it?" The inventor adjusts the royalty in direct proportion to the quality of the property. Which is why I can't charge you a million dollars for land in Montana, but I can charge you a million dollars for land on Park Avenue.

S+B: Another fear generated by the new rush to patent is that we are inhibiting free inquiry, especially in universities, where the reflex action among faculty and students is no longer to publish or perish, but to patent or perish. At our lunch in Davos, Bill Brody, the president of Johns Hopkins University, said, "Value recognition is driving a stake through the heart of open communication."

WALKER: It's great news that we are now putting a commercial incentive system for innovation in our universities, which had been struggling to find R&D money. As there was never a feedback loop, we couldn't retain our best people in universities. They went to private institutions. And when they were there, we couldn't get them the budgets. What's more, the fears about information dissemination are misplaced. We live in a first-to-invent country. There is nothing stopping you from openly sharing all of your information. You have one year and a day after you disclose it to the public to file a patent. So disclosure loses you nothing.

S+B: It's a full circle. Ideas build businesses, and the business incentive builds more ideas. The idea rules.

WALKER: We are always better off putting in place economic feedback loops that are balanced for the interest of all parties than we are avoiding economics. No great society was built on giving it all away. +

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