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Research

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PayPal's New Micropayment Pricing Will Dominate Market

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PayPal's micropayment strategy may precede plans to manage more traditional payments, as well as online transactions. Vendors should adjust plans to encompass PayPal rather than hold fast to outdated payment methods.

NEWS ANALYSIS

Event

On 31 August 2005, the online payment service PayPal announced new micropayment pricing for online goods. (Gartner defines “micropayments” as the transfer of funds from the buyer to the vendor for transactions under $5.)

Analysis

PayPal’s move into the micropayment market was a sound business decision, and one that is likely to lead to market domination. PayPal can beat credit card pricing because it blends credit card, bank account transfer and stored PayPal account value funding on the payer side, lowering PayPal’s overall cost of funding any payment. PayPal encourages repeat payer customers to keep money in their PayPal accounts (the company’s lowest-cost funding method), and to use credit cards (the most expensive funding option) as a last-option funding method.

PayPal has long had the capability to service the micropayment market. However, the company waited until it had amassed enough customers (it claims 78 million accounts) and enough opportunity to earn profits from merchants who sell goods and services priced under $3. The move to micropayments was simply a matter of changing PayPal’s pricing model and offering online merchants a rate of five cents plus five percent of the total cost for transactions under $3. For example, PayPal’s micropayment fee reduces the merchant fee from 35 cents to 15 cents on a typical $2 transaction — roughly the price of one ring tone or single online greeting card.

PayPal’s expansion is bad news for countless startups around the world that have tried to enter the micropayment market. Although credit/debit card companies could enter this market simply by lowering merchant transaction fees, these companies don’t have the PayPal advantage of funding payments from PayPal stored accounts, as well as traditional bank accounts.

Recommendations

- **Vendors in the micropayment market:** Offer value beyond payment processing to compete with PayPal. (For example, a vendor serving the vending machine market could also manage vending machine maintenance and inventory.)
- **Banks, card issuers and other vendors**: Consider reselling PayPal payments to merchant customers, instead of devising ways to compete with PayPal.

Analytical Source: Avivah Litan, Gartner Research

Recommended Reading and Related Research

- "Federal Reserve Conference Highlights Impasse on Card Interchange Fees" — U.S. regulators and Department of Justice officials should enable merchants to collaborate on implementing card payment alternatives and force more disclosure and transparency in interchange rate setting. **By Avivah Litan**
- "Online Bill Payment Is Finally Ready for Prime Time" — Providers and billers need to determine which long-term competitive and service strategies to pursue via the promotion of online bill payment, and develop alliances and marketing programs that enhance these goals. **By David Schehr, Avivah Litan and Mike Cruz**

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