Good-bye Flat Rate!!

Germany's T-Online made a bold but correct move when it dropped flat-rate pricing.

When will others see the light?

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Flat-rate pricing is a temptation many corporate managers find hard to resist. And why not? It makes life much simpler. A flat rate is easy to communicate, easy to understand, and easy to plan around.

It is also economic nonsense.

When Thomas Holtrop, the CEO of Germany's T-Online, decided to end his company's flat-rate pricing policy, he did so to stop the bleeding and to send a clear message to investors. The era of "customers at any cost" marketing is over. Analysts say that the introduction of the flat-rate had contributed to T-Online's estimated pre-tax loss of € 125 million in 2000. The mathematics behind those losses are actually quite simple, as any California electricity regulator can tell you. A producer's absolute costs explode as demand surges, and he has no way to recoup those costs if consumer prices are capped. And that is exactly what a flat rate does.

Mr. Holtrop referred directly to our own research when he said that consumers' use of the Internet is *needs-based*, not price-driven. This knowledge has implications far beyond the customer base of T-Online, the world's second-largest Internet Service Provider (ISP) behind AOL. Every single company now grappling with a new pricing policy - from media companies such as Yahoo! and the Financial Times to future UMTS carriers all over the world to software or service providers like Microsoft and Napster - should thoroughly explore their pricing options instead of saying a zombie-like "yes" to the siren call of the flat rate.

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The flat-rate is straight out of central planning

In the former East Germany, consumers paid a flat rate for home heating. This policy had a predictable result. People simply left their heat running at full strength all day and all night. When they needed to regulate the temperature, they simply opened their windows.

It should come as no surprise that Internet surfers - not only in re-united Germany, but all over the world - behaved much the same way when they were offered a flat rate for their Internet use. American surfers have known flat rates for even longer. When AT&T announced a flat rate for Internet access in February 1996, then-chairman Robert E. Allen pronounced that "the company that brought everyone the phone now will bring the Internet to everyone. We believe the Internet will make communities more cohesive and businesses more competitive when it extends beyond the small percentage of people who use it today."

Five years later, the company is still at it. In February 2001 AT&T announced "a single, simple new service" called the AT&T 7/7 Offer. The flat rate is now down to US$7 per month, for which a customer receives unlimited Internet usage. Where is this getting AT&T? It's hard to say, because they only report revenues for WorldNet, not earnings. But one thing is clear. They won't make any money with it.

Far from promoting a utopian "Internet for everyone" dream, the use of a flat rate impedes technical progress and causes costs to rise much faster than revenues. This helps explain why a large number of ISPs have run into financial trouble. While even the most hungry guest in an "all-you-can-eat" restaurant will eventually push himself away from the table, the voracious demand of "all-you-can-eat" online users is nearly insatiable. They never stop "eating", because they leave their PCs permanently logged on to the network. They download MP3 files until their hard drives crack, no matter how long it takes. This "always-on" mentality - after all, one could miss an *very* important e-mail while being offline - is the root of the ISP's troubles. Losses were inevitable.

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Do Internet flat rates make sense and benefit the Internet community? No, they don't, for the following reasons:

- *Internet flat rates foster neither Internet penetration nor e-commerce.* Given the choice, no Internet novice will start with a flat rate, because flat rates only make sense for heavy users. The flat rate won't help the ISPs to acquire a single new customer. No one buys a year-long pass for a swimming pool when they don't know how to swim. It is wrong to place the blame for e-commerce's struggles on resistance to a "high" charge of € 0.01 per online minute and implement a flat rate its place. At the cost of one SMS message, you could surf for 20 minutes in the Internet. Most Internet-based business models simply lack both real benefits for the consumer and a simple, attractive system for micropayments.

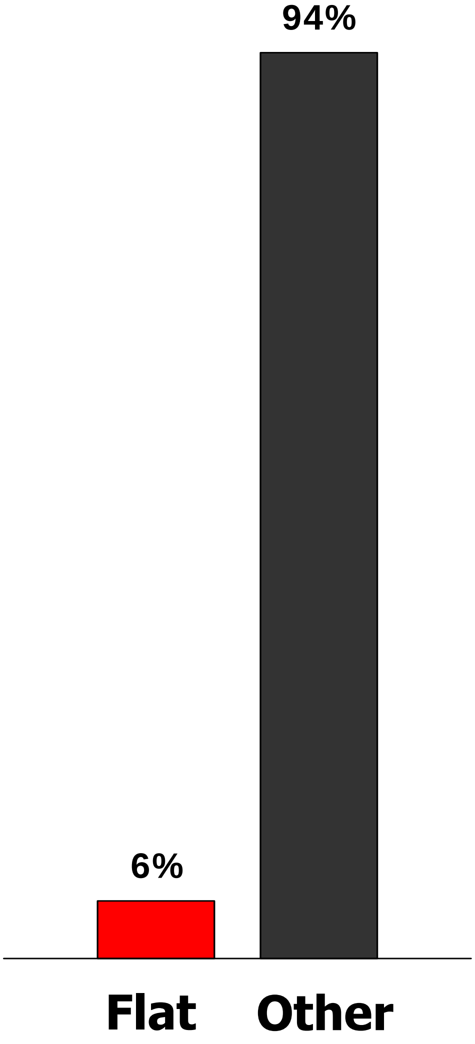
- *Flat rate tariffs make no financial sense for ISP's.* When introducing an unmetered flat rate tariff, an ISP has to take three customer segments into account: **heavy users**, **low users**, and **potential new customers**. Heavy users can run up bills of up to € 150 per month under a per-minute billing system, which means that a flat rate below € 50 per month represents a huge discount. At the same time, their capacity-crippling "always on" mentality increases the ISP's costs. Low users, meanwhile, will hesitate to change to the flat rate tariff. If they do sign on, they will make sure they get their money's worth. As a result, they generate significantly higher costs for the ISP, but only slightly higher revenues. As for potential new customers, it is doubtful that a flat rate has any effect at all. When all competing ISP's offer nearly identical flat rates with comparable services, where is the customer's incentive to switch?

Finally, the Internet novice will stick to Internet-by-call offers and won't opt for the flat rate, because the flat rate is too expensive.

- *Flat rates bring no public benefit, because the vast majority of low users subsidize the small minority of heavy users.* Fewer than 10 percent of Germany's Internet users are online for more than 40 hours per month. That's the small fraction which actually benefits from a flat rate. After AT&T introduced an Internet flat rate in the United States, it soon found that 4 percent of its users blocked 50 percent of its available capacity. Other ISPs report similar figures. "All-you-can-eat" offers — unless they have a strict upper limit on consumption — benefit the gluttons at the expense of low users. It might be noble to help bring a new product idea to a mass market, but this must also be done profitably. It is difficult for us to imagine John D. Rockefeller offering "all you can drive" gasoline by subscription, Sam Walton opening an "all you can buy" Wal-Mart, or Ray Kroc building his McDonald's franchise on the back of "all you can eat" burgers and fries. Let's not confuse affordability for the masses with charity for a select few, which is exactly what a flat rate policy does.

- *Flat rates in narrow-band connections lead to an inefficient allocation of investment.* The promoters of flat rates seem to think that Internet usage and costs are completely unrelated. That is essentially correct until maximum network capacity is reached, which actually happened in Germany after the introduction of the flat rate. A flat rate tempts users to stay online permanently, and the data show that they yield to this temptation. While an average phone call lasts 2-3 minutes, flat rate users remain online for hours. A flat rate user who stays online for 8 hours blocks the equivalent capacity for 72 average telephony customers. This creates bottlenecks in network access capacity, which can only be eased by heavy investments into a network which was never designed to handle massive data traffic.

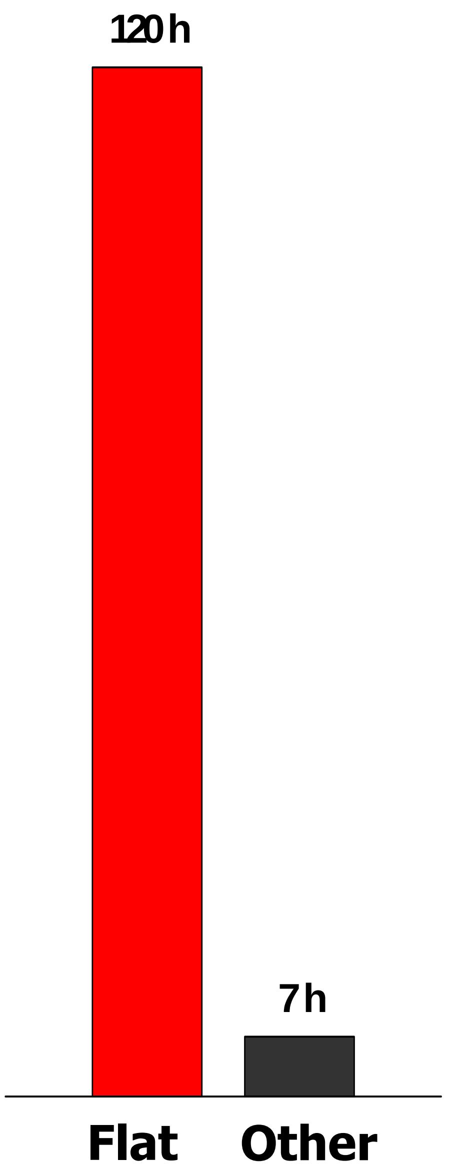
Here's how many narrow-band customers on average actually take advantage of a flat rate ....



Flat rates are not profit-maximizing, but rather "work minimizing"

In the baseball film *A League of Their Own*, Tom Hanks' character Jimmy Dugan scolds Geena Davis' character Dottie because she quit the team when "it just got too hard."

... and here's the relative amount of capacity (online time) those same users eat up !



"It's supposed to be hard," Dugan says. "The hard is what makes it great. If it wasn't hard, everybody would do it."

No better sentence exists to describe the blood and sweat that ought to go into the development of a pricing strategy which leads to consistent profits. Most companies which opt for flat-rate pricing essentially admit that "it just got too hard." It got too hard to develop a better value proposition and fight on other terms besides price. Perhaps frustrated in their attempts to recognize true value-to-customer and develop a sustainable product which delivers it, companies take the easy route and say "we're not different, we're just cheaper."

But as T-Online's Holtrop pointed out, Internet usage is needs-driven, not price-driven. This holds true, even though the ISP - described by some analysts as nothing more than a "dumb pipe" - seems like a standard me-too commodity business. In our research in many industrial and consumer areas, it is not uncommon for us to meet marketing managers who happily describe their prevailing pricing philosophy and supporting research in one sentence: "I look what our market leader does and come in 5%-10% lower."

We cannot deny that many companies also make a nice living with that simple pricing philosophy. But this comfortable approach has a short half-life in today's investment climate, which is still guided by the principle of shareholder value. At some point investors and analysts will realize just how large the gap is between "comfortable" profit and "optimal" profit, and exact their penance.

Why should companies allow such a clearly avoidable situation to arise? The reasons are myriad. They range from internal political factors, to an unwillingness to change, to an incomplete understanding of what value the company provides its customers and what effects its pricing - both in terms of structure and levels - can have on sales and profitability. We will focus on the latter point, because it provides the necessary foundation to make a case for changing the way a company goes to market with its products and services.

A needs-based approach systematically embraces the entire marketing mix

When Bertelsmann CEO Thomas Middelhoff told an audience at the World Economic Forum in Davos, Switzerland that Napster would become a for-pay service by summer, he touched off even more speculation on what approach the company would take and how much using Napster will cost consumers in the future. Napster's complex situation illustrates the kind of homework companies need to undertake if they want to avoid the trap of flat-rate pricing.

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Who are my customers? This question digs far deeper than demographic profiles and traditional genre labels, and focuses the discussion on value. Think for a moment why someone would want to use Napster. While some simply want to avoid buying compact discs at retail prices, others have sharply different motivations. Some fans may seek out-of-print songs, because they can't find them in second-hand stores or don't have the time to look. Others may want music that has never even been available commercially, like recordings from a successful local artist or a concert outtake. In each case the customer receives a song, but the benefit - and the associated willingness to pay for that benefit - can vary greatly. A flat rate cannot even begin to capture these value differences, and the company which adopts one simply leaves money on the table.

What are my products? In this regard, Bertelsmann Music Group (BMG) and Microsoft face similar challenges. Traditionally these companies develop software, then stamp out compact discs, package them, and sell them through a vast network of retailers. What happens when this physical constraint is suddenly gone? What is the real product when Napster becomes an application service provider (ASP) for the record industry and Microsoft becomes an ASP for, well, Microsoft? Again, the question comes right back to one word: value. How do customers benefit if Microsoft starts delivering its Office Suite online instead of in a shrink-wrapped carton? What other product bundles are possible? And with whom can they work to reach a broader group of customers or serve them more easily? There are possibilities of hooking up with mobile phone carriers, who will soon need attractive, traffic-generating content to fill their UMTS airwaves.

How much should I charge, and how should I charge it? It's time to turn value into money. There are literally hundreds of viable ways to charge customers, ranging from the mundane elements we know from mobile phone tariffs to more complex constructions based on non-linear pricing schemes and carefully constructed bundles. Putting numbers to these possibilities demands a complete understanding of how these variables are interrelated and how sensitive they are to changes. In other words, it requires:

- identifying all relevant pricing elements,
- measuring and quantifying price elasticities for these elements,
- developing decision support models which represent the realtionships between the price elements and their elasticities,
- modeling and quantifying the sales and profit effects of different price structures, levels and strategies.

Overwhelmed by the complexity of the task and unwilling to uncover price elasticities and price-response functions, many managers make a trade-off. They opt for a comfortable way out - often a flat-rate - and skip the hard math, in the illusory belief that they are least doing their business no harm. Our experience in the last 15 years has shown just how illusory this belief is. Far from protecting their business, these managers risk harming their long-term success by easily sacrificing up as much as 30% in their potential profits. Pricing is a dangerous lever, and most companies have little room for error. But pursuing this extra 30% makes the blood, sweat, and math worthwhile.

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