The Price Is Right

Best Practices in
Pricing of Telecom Services

Summary

Price is a key buying factor for telecom services. It communicates the value of your offer and creates a host of expectations about it. Indeed, pricing can make or break the success of a new product or service.

An overpriced offer will almost always lead to slow penetration and low market share. For services that have a critical mass threshold to function properly and reach profitability, overpricing can be detrimental to say the least. Many telecommunications services need this critical mass; there's little use in having a phone if there is no one to call.

On the other hand, underpricing an offer can make an otherwise viable value proposition unprofitable. This lack of profit can eventually lead a company to discontinue the service: destroying customer value and loyalty in the process. When 'pay as you go' tariffs were first launched operators were unable to invoice text messages. Had they not been able to set a correct price for the service they would have been forced to discontinue it. Knowing what a success texting has become, we can see how they would have missed out on a wealth of customer value.

How do you set a price? What are the key factors to consider? Let's look at what pricing methodology has to offer.

1. Cost Plus Pricing

With cost-plus pricing you calculate the cost of your product and then add a mark-up (that accounts for profit margin) to set the price. For products that have a lot of direct costs this is a fairly easy method.

There is a major objection to cost-plus pricing: the customer is absent in this process, as is the competition. A cost-plus price is typically enterprise centric, not market centric. Cost is of course important to evaluate the impact of a price on enterprise profitability. However it should not be the initial factor to consider when setting a price, but the final factor that allows you to decide which one of the price/volume scenarios would be the most profitable.

2. Competitive Pricing

Competitive pricing looks outwards to the market. Competitors are offering products and services that cater to the same needs as your offering. If your value proposition is significantly different from your competitors', you first need to quantify your value differential in terms of brand image, network coverage, bandwidth, customer service... In many cases what you offer is quite similar to the competition and customers might not readily perceive an advantageous difference in value.

Many telecom providers have taken the route to gain (or protect) market share using competitive pricing. Look at what operator X is charging, go below it to get (or keep) a piece of the pie. Operator X will very often respond by dropping its prices too. This could lead to a price war. Some telecom markets have recently shown a dynamic of this type with new competitors entering mature markets and using aggressive prices and disruptive pricing models (such as flat rates) to grab market share. The result has been destroyed value for the consumer and lower profit for telecom providers.

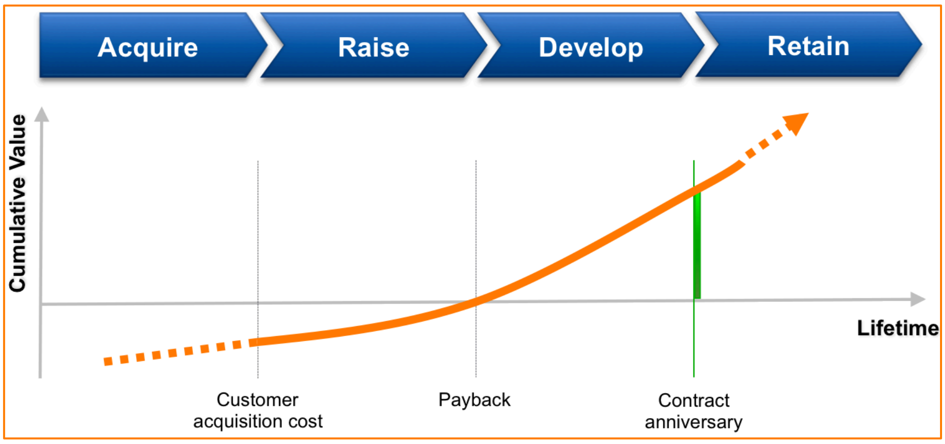
3. Value-Based Pricing

Value-based pricing brings the customer into the equation. He is the only judge and decider of the value of a product or service. To set a value-based price you need to understand the needs of your customers and quantify how much they value the different features of your offering. This can be achieved by talking to customers, through market research or through analysis of customer behavioral data (i.e. expenditure, usage, subscription/renewal/churn, satisfaction and how they impact customer life time value). This analysis will reveal different customer segments in terms of perceived value and price sensitivity.

Quantifying the value that a customer assigns to a product or service is the first part of the value-based pricing process. Next you will need to analyze your value proposition and price versus competition. It is the combined knowledge of those two elements that will allow you to formulate an efficient pricing policy that maximizes profitability by reflecting customer value whilst concurrently keeping the offer competitive enough to gain/protect market share.

4. Optimizing Customer Lifetime Value

Lifetime value (LTV) is the best metric to assess the impact of pricing decisions at the customer level as it takes the short and long-term effects into account. The chart shows the three key levers that influence the lifetime value of a customer.



At acquisition time: the customer will perceive the benefits of a subsidized telephone set, more usage (e.g. call time, internet access...) and a lower perceived price.

Then comes the raise time: the customer will be offered tariffs that better suit his voice and data consumption within the same plan he subscribed to.

During the development time: the customer may be ready to pay for up-sell and cross-sell options such as more time for international calls, data/multimedia services or other value added services.

Finally, at the retention time: the customer may be happy with a loyalty subsidy for a new telephone set. If you assess a high churn probability due to quality reasons or due to a significant price gap with competition, a special discount on the price plan or additional usage time to targeted destinations may be good tactics. At this point in time the telecom operator will have knowledge of customer true usage profile and may be able to simulate the precise effect of a special promotion on customer lifetime value.

5. Competitive Price Positioning and Customer LTV

Let's take a look at one particular customer segment and try to assess the impact of competitive price positioning on customer's LTV. By analyzing the usage profile of each customer and the different price plans proposed by competitors we are able to identify the best offer for each customer and derive the competitive price index reflecting the gap between the current price/value for each customer and the price/value available in the market for the customer based on the customer's actual usage.

This base point is used to benchmark actual customer price and analyze the impact on their lifetime value through revenue stream and churn rate as observed for different levels of the competitive price index.

The result is a price playing field with 3 zones:

Underpricing zone: The price level applied to these customers is too low: Customers are actually willing to pay more for the service. A price increase will be positive as its impact on revenue is higher than the potential decrease of loyalty.

Optimal pricing zone: in this zone the effects of price changes on LTV are very small. This also means that price reductions within this zone have no impact on total value.

Overpricing zone: Customers are churning in larger numbers and LTV for these customers drops fast. A price increase is offset by a knock down effect on loyalty.

Operator's customers are spread over these three zones. Understanding each customer's actual positioning and migrating customers from zone 1 and 3 to zone 2 will significantly boost the total value of the customer base.

Migrating zone 3 customers is quite easy: A better price or a better offer for the same price (e.g. more minutes, better phone set, value added services included in the pack...) can be proposed to these customers.

Migrating zone 1 customers is somewhat more tricky: These customers benefit from a very good deal and would most certainly not find a better one in the market. The main learning here is to find out which price plans are responsible for this situation and to see to improve these price plans.

Conclusion

By identifying customers in zone 1 and 3, mobile operators can improve the total value of their customer base by using targeted offers for each customer at risk (zone 3) and increasing yield of price plans for customers with a low competitor price index and with very limited impact on churn (zone 1).

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