



NEW ZEALAND INSTITUTE FOR THE STUDY
OF COMPETITION AND REGULATION INC.

FLAT-RATE TARIFFS AND COMPETITIVE ENTRY IN TELECOMMUNICATIONS MARKETS

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FLAT-RATE TARIFFS

Widespread in broadband markets

- increasing popularity in fixed voice markets

Strong support from

- policy-makers (e.g. OECD)
 - increased uptake, usage of internet access under flat-rate PSTN tariffs
- consumers
 - ‘insurance’ from unexpectedly high usage fees (Mb usage unknown)
 - very high volume users (subsidy from low-volume users)
- operators
 - predictable income streams (especially for new entrants)
 - appropriate surplus from risk-averse/uninformed consumers



LIMITATIONS (I) – WELFARE AND UPTAKE

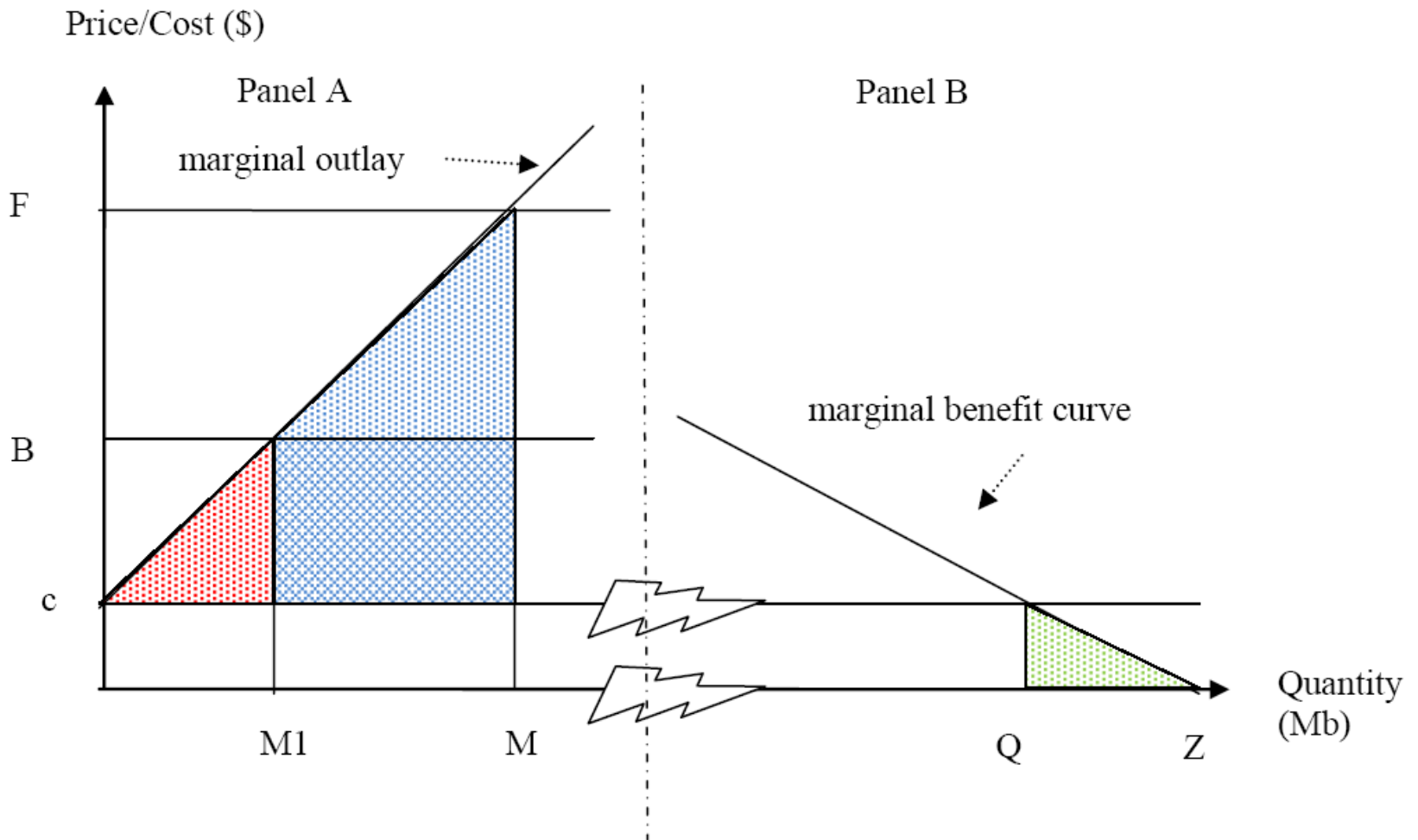
Flat-rate tariffs prioritise welfare from more usage over welfare from more connections

- users consume until marginal benefit of usage is zero, not marginal cost
 - usage below marginal cost is ‘subsidised’
- ‘average’ flat-rate tariff prices low-volume users out of the market, even though the value of their use is higher than that usage the flat-rate tariff induces from subsidised (high-volume) usage

Flat rate broadband tariffs thus depress the rate of broadband connection purchase

- relative to a two-part tariff





LIMITATIONS (II) - STRATEGIC

What to do when average consumption increases?

- network operators ultimately bear costs of demand variation
- flat-rate tariffs accelerate rate at which risks crystallise

Broadband usage is not costless

- CONGESTION!!!!
 - consumers insulated from price variations, but bear quality degradation
- ultimately network upgrades required => costs increase

Increase flat-rate tariff?

- costs increase, revenues decrease as low-valuing consumers exit

Set two-part tariff?

- also cannibalises revenues if median usage is less than average from which flat-rate tariff derives



SOLUTION (I) - INTERIM

Two-part tariffs enable the practice of a form of price discrimination

- connection, usage sold in a bundle
- menus enable self-selection into tariffs by usage volume

How to engage in price discrimination using another metric?

- invest in increased connection speed – segregates users on value of the internet connection based on value of time
 - high time-valuers (demand-inelastic) substitute to faster connections
 - low time-valuers (often high-volume, price-elastic users) stay on congested slower connections
 - can continue to price faster connections at flat rate at a high premium
 - although cycle repeats



FASTER CONNECTIONS A SUPPLY-SIDE (NOT DEMAND-SIDE IMPERATIVE) DRIVEN BY FLAT-RATE TARIFF STRUCTURES

US – Pew Internet Survey 2008; OECD 2009

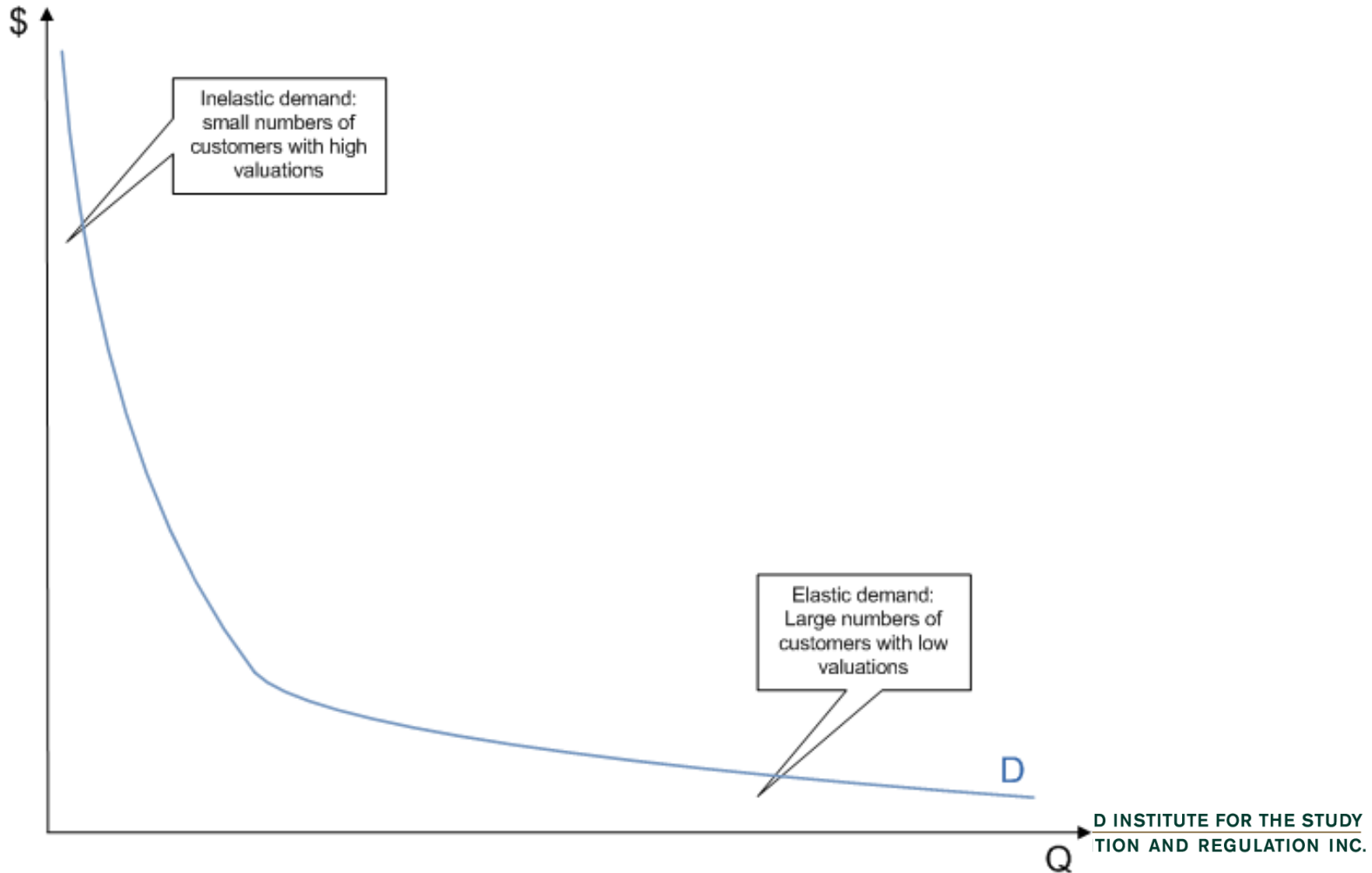
- only 33% of households purchase a connection faster than their operator's standard speed connection
- willingness to pay a price premium low – revenues per connection from premium speeds only 1.2 times standard speed, despite very high speeds being sold at multiples of 4 to 7 times standard speeds
- applications used differ very little between 'fast' and 'standard' households

Limits to selling faster and faster connections to existing consumers

- will eventually stop substituting unless new applications emerge



LIKELY DEMAND CURVE FOR FAST BROADBAND



THE SOLUTION (II) - SUSTAINABLE

The new 'low-hanging fruit' is non-internet and low-valuing users

Two-part tariffs

- fixed fee to connect and 'buckets of megabytes
- but only at the 'slow' 'low valuing' end of the market

Competitive incentives

- as long as demand is asymmetrically distributed, an entrant can charge a two-part tariff that will attract low-volume users away from incumbents (adverse selection)
- incumbents left only with (relatively) higher-cost high-volume users => must increase charges for flat rate tariffs, or respond likewise with two-part tariff



OECD EVIDENCE (2009)

Countries that started with two-part tariffs (capped plans) have largely maintained them

- Australia, Belgium, Canada, Iceland, Luxembourg, New Zealand, Slovakia

Capped plans are starting to emerge in some countries where flat-rate tariffs once prevailed

- increase in the percentage of capped plans on ADSL 2006-8
- appear to be offered on low-speed plans (UK, US)
- but fibre connections rarely capped

Flat-rate tariffs more likely to prevail if cable operators were offering flat-rate plans initially

- co-ordinated strategic action?



CONCLUSION

Flat-rate broadband tariffs are a phenomenon of an early-stage technology

- still diffusing
- usage growing as new applications developed

Unlikely to survive as technology, demand mature

- competition, asymmetric usage patterns will lead to tariff differentiation

Tariff structure implicated in a supply-side driven investment in faster technologies ahead of consumer demand, willingness to pay

- speed used as a proxy to separate out high-valuers for the practice of priced discrimination
- possible only because of collective strategic market power
- unlikely to be a stable tariff structure long-term

