Cost-based and demand-based tariffs

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Agenda

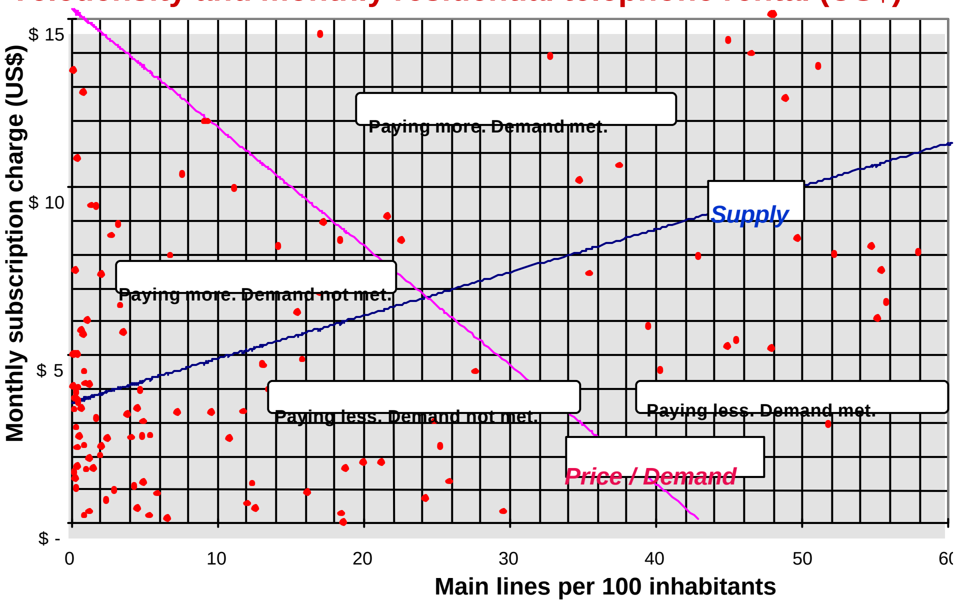
- Supply and demand
  - ⇒ The functions of the tariff
  - ⇒ Pricing strategies
- Approaches to pricing
  - ⇒ Demand-based
  - ⇒ Cost-based
  - ⇒ Market-driven
- Tariff structures
- Tariff rebalancing

The functions of pricing

- To forge a link between supply and demand
- To generate revenues and cover costs of providing service
- To convey information to customers concerning the service
- To provide a platform for competition

Demand is a function of price

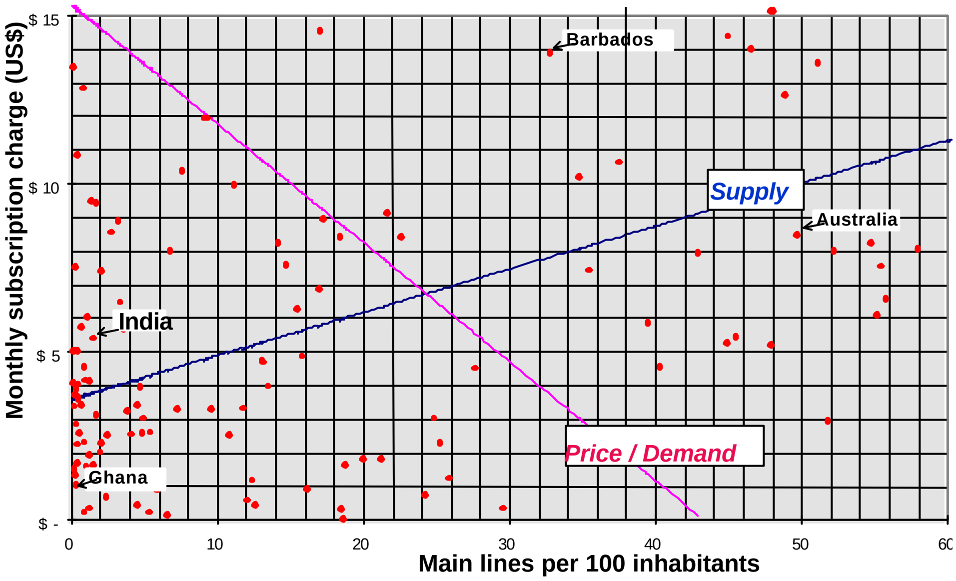
Teledensity and monthly residential telephone rental (US$)



Source: ITU "World Telecommunication Development Report, 1998: Universal Access"

Pricing strategies, selected countries

Teledensity and monthly residential telephone rental (US$)



Source: ITU "World Telecommunication Development Report, 1998" (forthcoming).

Cost-based and demand-based tariffs

Approaches to pricing

- **Demand-based pricing**
  - ⇒Pricing according to what the customer is able to pay
  - ⇒May be required by politicians (monopoly environment)
- **Cost-based pricing**
  - ⇒Pricing according to what the service costs to supply
  - ⇒May be required by regulators (regulated environment)
- **Market-based pricing**
  - ⇒Pricing in order to compete with other suppliers in the marketplace
  - ⇒May be required by shareholders (competitive market)

Reasons for cost-based pricing

- To cover the full costs of providing the service
- To recognise cross-subsidies between services and between users
  - ⇒to eliminate them
  - ⇒to make them explicit, e.g., for Universal Service
- To prepare for competition
- To prevent abuses of competitive position

Approaches to costing

- Fully-allocated pricing models (e.g., TAS cost model)
  - ⇒ total costs for providing service (including historical, depreciated investment costs) divided by the volume of service provided (e.g., minutes of use, number of subscribers)
- Incremental pricing models (e.g., LRIC)
  - ⇒marginal cost of providing an additional unit of service (e.g., next minute of traffic, next subscriber)
- 1001 different flavours of the above

Traditional pricing structures

- Cross-subsidies to network access
  - ⇒Connection charges cover only a fraction of costs
  - ⇒Low-cost monthly rental
- Cross-subsidies to local loop
  - ⇒High-cost international and long-distance charges
  - ⇒Free, unmetered or low cost local calls
- Geographical and social averaging of costs
  - ⇒Uniform charges for connection & rental
  - ⇒“One price fits all”

Market-oriented pricing structures

- Cost-oriented
  - ⇨ Connection charges reflect real underlying costs
  - ⇨ Monthly rental includes only a small element of usage
- Reflecting technology trends
  - ⇨ moving towards distance-independent tariffs
  - ⇨ biggest price cuts in international call charges
- Market-driven
  - ⇨ Tariff options for different user groups
  - ⇨ Discounts, special offers, promotional prices ….

Cost-based and demand-based tariffs

Typical evolution in monthly subscription charge

Social

- Monthly fee kept well below cost
- Monthly fee includes free local calls plus rental of handset plus services
- Unbundling of monthly subscription
  - ⇒handset rental;
  - ⇒local calls
  - ⇒extra services, e.g., Directory inquiry
- Split between residential and business subscriptions
- Progressive rise towards costs

Cost-based

Cost-based and demand-based tariffs

Typical evolution in local call charges

Social

- “Free” local call charges included in monthly subscription
- Limited number of free calls included in subscription, others charged
- Local calls timed and metered
- Size of pulse unit shortens
- Size of local call zone shrinks

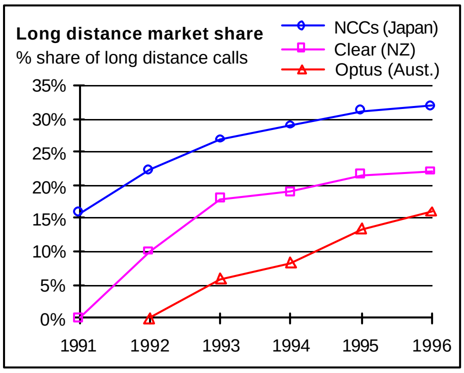
Cost-based

Typical evolution in long distance prices

Social

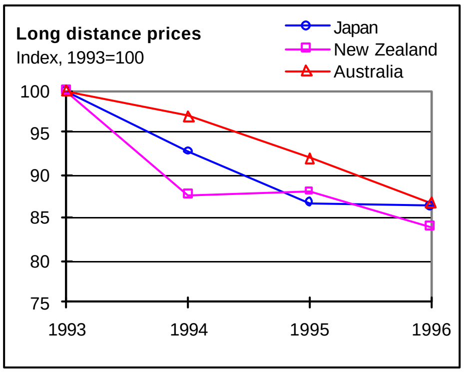
- Highly distance sensitive charges. Long distance call >100 times cost of local call
- Introduction of off-peak rates
- Reduction in number of bands
- Reduction of distance and duration elements
- Long-distance call <3 times cost of local call

Cost-based



As competitors gain market share ...

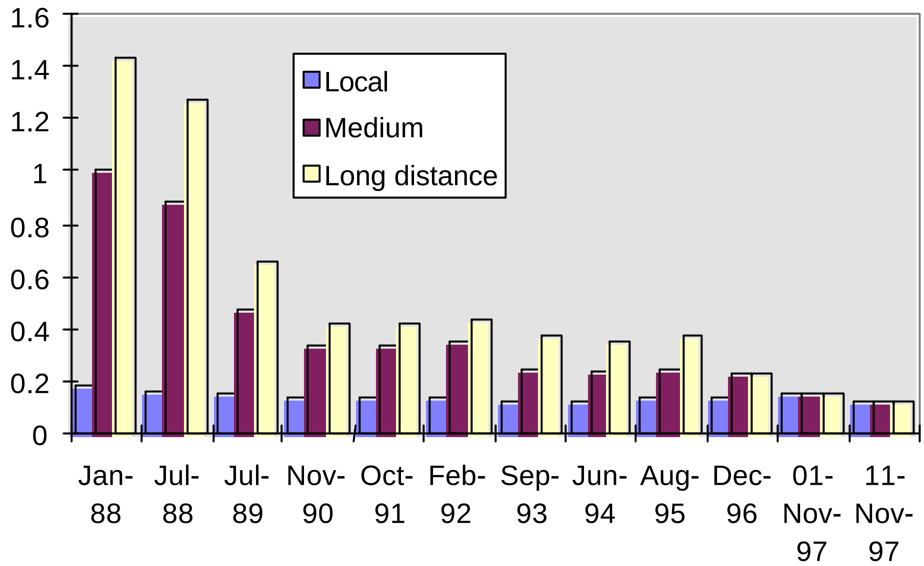
Long distance prices come down ...



Source: ITU Asia-Pacific Telecommunication Indicators, 1997.

Rebalancing in action:

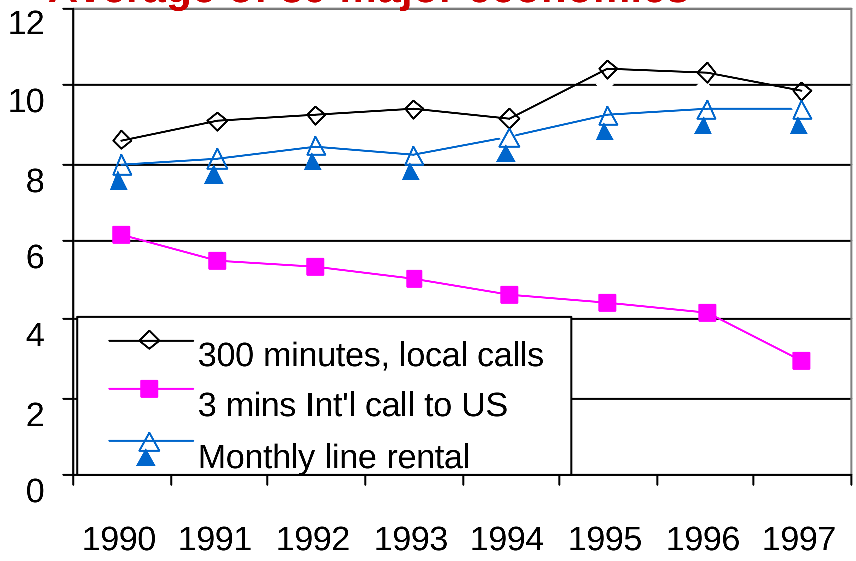
Iceland Telecom, price of 3 minute, peak-rate call, includ. tax



Source: Iceland Telecom, OECD.

Tariff rebalancing trends, in US$

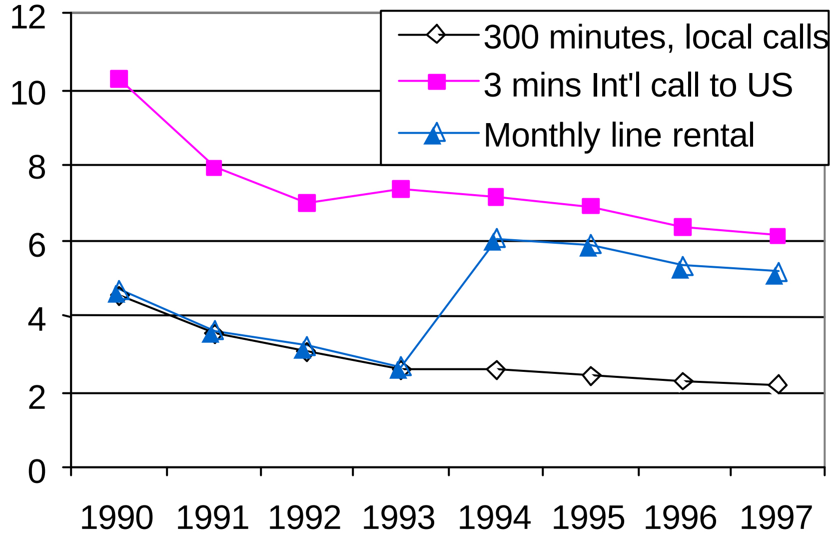
Average of 39 major economies



Source: ITU World Telecommunication Indicators Database.

Tariff rebalancing trends, in US$

For India



Source: ITU World Telecommunication Indicators Database.

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Conclusions

- **Introduction of competition requires fresh approach to tariff strategy**
- **Under monopoly, social-pricing or demand-based pricing was possible**
- **Under competition, pricing which is not cost-oriented will be rapidly undermined**
- **Market-driven pricing means understanding customer requirements**
- **Tariff rebalancing should be gradual, but the best time to start was yesterday**