The Flat-Rate Fallacy

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BONN -- New Economy companies are finally looking for ways to make money. This will be difficult, but not for the reasons usually cited.

The problem is not some ingrained notion that Web content should be free of charge and uncorrupted by profit making. Even the Internet bible, the *Cluetrain Manifesto*, hints that the online community will pay up if someone makes the offer attractive.

Rather, the problem involves finding the right relationship between value and price.

Pricing is a vast unexplored territory for much of the New Economy. As such, it holds unexpected dangers and more than a few nuggets of fool's gold.

One such danger is flat-rate pricing, a temptation many managers find hard to resist. And why not? Flat-rate pricing is easy to communicate, easy to understand, and easy to plan around. Unfortunately, it is often economic nonsense.

The mathematics behind the flat-rate fallacy are 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. A single inflexible price for everyone can also miss the mark if consumers have vastly different needs and demands.

When Thomas Holtrop, the CEO of Germany's T-Online, decided to phase out flat-rate pricing earlier this year, he referred directly to our firm's research when he said that consumers' use of the Internet is needs-based, not price-driven.

This means that the future online customer relationships can be value-driven, if companies find the right equation. Companies such as Yahoo!, future mobile-Internet carriers, Microsoft and the soon-to-be-relaunched Napster should all explore their pricing options thoroughly instead of succumbing to the siren call of the flat rate, a one-size-fits-all option that leaves much of that value untapped.

What is wrong with flat-rate pricing? First, flat-rate prices take a page directly from central planning. East Germans used to pay a flat rate for home heating, so some people left their heat running at full throttle all day and night. When they needed to regulate the temperature, they opened their windows.

Internet surfers behave the same way. Flat rates, unless they have a strict upper limit on consumption, benefit heavy or greedy users at the expense of less intensive users. Fewer than 10% of Germany's Internet users stay online for more than 40 hours per month. So a small fraction of users actually get the full benefit of a flat rate. After AT&T introduced an Internet flat-rate price in the United States, it soon found that 4% of its users used up 50% of its available capacity.

It might sound noble to bring a new service to a mass market, but this must also be done profitably. It is difficult to imagine John D. Rockefeller offering "all you can drive" gasoline by subscription or Ray Kroc building his McDonald's franchise on the back of "all you can eat" burgers and fries. But that's exactly what a flat-rate pricing policy does when aimed at a market with very diverse needs and requirements.

Flat rates are also "work minimizing" for a company, not profit-maximizing. In the film "A League of Their Own," Tom Hanks' character Jimmy Dugan scolds Geena Davis' character Dottie because she quit his baseball team when "it just got too hard." "It's supposed to be hard," Dugan says. "The hard is what makes it great. If it wasn't hard, everybody would do it."

Many companies that opt for flat-rate pricing admit that variable pricing "just got too hard." It got too hard to develop a better value proposition and fight on other terms besides price. They take the easy way out and say "we're not different, we're just cheaper." In our work, we often meet marketing managers who happily describe their prevailing pricing philosophy in one sentence: "I look at what our market leader does and come in 5% to 10% lower."

Some make a nice living that way. But this comfortable approach has a short half-life in today's investment climate. Investors will soon realize just how large the gap is between "comfortable" profit and "optimal" profit, and exact their penance.

Companies need to develop an appreciation for the kind of homework they need to do, if they want to avoid not only the trap of flat-rate pricing, but also the introduction of a pricing system that does not jibe with users' willingness to pay. The fundamental questions include:

Who are my customers? Think for a moment why downloading music appeals to so many people. While some simply want to avoid buying compact discs at retail prices, others may want a hard-to-find or out-of-print song. 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 capture these value differences, and the company that adopts one leaves money on the table.

What are my products? Microsoft traditionally develops software, then stamps out compact discs and booklets, packages them, and sells them through a vast network of retailers. What happens when this physical constraint is suddenly gone? How do customers benefit if Microsoft starts delivering its Office Suite or its games 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? A simple, single product in the New Economy is not always easy to define. The more room a company has to customize its products or combine them with additional services, the more leeway it has to vary its prices intelligently. A flat rate does not do justice to this opportunity.

How much should I charge, and how should I charge it? There are hundreds of viable ways to charge customers. Putting numbers to these possibilities demands a complete understanding of how they are interrelated and how sensitive they are to changes. If managers opt for a comfortable way out -- often a flat rate -- and skip the hard math, they are making a risky trade-off. 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 powerful lever, and most companies have little room for error. But pursuing this extra 30% makes the blood, sweat, and math worthwhile.