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Bundles of joy

THE ECONOMICS OF 'FREE' BROADBAND OFFERS

Consumers have been targeted with offers of heavily discounted bundles of information and communications technology (ICT). Do these help providers maximise the lifetime profitability of customers, or represent a rush for market share? And will they secure providers a sustainable competitive advantage?

Traditional divisions between voice telephony (offered over distinct fixed and mobile networks), broadband internet access and digital TV are rapidly breaking down. New technologies have given operators the ability to offer TV and Video-on-Demand over broadband; Mobile-TV and IP-TV services bring new opportunities. Deregulation has made it possible to offer a full suite of retail services without owning any direct physical connections.

Providers have responded by launching heavily-marketed bundles of products and services, in which "free" or "discounted" broadband access can feature strongly. While bundling is certainly not new to ICT (cable companies have been offering combinations of fixed telephony and TV for years), there has been a step-change in the variety and mix, so that consumers can now buy all their ICT

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needs in one "triple-play" or "quad-play" package. This trend has been accelerated by aggressive price discounting of some elements (notably broadband) and content differentiation. For example, the UK provider BT has, through a tie in with Setanta, secured rights to show some Premiership football from 2008 over its broadband-based service.

By the end of 2007 some 49% of Virgin Media (formerly NTL and Telewest) customers took a triple-play package of broadband, telephony and television.[1] In the eight weeks following its launch in 2006, 340,000 customers signed up to Carphone Warehouse's 'TalkTalk" free broadband offer – double its initial projection. By March 2008, Carphone Warehouse had over 2.7 million broadband customers and its target is to reach 3.5 million by March 2010.[2] But how are such providers going to make money?

FIRST STEPS

In thinking about this strategic question, it is helpful to break it into two. Does bundling increase customer lifetime value? And can it create a sustainable competitive advantage?

The lifetime value of a given customer depends on:

- the costs of acquiring that customer;
- how long the customer is retained; and
- how profitable the customer is during that period (commonly measured by deducting service costs from the average revenue per user, or ARPU).

There are four ways in which bundling might improve these metrics.

- **By reducing acquisition costs.** Plainly, if providers can sell more than one product at a time, they may reduce marketing and connection costs. However, experience suggests that such savings are likely to be limited.
- **By cutting customer account management costs.** Equally plainly, the cost per product of billing or customer service will be lower if that cost can be "shared" across other products. However, experience from the financial services sector suggests that bundle providers do well to achieve savings in the region of 5-10%, and Ofgem has estimated the savings from "dual fuel" supply contracts at around 10%.[3]
- **By improving retention.** Here too there is some supporting evidence from the energy markets. France Telecom has also suggested that customers taking a bundle of mobile and broadband services are less likely to churn than those taking only mobile services. However, an Ofcom survey found that customers of bundled services that include broadband services experienced the highest switching activity.[4]
- **By increasing ARPU.** In theory, bundling helps firms with market power to increase revenue by "metering", or price discriminating between customers on the basis of the type and volume of services they use. However, intense competition in these markets limits the gains to be made.

Such increments to customer lifetime value have to exceed the cost of discounts for a bundling strategy to be profitable. And as the worked example in the tables below illustrates, this is a challenge.

The tables give the net present values (NPVs) of a number of different offers made by a hypothetical operator in the UK market. Monthly revenue for both stand-alone services and the bundle reflect our understanding of the types of tariff packages available in the market, and an analysis of the EBITDA margin of a number of providers is used to estimate the costs of the stand-alone products.

Unbundled product offering

Product	Revenue/ month	Cost/ month	Customer lifetime (month)
Voice (including rental)	20	18	60
Broadband	20	18	60
Total	40	36	

Combined monthly profit	Present value over customer lifetime
4	£181.96

Bundled product offering

Product	Revenue/ month	Cost/ month	Customer lifetime (month)
Voice (including rental)	20	18	60
Broadband	0	18	60
Total	20	36	

Combined monthly profit	Present value over customer lifetime
-16	-£727.83

To earn same profit per customer as unbundled situation, need to reduce costs by more than 50%...

Product	Revenue/ month	Cost/ month	Customer lifetime (month)	Cost reduction (%)
Voice (including rental)	20	8.5	60	-53%
Broadband	0	8.5	60	-53%
Total	20	17		

Combined monthly profit	Present value over customer
3	£136.47

And increase average customer lifetime (reduce churn)

Product	Revenue/ month	Cost/ month	Customer lifetime (month)
Voice (including rental)	20	8.5	96
Broadband	0	8.5	96
Total	20	17	

Combined monthly profit	Present value over customer lifetime
3	£192.06

Illustrative NPV of a discounted bundled offer (assuming a discount rate of 10%)

Source: Frontier calculations

The top table shows the profitability of a customer who buys fixed line telephony and broadband access separately. If, instead, the customer buys a bundle of the two products, receiving broadband services for "free", the lifetime value of that customer becomes negative (second table). To move value to positive again, the provider would need cost savings of 50% and lower churn (bottom two tables).

Clearly, therefore, the pursuit of customer lifetime value can only be part of the story. Providers are engaged in a scramble for market share. So will this deliver a sustainable competitive advantage? There are three ways in which it might.

- **By yielding economies of scale.** Where providers have incurred substantial fixed costs, for example in deploying broadband infrastructure, spreading them across a wider customer base certainly helps. However, there is a danger of overestimating scale economies, particularly where the investment is replicable. They need to be achievable by only a few very large providers to be worth pursuing at high cost. Gambling on these effects in such a rapidly changing industry is risky.
- **By securing favourable access to content and advertising revenue.** As access and distribution platforms become less of a competitive advantage for operators, compelling content may become a critical success factor. Growth in market shares may have a more-than-proportionate effect in securing these advantages. Whether they are sustainable is another question.

- **By reducing future acquisition and retention costs.** Providers may reckon they need to act now, while the market, particularly for broadband services, is still rapidly expanding, in order to pre-empt others' bundled-based efforts to enhance retention. As the market matures, some argue, customers will become less price-sensitive and ready to switch. But again, the sustainability of this advantage is not proof against a pace of technological change that encourages the entry of aggressive new players unencumbered by old infrastructure or strategies.

JOY INTO TEARS?

So it is still far from clear that discounted bundling will secure a sustainable competitive advantage. The risks and potential rewards to providers will differ, depending on the services they already offer, the competition they face and the technology available to them. Fixed line operators, already offering voice and internet services, may find bundling most advantageous. Benefits to mobile operators appear more limited. Offering services outside their core skills set risks dilution of valuable brands.

Sustainable advantage must, in the end, stem from non-replicable features of a provider's offer. The battle for content may be the best rationale for the current scramble for market share. But providers must still focus on factors other than price that are valued by their customers, such as easy-to-understand propositions, trusted brands and efficient customer relationship management.

Meanwhile, in the short term, we can expect to see bundling and discounting continue, particularly with respect to broadband services – where the stand-alone provider will be at a disadvantage. Any provider engaging in deep discounting must clearly seek to secure every potential advantage from bundling, segmenting the customer base to minimise the revenue foregone.

If the long-term gains from this to the providers are uncertain, the short-term benefits to consumers are evident. For the moment they, at least, can choose between different "bundles of joy".

SOURCES

1. *Virgin Media, fourth quarter 2007 results presentation, February 2008.*
2. *Carphone Warehouse Plc fourth quarter trading update, April 2008.*
3. *"Domestic Competitive Market Review", 2004, Ofgem.*
4. *35% of clients of bundled and/or broadband services experienced or considered switching to a new supplier. The equivalent figure was 23% for single fixed-line services, 26% for single mobile services and 12% for single TV services. The consumer experience, Ofcom (November 2007).*

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