

Usage Based Pricing in Subscription Business

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There is more to subscriptions than monthly payment plans

Consumer behavior has changed considerably in one generation. The advent of the internet has accelerated the rate of innovation and in turn has educated consumers to increase their service expectation levels. This holds true across the majority, if not all sectors of the economy. Consumers bring these new expectations to the workplace, impacting B2B expectations and preferences as well.

To remain competitive in fast-paced environments, companies have opted for various improvements across their product features, supply chains, services offered, but perhaps most noteworthy are those that flip business models on their heads. Along with the emergence of technologies such as Cloud, mobility, and machine learning, these pioneers helped bring about the emergence of a Subscription Economy.

Subscriptions are more than a financial model, they represent a new way of defining relationships between customers and providers. Today's customers aren't simply buying a product, they're committing to a relationship with a brand. For providers, finding ways big and small to demonstrate that you understand your customer and care about their needs will build trust and loyalty over time. This includes identifying the best way to align the price and value of their offerings. Fortunately, subscription companies have a range of tried and true options available to them, including flexible, usage-based pricing models.

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Varieties of Pricing Models

There are a variety of pricing models available to subscription businesses, from the fixed price model which does not closely align price and customer value, to a 100% usage-based pricing model, often referred to as pay-per-use. There are hybrid models that combine fixed with more flexible models such as usage. Many of these hybrid models are multi-dimensional in nature to account for several price variables.

1. Fixed price / “All you can eat”

The fixed price model is also known as an “all you can eat” approach. Fixed pricing allows a business to charge a simple fee for a period of time, usually monthly or annually, regardless of usage.

Benefits:

The main benefits are there are no surprises and budgeting is simple, but most importantly, it is convenient for customers.

Challenges:

A fixed price approach does not allow businesses to scale with customer use. It also means that low usage consumers subsidize high usage consumers, which some customers may perceive as unfair. In high variable cost businesses, this can have disastrous consequences for companies that under-estimate consumer usage. Finally, there is no pricing differentiation and therefore no segmentation of subscribers based on usage or willingness-to-pay.



2. Pay-per-use

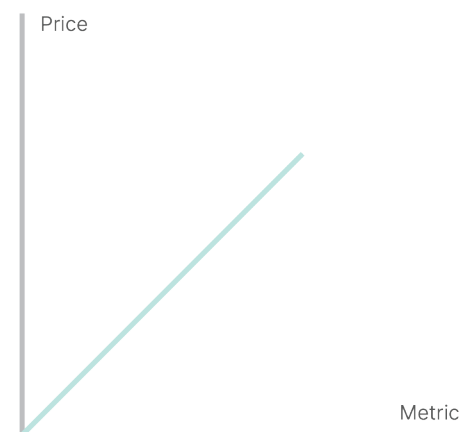
Pay-per-use offers a pricing option that relies 100% on usage. When done well, pay-per-use can allow businesses to closely align their pricing with the value its consumers derive from using their product or service. Smart businesses that investigate new ways of charging for products and services often to find new metrics that better align customer objectives with their own. Rolls-Royce's Power-by-the-Hour is probably the most well-known example.

Benefits:

Not only is pay-per-use easy to communicate, but it is also considered fair and ensures a direct link between usage and revenue generation, clearly offsetting existing variable costs.

Challenges:

The difficulty in predicting usage ahead of time, and therefore budgeting both for the business and its customers, can be a hurdle. Of course, the success of this model is highly dependent on which metric is selected. Also, taxi-meter psychology sometimes leads customers away toward capped models, even if it means paying a premium.



3. Tiered

A tiered approach is a blend between pay-per-use and fixed price where bands of usage are provided, and the customer is required to select a bundle that best serves its needs. It draws combined benefits from both pure models which helps explain its prevalence.

Benefits:

It blends the convenience of having a set budget with the ability to scale based on needs. Also, from a psychology perspective, customers seeking convenience will tend to overestimate their usage to be on the safe side.

Challenges:

Too many tiers can lead to a complex offering. It also requires some smart price tactics to bundle optimally and create paths to upsell.



4. Freemium

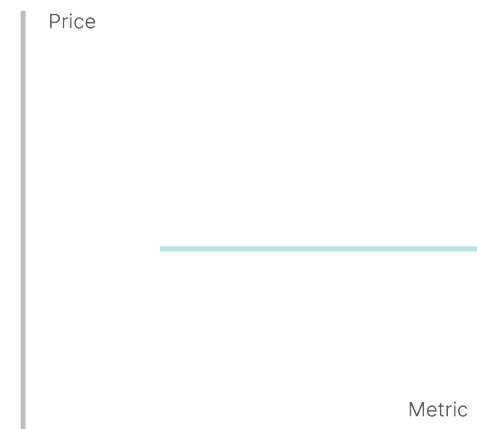
Another popular choice in subscription businesses is Freemium, where a basic version of the product is available for free with additional features locked behind a payment plan. Freemium is distinct from free trial, with the latter being more akin to a 100% discount on a small time period rather than a pricing model.

Benefits:

This is a great way to maximize penetration in the market, while allowing subscribers to familiarize themselves with your products or services.

Challenges:

Unfortunately, it also means that a potentially large portion of the subscriber base is not monetized, and the product features behind the payment plan need to be enticing enough for subscribers to want to upgrade to the premium offering.



5. Volume based

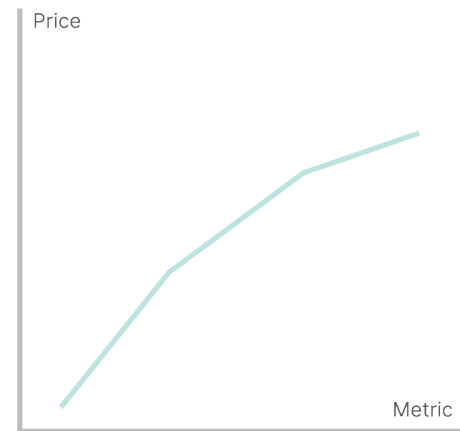
Much closer to the pay-per-use model, this variant sees diminishing marginal price as usage increases. As such, while you only pay for what you use, the value-price relationship is not linear but rather incorporates an inherent size discount.

Benefits:

The inherent size discount helps upsell and reward large accounts.

Challenges:

The limits to this model are aligned with pay-per-use, with the added complexity in communication of the various size thresholds and simulations that may come with it.



6. Overage based

Overage based is the middle ground between fixed pricing and pay-per-use. It assumes a base plan with a set amount of units, and the ability to pay for more.

Benefits:

It is relatively simple to communicate and scales with usage.

Challenges:

Depending on the context, it may trigger consumer resentment after high usage periods, and even lead high value customers to switch to capped competing offers.



7. Tiered with overage

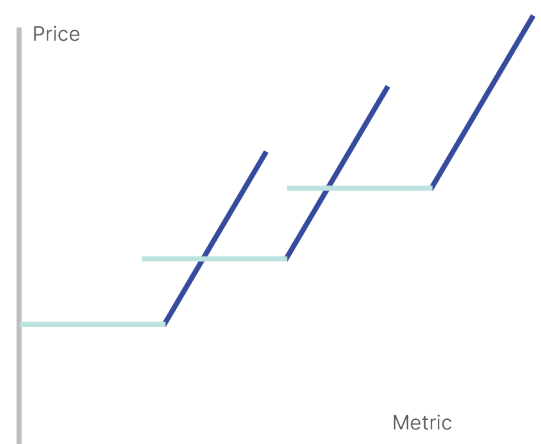
Tiered with overage is simply a blend between the tiered and overage models previously described so that there are various base options to select from with overages triggering at different usage levels. The most well-known examples of this model are the early cell phone plans which included various amounts of minutes and text messages, with a pay-as-you-go option when you went over. While it does create a clear path to upsell, the cell phone example reminds us that overuse can leave a sour taste in consumers' mouths. As such, it combines both the pros and cons of the tiered and overage models.

Benefits:

The customer has the ability to scale based on usage needs and tend to overestimate their usage to be on the safe side.

Challenges:

It is a complex offering which requires smart price tactics to bundle optimally and create paths to upsell. Also it may trigger consumer resentment after high usage periods, and even lead high value customers to switch to capped competing offers.





What metrics to use

Key to usage-based pricing is metric selection. Assuming you decide you wish to trace a clear correlation between usage value and price, whether through a pure pay-per-use go model or a hybrid model, how do you choose the right metric?

Here are the 3 core considerations in selecting the metric:

- **Value-based**

The value exchange must be apparent to the customer. The more this metric is used, the more value the customer receives.

- **Measureable**

The metric must be tracked and measured accurately. You cannot charge on things you cannot measure.

- **Controllable**

If you charge a customer for usage, they must feel in control. Do not leave it to external factors to determine the customers' bills.

Whether it is a number of accounts, number of units, or number of service events, choosing the right metric is the single most important aspect of a successful usage-based pricing model.



What the Zuora client database tells us

In order to identify the key design elements of successful subscription businesses, Zuora's Subscribed Institute conducted an analysis of one year of performance data from over 350 companies.

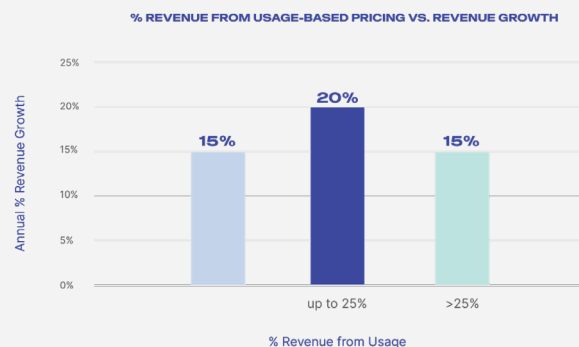
We compared indicators such as revenue growth, average revenue per account, and net retention of these companies against the revenue percentage generated from usage-based pricing elements. It is important to note tiered hybrid models fell under the "No usage-based pricing" classification, as the relevant metrics were blended into pricing bundles. Our study found that in 2020, companies that relied on usage-based pricing for between 1 and 25% of their revenue outperformed those that did not and those that relied too heavily on it.

Usage-based pricing

Data & Insights

- Sweet spot is to have up to 25% of your revenue come from usage pricing
- Above 25% usage-based pricing growth seems to decelerate back to no usage-based level

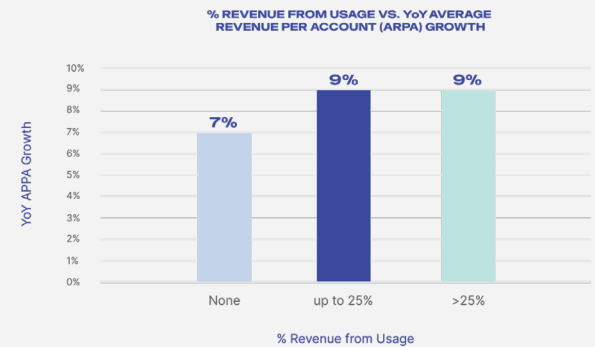
Firstly, introducing usage-based pricing led to growth improvement, from 15% to 20%. Above 25% usage-based pricing, growth seemed to decelerate back to initial growth levels. While this holds true across B2B, the effects are more acute in B2C.



Usage-based Pricing & Upsell

Data & Insights

- Usage leads to higher YoY upsell, a 13x boost
- Usage-based pricing improves ARPA growth at any level

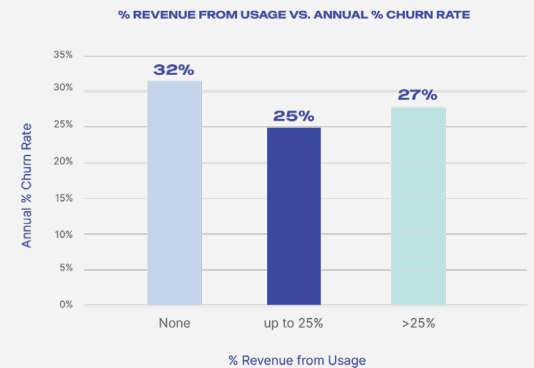


Secondly, usage-based pricing leads to better upsell. In fact, those companies that had no element of usage-based pricing reported 7% Average Revenue Per Account (ARPA) growth, while those that did saw a 9% improvement.

Usage-based Pricing & Churn

Data & Insights

- Usage reduces churn by 1/5
- Sweet spot is <25% of revenue from usage



Finally, annual churn levels observed were 32% for no usage-based pricing, 25% for those that used it for less than 25% of their revenue, and 27% for those that relied on usage-based pricing for more than 25% of their revenue. Usage-based pricing helps reduce churn by up to 1/5.

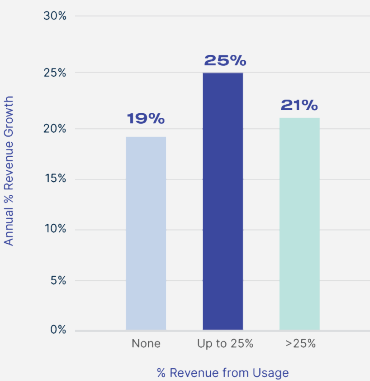
Contrasting the 2020 results with prior years

These results were very similar to those of previous years. In June 2020 we conducted a similar exercise looking at three years of data. At the time, we found that companies with 1 to 25% of revenue generated through usage-based pricing showed the best performance across revenue growth (25%), ARPA growth (13.6%) and churn (26%). In contrast, companies with no usage-based pricing had slightly slower revenue growth (19%), ARPA growth (9.4%), and higher churn rates (33%). We concluded the 1-25% usage-based pricing was the sweet spot.

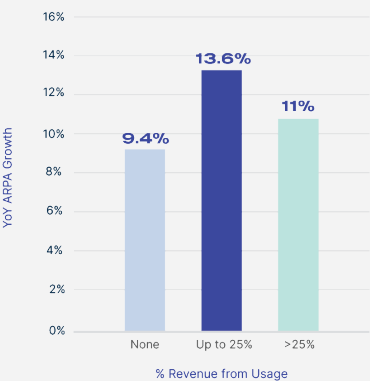
What has changed? 2020 was not an ordinary year, and despite the sustained growth of subscription businesses (see our Subscribed Economy Index), many customers saw their consumption reduced during the period. While both revenue growth and ARPA growth numbers are down across the board for 2020, 1-25% usage-based pricing still outperformed its alternatives. In fact, it showed resilience in times of economic slowdown while the other two models showed stark declines. Testing the performance of these models across periods of economic expansion and slowdown, reinforces our earlier conclusion that 1-25% usage-based pricing is indeed the sweet spot.

How does it contrast with the previous 3 years?

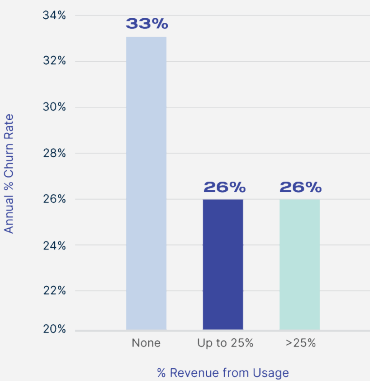
% REVENUE FROM USAGE-BASED PRICING VS. REVENUE GROWTH



% REVENUE FROM USAGE VS. YoY AVERAGE REVENUE PER ACCOUNT (ARPA) GROWTH



% REVENUE FROM USAGE VS. ANNUAL % CHURN RATE



Subscription strategy and usage-based pricing

One way to consider whether usage-based pricing, or its hybrids, are relevant for your company is to consider it in relation to your subscription business strategy. We thus detail benefits based on your plans to acquire, grow and retain subscribers.

Acquire: Simple and transparent price communication is essential in the acquisition process. Equating usage to value can be a good way to reassure a customer that they will derive value from the product regardless of scale. Usage-based pricing allows companies to adopt a “land and expand” growth strategy with initially small accounts.

Grow: Monetizing customer use is paramount in high variable cost businesses. More than just covering costs, however, usage-based pricing allows companies to grow with their clients using a “win-win” formula. Create a path to upsell to entice customers to upgrade their packages and opt-in for deeper commitments.

Retain: An inherent feature of usage-based pricing is the overall price decrease which comes with reduced consumption. This ensures that value provided and price charged are balanced. Our data suggest that churn can be reduced by up to 1/5 with usage-based pricing.

Ultimately, we encourage businesses to experiment with their pricing rather than simply follow industry trends. Significant benefits can come from being a first mover and introducing unique offerings to customers. This can be achieved by rethinking the metrics used to value products and services, moving toward solutions that are perceived as reflecting fair value to customers. Subscriptions are more than a fixed monthly payment plan, they are a business model which places customer experience at its center.



The Subscribed Institute

The Subscribed Institute is a dedicated think tank focused on the Subscription Economy. The Institute supports its 1000+ business executives across 500+ global companies with critical data, thought leadership, and connections. Research provided by the Institute helps business leaders and their organizations to maximize the opportunities of the Subscription Economy.

More at www.subscribedinstitute.com