



3 QUESTIONS TO IMPLEMENT A USAGE-BASED PRICING MODEL

*Zuora recently convened an expert panel to share data, insights, and best practices for adopting usage-based pricing to grow your subscription business. The panel included Ted Miller, senior solution architect at DigitalRoute; Wendy Hayden, VP of customer engagement at DigitalRoute; Amy Konary, founder and chair of Zuora's **Subscribed Institute**; and Carl Gold, Zuora's chief data scientist.*

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WHY USAGE-BASED PRICING?

Why usage-based pricing? The simple answer is subscription companies are turning to usage-based pricing because it works. At this point, incorporating at least some usage-based pricing is table stakes for both B2B and B2C companies. Not only does it put customers front and center by closely linking their consumption to value (thus helping to reduce churn), but usage-based billing can also maximize subscription companies' revenue.

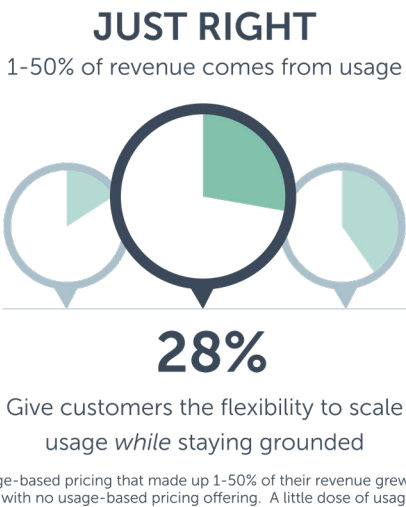
That's the value proposition. But what does the actual data show us?

- How can companies implement usage-based pricing in a way that delivers tangible customer value?
- What considerations do they need to take into account?
- And what are some alternatives?

WHAT THE DATA SHOWS

When we analyzed historical data on revenue growth rates for Zuora customers, we found a consistent pattern:

With usage billing, the sweet spot, or Goldilocks zone, for upselling and customer retention is just over 25% of revenue.



Beyond that, companies experienced diminished returns from having more usage-based billing versus recurring pricing. This played out for both business-to-business and business-to-consumer companies, with a slightly more negative affect for B2C companies.

B2B Companies	B2C Companies
More than half employ some usage billing, with a quarter having a moderate level or 25%.	Roughly one quarter have adopted usage-based pricing.
Companies generating around 25% of revenue from usage billing had the highest growth rates in our database.	Companies with a moderate amount, around 25%, of usage-based pricing have higher growth rates.
We did not observe a big difference in results across industries.	Companies with a high percentage of usage-based pricing show slightly worse than average growth. (Note: These made up only 18% of our sample.)

Essentially, some amount of usage billing helps customers understand the value they are getting from your product. But too much usage-based pricing can discourage use.

Gold explained that “All the companies that are employing usage billing, see reduced churn on average.” But the optimally positive impact on churn, where customers upsells are maximized, is constant when usage-based billing is around or under 25%.

IMPLEMENTING A USAGE-BASED PRICING MODEL: THE 3 ESSENTIAL QUESTIONS

So how can you design a usage-based pricing strategy to grow revenue?

There are two elements to usage-based pricing:

- Driving more revenue from new customers (acquisition)
- Upselling existing customers.

Upselling is more likely, since companies usually structure usage-based pricing in tiers. So moving customers further along once they hit the top of their tier is natural.

But just launching usage-based pricing isn't a guarantee of success. As Amy Konary explained, "not all usage-based pricing is the same." Companies need to focus on coming up with the right approach.

There are 3 best practices for adopting usage-billing — and 3 corresponding questions to ensure you're on the right track:

1. **Choose a metric that you can link to customer value.** Subscriptions are all about value. Customers should be able to see the value they get from using your product. They should also be able to clearly tie that usage to their cost so that, as Konary put it, "they 'know, 'by doing this action, I am increasing usage, and therefore, I will be paying more.'"

Key question: *Can customers see the clear connection between usage and value?*

2. **Choose a metric that's familiar.** The right usage metric is also one that is transparent — in other words, customers clearly know what they're paying for and can predict how a change in their usage will impact their billing. Transparency is key. Going with something esoteric won't work. Whatever you choose should be both familiar to your customers and easy for you to track.

Key question: *Is this metric obvious to your customers (i.e. something they are already aware of, and possibly even tracking)?*

3. **Choose a metric that your customers have reasonable control over.** They should understand what drives their usage and be able to control it. This becomes even more important when you're dealing with B2B customers.

Key question: *Do customers have control (and feel that sense of control) over this usage metric?*

There are other considerations too. If you offer different usage tiers, customers' cost per unit should decrease as their usage increases. Data from Zuora customers show that volume discounts are typical where usage is higher. That's because it's important to balance maximizing usage with making sure customers are interacting with your product/service enough to see value.

Having tiers and usage costs that can scale up and down gives customers more certainty than going all in on a 100% usage-based approach.

3 COMMON APPROACHES TO USAGE-BASED PRICING



There isn't just one way to "do" usage-based pricing, but there are some common approaches:

- **Per unit pricing.** Per unit pricing (aka pay per use) is the most flexible and the model that most closely aligns customer usage with value. Zillow's a good example of this model. Your first listing is free. Beyond that, there's a \$9.99 per listing per week fee.

The tradeoff here is that while per unit pricing might be a great way to get people to dip a toe in and try a service, as their usage rises, it can get expensive.

- **Tiered pricing plus overage.** The middle approach is a combination of tiered pricing plus overage fees. It works well in B2B or B2C settings where you expect high usage—Konary gave the software industry's annual true-ups as an example of this.

With overage pricing, companies charge a fee for usage over and above the tiered allowance. For example, PagerDuty, a leader in digital operations management, offers a variety of different plans, from Free to Business, and even an additional tier called Digital Operations, an "end-to-end digital operations solution tailored to you." But if you need more global notifications than is allotted for in your plan, you can pay an additional charge per notification.

Another option is for companies to automatically move customers with higher than expected usage to the next tier. Companies can use this combo approach to set usage and pricing thresholds based on what actual usage looks like.

- **Multi-attribute pricing.** In a multidimensional model, companies adjust pricing based on a number of factors. Zuora customer Octo Telematics (formerly Omoove), the European leader in technology solutions for the mobility market, provides a good example of this model, leveraging multi-attribute pricing to change pricing based on various attributes including type of car, day of week, time of day, miles driven, and garage location.

This isn't an exhaustive list. The key is offering customers choice and flexibility. Whichever approach you use, the context should be what your customer journey looks like, and what behaviors you want to motivate.

CHALLENGES OF USAGE-BASED PRICING



Of course, it's not all smooth sailing on the road to implementing usage-based pricing. There are some caveats:

- **Revenue recognition.** One area of major impact is revenue recognition. We've seen finance teams act as gatekeepers preventing product teams from adopting usage-based pricing because of the impact. Because trying to manage usage-based pricing manually is so time-consuming, not to mention error-prone, it's something you want to automate. And you need to have a plan to tackle it efficiently. But at the end of the day, scaling your processes to handle usage-based billing shouldn't be used as a roadblock to moving forward.
- **Pricing agility.** Konary spoke to the importance of having agility in pricing systems as well as building in flexibility. For instance, not 100% usage, but usage plus tiers—so customers can scale pricing up or down. Basically, it's a balance between monetizing the usage and making sure they are interacting with the system or the service. You're always trying to increase customer lifetime value. But without the right agile systems to support this pricing optimization, you're likely to run into trouble.

- **Managing usage data.** Everything from the complexity to the volume to the real-time component of collecting usage data—including alerting customers they're close to hitting usage limits—drives up the difficulty in managing usage pricing.

You need to have a process for data collection, handling, and aggregation to avoid data loss and the resulting revenue leakage. You also need to be able to capture all of that data in the right place at the right time, in real time. Hayden identified the data quality step as a critical point where revenue leakage occurs. This makes detecting and isolating data issues super-important for successfully moving to a usage-based pricing model.

Be proactive and plan from the beginning, putting systems and data governance processes in place, early on. Hayden advised, "usage growth is not linear. It's exponential. You probably have less time than you think to deal with this because it grows really fast."

FINDING THE RIGHT USAGE METRIC



Figuring out the right metric takes deep thought, and deep awareness of — and empathy for — the customer experience. Hayden advised even before you adopt usage-based pricing, it's important to be capturing customer data so you can use it to inform pricing. Not only will you be in a position to be proactive in meeting customer needs, but it keeps you close to your customers. And that's key for subscription businesses.

Getting the balance right enables companies to closely tie customer value to usage, and encourages customers to experiment with products and services in a way that minimizes their risk of being hit with unexpected costs.

Lastly, remember that the “right” usage metric isn't necessarily the right pricing for all time. Incorporating usage-based pricing into your revenue mix means you need to commit to staying flexible enough to pivot your processes and iterate pricing based on market feedback.

About Zuora

Zuora provides the leading cloud-based subscription management platform that functions as a system of record for subscription businesses across all industries. Powering the Subscription Economy®, the Zuora® platform was architected specifically for dynamic, recurring subscription business models and acts as an intelligent subscription management hub that automates and orchestrates the entire subscription order-to-cash process, including billing and revenue recognition. Zuora serves more than 1,000 companies around the world, including Box, Rogers, Schneider Electric, Xplornet and Zendesk. Headquartered in Silicon Valley, Zuora also operates offices in Atlanta, Boston, Denver, San Francisco, London, Paris, Beijing, Sydney, Chennai and Tokyo.

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