7 Popular Pricing Paradigms

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Overview

The subscription based economy continues to soar as more and more products and services are being sold on a recurring basis. Forrester Research predicts that by 2016 subscription licensing models will reach 50% of the total software license market[1], and it's impacting more than just how software is delivered. Significant changes are also being seen in how businesses are pricing their products and services in direct response to changes in customer demand and behaviour.

This shift in customer demand stems from the software-as-a-service model itself, specifically its delivery mechanism. Customers are embracing the value of purchasing only what they need, when they need it, and for as long as they have the need.

To succeed in the new economy, businesses will have to increase their focus on their monetization strategy or face the repercussions on their revenue, profitability, and competitive standing.

This paper examines several of the most popular pricing strategies for subscription based companies including benefits, pitfalls, and examples of successful applications for each.

[1] Holger Kisker, "The New Software Paradigm: Buy-, Deploy-, and Pay-As-You-Like" *Forrester Research,* 1 April 2012.

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Introduction

In the past – past being before the late 90’s - most companies had one monetization strategy, the one-time transaction. Businesses offered a product that people purchased. When the product broke, wore out, or was improved upon, etc., the business counted on its customers to simply buy another one.

Of course there were exceptions. Businesses selling cable television, telephone, newspapers, magazines, and even milk delivery were some of the pioneers of the subscription strategy.

Enter software-as-a-service (SaaS), and it changed everything. In 1999 Salesforce.com moved to the cloud offering enterprise applications on the web. Amazon Web Services was launched shortly thereafter, and it wasn’t long before all of the major players adopted a SaaS strategy. By 2010, small and medium-size businesses (SMBs) were also looking for ways to take advantage of this new way of doing business.

By 2011, subscription commerce or “box of the month”, which began in 2009 with companies like shoedazzle.com, was in full swing, bringing Product-as-a-Service (PaaS) into the recurring revenue family.

With this move from traditional to cloud-based selling of packaged goods and services, it was inevitable that different monetization strategies would be born.

1 Freemium + Up-sell

The Freemium + Up-sell strategy is one in which a business offers customers a ‘free forever’ version of their product or service, but also offers a paid version with additional features and functionality, allows for more users or data, or removes advertisements, and so on. The goals of a Freemium + Up-sell strategy are usually to increase brand awareness and customer acquisition, however, it can also be used effectively to test-market a new product or service.

Freemium has its roots in the software industry, as far back as the early 80’s when software companies started offering a ‘lite’ version of their software on a CD. These CDs were often packaged with other software or hardware, such as computer components, that were marketed as ‘value adds’. The term itself, however, wasn’t coined until 2006 when financier Fred Wilson introduced it in a blog post.[2]

LinkedIn exemplifies just how successful a Freemium + Up-sell strategy can be. Anyone can open a free account in exchange for their email address. Once registered, users can create a profile and begin inviting colleagues and business contacts to join their professional network.

There is no expiry date on what LinkedIn calls its “Basic account“

However, if Basic account holders want access to premium features, such as the ability to view the full list of LinkedIn users who have viewed their profile, to use the InMail feature, or get better and faster access to job postings, account holders must upgrade to a Premium account, and they’ll be asked to pay a fee for that service.

Figure 1 LinkedIn Tease to Basic Account holders.

[2] Wilson, Fred, “The Freemium Business Model.” AVC Musings of a VC in NYC. 2006/03/23 http://avc.blogs.com/a_vc/2006/03/the_freemium_bu.html

Figure 1 illustrates how well LinkedIn self-promotes by incorporating advertising for its Premium service into its Basic (free) service. LinkedIn 'teases' Basic account holders by promoting Premium benefits throughout the user experience, and provides users with instructions on how to get them.

Clicking a teaser ad takes the Basic account holder to a list of LinkedIn plans, from which the account holder can select and purchase a monthly subscription for the Premium account that best suits their needs.

Figure 2. Premium Job Seeker Purchase Page.

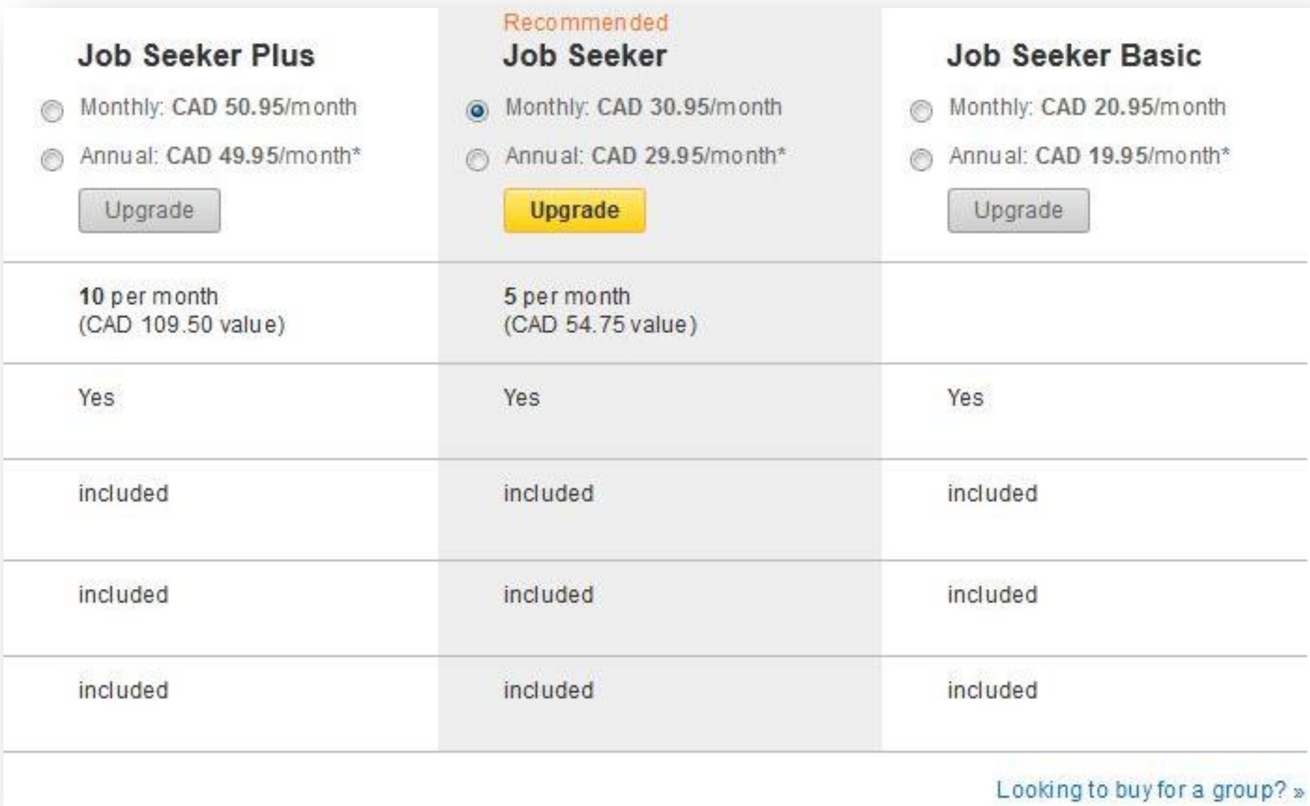


Figure 2 shows the purchase page for just one of LinkedIn's audience segments. There are customized purchase pages for other audience segments including Recruiters, Sales Professionals, and Business Professionals.

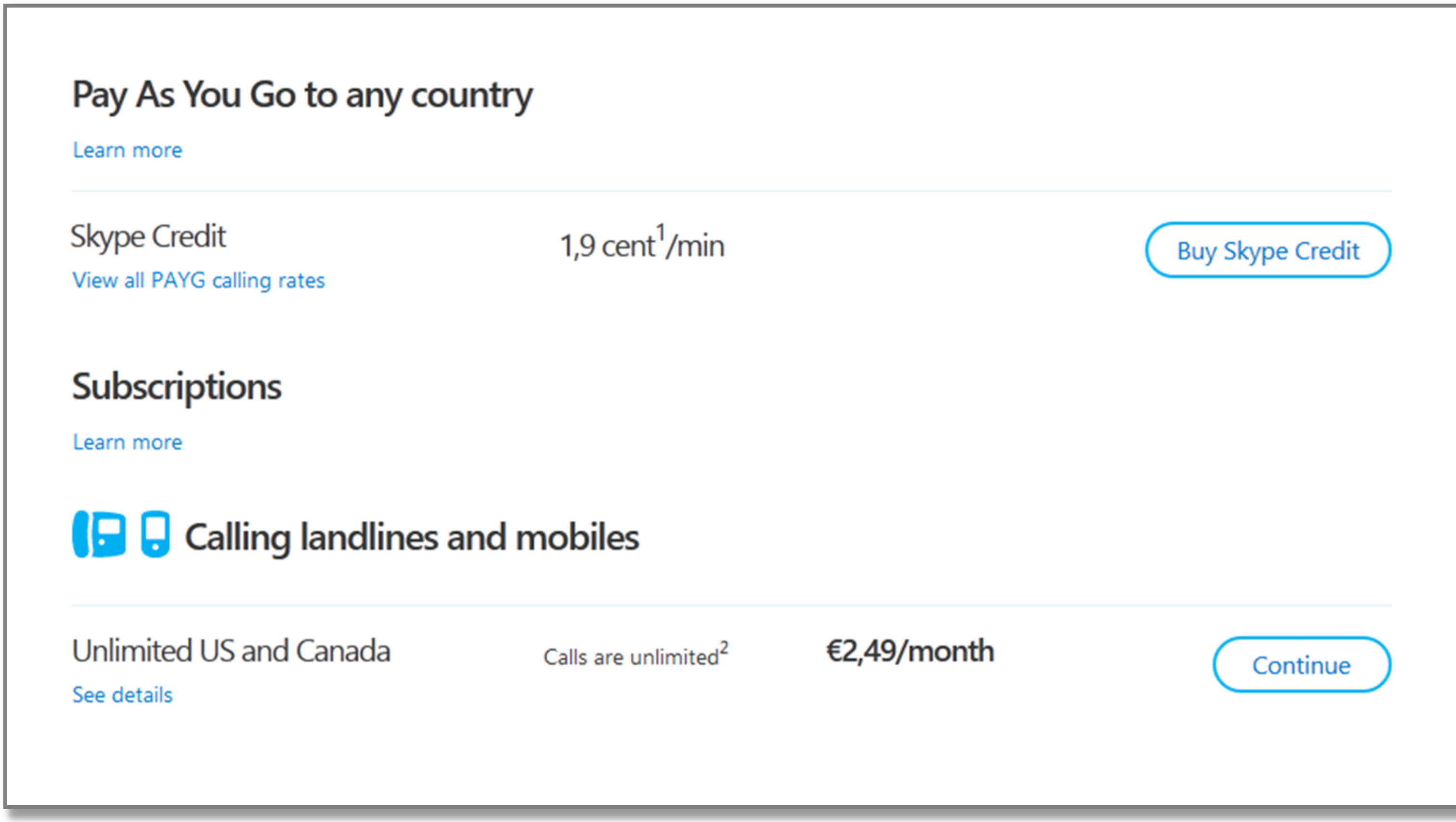


Figure 3 Skype Up-sell

A second example of a business that has successfully implemented the Freemium + Up-sell strategy is Skype. Like LinkedIn, Skype has always had a freemium component to their service. Unlike LinkedIn, which launched with both freemium and up-sell options, Skype added their up-sell component after their freemium version became popular. The freemium component – free computer-to-computer calls between Skype members – is still free after signing up, but a charge is applied to telephone calls, both landline and mobile.

Figure 3 demonstrates not only the simplicity of Skype's up-sell pricing – the customer chooses to purchase credits to be used as required, or a subscription based on their calling pattern – it also shows the simplicity of the service itself. When a user purchases a paid version of Skype, they aren't paying for a variety of extra features or increased access; they're purchasing telephone time only.

However, it would be a mistake to equate a one feature up-sell with a low bottom line. In actuality, this simple up-sell was a primary factor in eBay's $2.6 billion acquisition of Skype in 2005, and Microsoft's purchase of Skype from eBay for $8.5 billion in 2011.[3]

Whether or not a business already has a for-pay product or service is not a deciding factor when contemplating a Freemium + Up-sell strategy. As mentioned earlier, the main goals for adoption should be to increase customer acquisition, build brand awareness, and in certain circumstances to test the market value of products and services. Non-paying customers who don't provide value to the business can become a burden, so it's critical that businesses move these users through the sales process, or attract more paying customers. Both Skype and LinkedIn have enjoyed success using the Freemium + Up-sell model. Both businesses limited the value of the free service, while offering even greater value to those willing to pay for it. Of course, there are many examples of when a Freemium + Up-sell model became detrimental to the business. This usually occurs when:

- The cost of non-paying customers (both acquiring them and servicing them) is too high;
- The gap between the value of the free and paid versions of the product or service is too narrow;
- The business is targeting a niche market, making it difficult to attract a sufficient number of paid users to support the non-users.

While the Freemium + Up-sell strategy may not be for every business, product, or service, it can be a very powerful approach to building a successful subscription based company. To increase the likelihood of success, businesses considering this strategy should take the time to develop a business case that supports it.

[3] Kopytoff Verne. "How eBay Fared in Latest Skype Deal." *The New York Times,* 2011/05/32

2 Multiple Editions

The Multiple Editions strategy, also known as versioning, is very popular with SaaS services. In this model, different editions or versions are offered at various price points in order to target different segments. What tends to drive a Multiple Editions strategy is that businesses want to charge the highest price customers are willing to pay, in order to maximize revenues. However, knowing the price threshold of purchasers can be difficult to discern, since customers have different needs and budgets. By offering Multiple Editions, businesses can appeal to a larger customer base by allowing customers to choose the “version” of the product or service that suits them best.

Pricing for the different offerings is usually dictated by the type of service the business is offering multiple editions for.

In Figure 4 the price is based on the number of end customers the purchaser has. This is an example of segmenting by volume.

Figure 4 Multiple Editions Volume Example

In contrast, Multiple Editions pricing for cell phone and/or online data businesses is usually based on usage. Usage can be comprised of the number of minutes consumed, the amount of data consumed, or a combination of the two.

Figure 5 Multiple Editions Usage Example

Also popular are packages based on feature bundles.

In Figure 6, the customer can only access all of the features of the service if they purchase the most expensive package. However, if the customer doesn't require the "premium features" they are not forced to pay for what they don't need.

Whether or not this type of price strategy is right for a business really depends on its offering. Traditionally, this strategy works best for businesses offering a service like the three examples mentioned above, as opposed to a physical product. That said there are always exceptions.

For example, if a business offers a weekly or monthly vegetable box delivery service, the Multiple Editions strategy could be used, whereby the cost of the subscription might be based on the volume or type of vegetables packaged in the box.

The benefits of this pricing strategy are obvious. As most customers are price sensitive, it's in the best interest of the business to offer a product that accommodates most budgets. This can translate into optimal profits for the business.

Conversely, for some businesses there may be a downside to choosing this strategy, including:

Research: The amount of research required to appropriately and fairly price the versions offered can be considerable. Even if different versions result in an increased number of customers, businesses will want to ensure new revenue created is greater than costs incurred, and that they're generating a positive and acceptable ROI.

Administration: With customers paying different prices on a recurring basis, the Multiple Editions strategy could be a complicated proposition. Before a business decides to implement this strategy, it's important to conduct a thorough review of the current billing system to ensure it can handle the requirements that this strategy demands.

Sense of Fairness: There will always be a segment of customers who may view the Multiple Editions pricing strategy as unfair. Real or not, their perception is that the lower priced editions are poorer quality.

3 Pay As You Go

The third pricing strategy we're examining in this paper is Pay As You Go, also called usage based or network based pricing, where customers pay by transaction.

There are two different strategies businesses can use when implementing this pricing model:

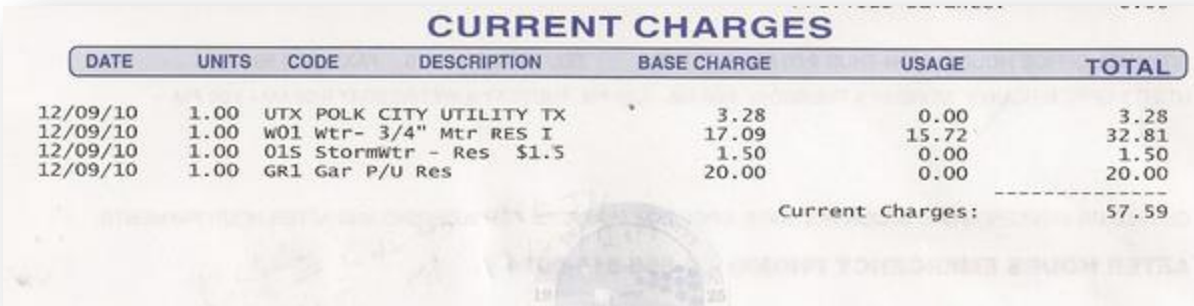
1. **Pay in Advance:** Business can choose to have their customers pay a sum of money in advance and this sum decreases as the service is consumed.

Figure 7 Pay in Advance Pay As You Go

   Figure 7 is an example of a popular email marketing company's use of the Pay in Advance option. Customers purchase a number of credits, where each credit equals one email sent. As customers send emails, they can view their credits counting down. Once the credit total equals zero, the customer can no longer use the service until more credits are purchased. Businesses employing this strategy can choose to associate a time limit with the purchase. For example, many telephone companies offer a Pay As You Go option, but customers have to use their credits within a certain number of days or they become invalid.

2. **Pay in Arrears:** The more traditional strategy when using the Pay As You Go model works in an opposite manner. Probably the most recognizable example of the Pay in Arrears strategy for the Pay As You Go model is demonstrated by utility companies. See Figure 8.

   Most utility companies charge their customers at the end of a billing period (usually 30, 60, or 90 days) for the amount of water, hydroelectricity, gas, and so on, used during that period. An invoice detailing service use or consumption is sent to the customer. The customer submits payment upon receipt, or the fee is charged automatically to the customer’s credit card on the invoice date.



CURRENT CHARGES

DATE	UNITS	CODE	DESCRIPTION	BASE CHARGE	USAGE	TOTAL
12/09/10	1.00	UTX	POLK CITY UTILITY TX	3.28	0.00	3.28
12/09/10	1.00	W01	Wtr- 3/4" Mtr RES I	17.09	15.72	32.81
12/09/10	1.00	01S	Stormwtr - Res $1.5	1.50	0.00	1.50
12/09/10	1.00	GR1	Gar P/U Res	20.00	0.00	20.00
					Current Charges:	57.59

Figure 8 Pay in Arrears Utility Invoice

In a web-based business, the Pay-As-You-Go model is most often applied to a software-as-a-service as opposed to a product-as-a-service offering. In this model, businesses bill for outsourced services by transaction, time in use, peak period, or some other subscription metric, and is delivered over the Internet. Some models are entirely usage based – though some businesses may include a mandatory or optional set up charge, usage fee, or support package – while others combine a monthly recurring fee along with usage charges.

In this pricing model, the benefits tend to be greater for the customer than the vendor. Pay As You Go customers can more easily track and budget for what they’re spending. They do not have to wait until an invoice is received to know the cost, thus eliminating overage charges. Pay-As-You-Go customers also enjoy the freedom to cancel or change the service, generally not an option when they lock into contracts. The downside for customers is that most vendors provide monetary benefits to customers who are willing to commit to a term agreement.

Many vendors avoid a Pay As You Go option for customers because they’re unable to accurately forecast a revenue stream when revenue is so directly tied to usage or non-usage of their service. However, there is one very important benefit for vendors that adopt this model; they stand to win a potentially larger base of budget conscious and/or contract wary customers.

4 Base + Overage

Sometimes referred to as two-part, or tiered + overage, the Base + Overage pricing strategy is most common in the offline world. The best example of this model is a car leasing or rental business, where customers pay a base price that includes a predetermined maximum mileage limit, with an added cost for every extra mile driven. For example, the leaser may offer a base price of $25 for a car rental with a mileage allowance of 100 miles, and then charge the customer 35 cents for each additional mile. The customer's total cost will vary depending on how many miles over the mileage allowance were driven. For online businesses, this is the pricing strategy of choice for communications and data storage services. How businesses set up their pricing can, however, be very confusing for the customer.

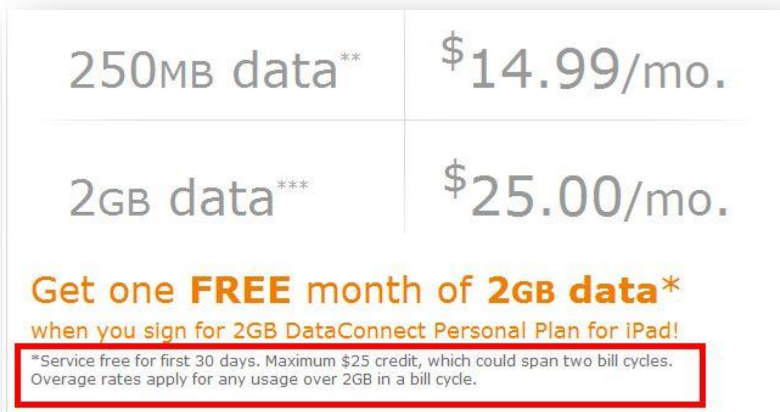


Figure 9 Data Storage Example of Base + Overage Pricing Strategy

Figure 9 is an example of Base + Overage but also demonstrates why customers may become confused. Here a base price of $14.99 is charged for 250mb of data. Note the small print highlighted in the red box detailing the overage charges. In this case, the overage charges are triggered if the consumer exceeds 2GB in the billing cycle. What this example doesn't define is exactly what the overage fees are.

Online fax companies are a second example of businesses that commonly use this pricing strategy. The difference between Figure 10 below and Figure 9 above is that in Figure 10 the overage fee is clearly stated.

Figure 10 Base + Overage Pricing Strategy with *clearly stated Overage fees*

Despite the potential confusion that this pricing strategy may cause some customers, if all of the fees are not explained up front there are several situations where its use may be advantageous to the business. For example:

- Businesses can create a “teaser” package with relatively low usage included. Additional usage charges can encourage many customers to upgrade;
- When there is a true incremental usage cost, and flat rate or unlimited plans create the opportunity for customers to become unprofitable;
- When businesses want to establish a minimum customer purchase amount, they can negotiate a lower rate in return for the customer’s commitment to purchase a specified volume of services. The 'base rate' then includes the commitment and the usage as negotiated.

Businesses contemplating this price strategy should keep the following best practices in mind:

1. Inform customers upfront what the overage costs are. Businesses are doing themselves

and their customers a disservice if customers are dissatisfied and grow angry over hidden or additional costs. And with social media being as pervasive and influential as it is, it's too easy for customers to voice their complaints publicly and possibly damage a brand's reputation.

2. While it may not be feasible in all cases, businesses should let customers know when they are getting close to their limit. This can be done effectively through email notifications or automated text messages. If the business service offers a customer portal, incorporating a meter that counts usage (Figure 11) is an effective way to achieve this. Such a service can improve customer loyalty and lead to a higher customer lifetime value.

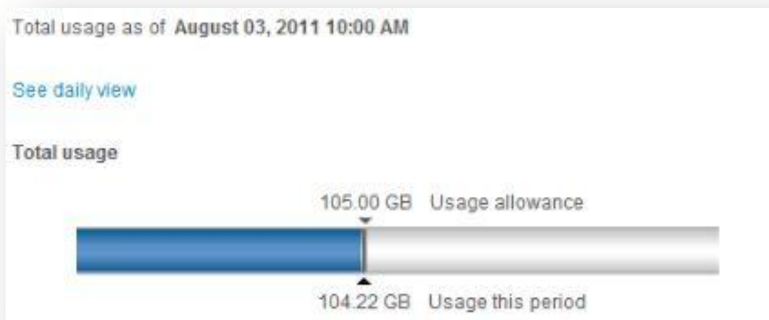


Figure 11 Example of a Usage Meter in a Customer Portal

3. Offering a tiered usage pricing system is effective for moving customers up to the next level, especially if they know they will be charged if they exceed their limit. However, businesses must ensure that the price of the next tier does not exceed the customer's original base plus overage charges, especially if they're graduated to the next level automatically.

When considering any pricing model, businesses should keep in mind that happy customers are long-term customers, and effective communication can go a long way to retaining them.

5 Tiered/Volume

The Tiered/Volume model is very popular in both SaaS and PaaS subscription–based businesses. In this model, businesses offer different price packages where volume is the key differentiator. What constitutes volume varies, of course. In the world of email marketing for example, volume is based on the number of unique email addresses or contacts a customer wants to send emails to.

In the Figure 12 example, customers are paying $15 to email up to 500 contacts. At 501 email contacts, the customer moves to the next tier and the price of the subscription increases.

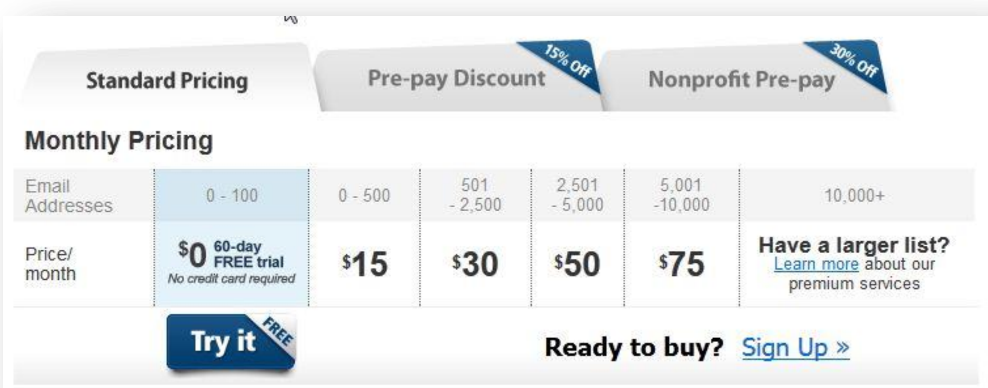


Figure 12 Tiered pricing based on number of contacts.

The number of users is another common tier measurement, especially for vendors of corporate or enterprise licensed software. Figure 13 shows one price for five users, a higher price for ten, and a third price for fifty users.

Figure 13 Tiered pricing based on number of users.

Both Figures 11 and Figure 12 also show that all tiers include a free trial. This is popular in many of the pricing models, and what it often means is that the first month (or in the case of Figure 12, two months) is offered at no cost to the customer. Customers must sign up with a credit card but are not charged until the free trial period is over.

The number of features, number of products, and quality of products are also common tier differentiators. Whatever the differentiator, the main benefit of this price strategy remains the same for both SaaS and PaaS businesses. Tiered pricing can accommodate a larger and more diversified buyer group, with buyers interested in the product or service, but with varying wants and needs.

Note: A three-tier offering is the most common approach, because it creates a frame of reference for the pricing. The goal is usually to generate the majority of sales at the middle tier price, with the lower and higher tiers creating the perception that the mid-tier cost is the best value. When a customer is presented with a single price point, they have no point of reference to determine if they're getting good value, or not. Without an appreciation of the value they're receiving, customers may become indecisive and make no purchase at all. But when bracketed by two other prices, value is easier to determine and buyer conversion goes up.[4]

Two other factors make this pricing strategy attractive to subscription businesses.

1. Most contracts include the caveat that if a customer exceeds the limits of the tier of the original subscription they are "bumped" automatically to the next tier. In this model the "up-sell" takes care of itself. However, best practices state that a business should inform their customers if their bill is going to be higher than expected. This demonstrates good

[4] David H. Krantz, R. Duncan Luce, Patrick Suppes, Amos Tversky, *Foundations of Measurement* (New York: Dover Publications) 2006.

will on the part of the business and will translate into a decrease in the number of calls from angry customers.

2. Perceived value is an intrinsic part of human nature. Many people will buy the tier higher than the one they actually need because it's perceived to have more value, to be the better deal. Figure 12 shown above is a very good example of this. It allows for 500 contacts for a price of $15, but for double the price of $30 the customer can email five times as many contacts. Even though this company will probably automatically bump the customer up when they reach 501 contacts, if the customer can be convinced to pay the price of the higher tier before they need it, the business can earn an additional $15 a month.

Any company contemplating the implementation of the Tiered/Volume based pricing strategy should conduct a market analysis to identify segments and devise pricing that addresses each. Such a study will provide the basis to support this, or any, pricing strategy.

6 Bundling

Sometimes called price bundling, product bundling, a compilation, or a package deal, this pricing model is based on selling two or more products or services together for a single price, rather than selling items separately at individual prices.

This is an interesting strategy because many people categorize it not as a pricing strategy but as a marketing strategy. Regardless, if bundles are properly constructed and tested, the result can have a significant and positive impact on a company's profitability. In fact, the right combination of products and/or services bundled together can:

- Increase overall sales;
- Increase the average deal size;
- Increase gross margin dollars;
- Decrease marketing expenses.

The basis of bundling is quite simple. Vendors offer several products or services for a lower price than if the items are purchased separately. The most common example occurs daily in fast food restaurants. Customers purchasing one or two items, such as a hamburger and French fries, are likely to be asked if they would like to make it a combo that includes a third item, such as a beverage, for a lower price than the original two-item order.

Building on the fast food example, bundling can be successful even if the bundle contains different types of products. A "kid's meal" often includes food products and a toy. In the travel and hospitality industry, all-inclusive vacations combine flight, hotel and meals for one price.

Bundles are not only popular in brick and mortar stores but online as well. Many B2B businesses offer solution-oriented bundles – products or services packaged together to solve specific customer problems. Telecom companies, for example, often bundle phone and Internet. Others create bundles that target a specific audience, as shown in Figure 14 where the target audience is small businesses.

Figure 14 Bundle targeting small businesses

Almost all of the “box-of-the-month” subscription businesses that have become so popular in the last few years are based on bundles. These businesses create bundles that are solution-oriented and targeted to specific audiences, and in many cases combine several types of products. Figure 15 illustrates an offer of a box-of-the-month club, Kitchen Turntable.

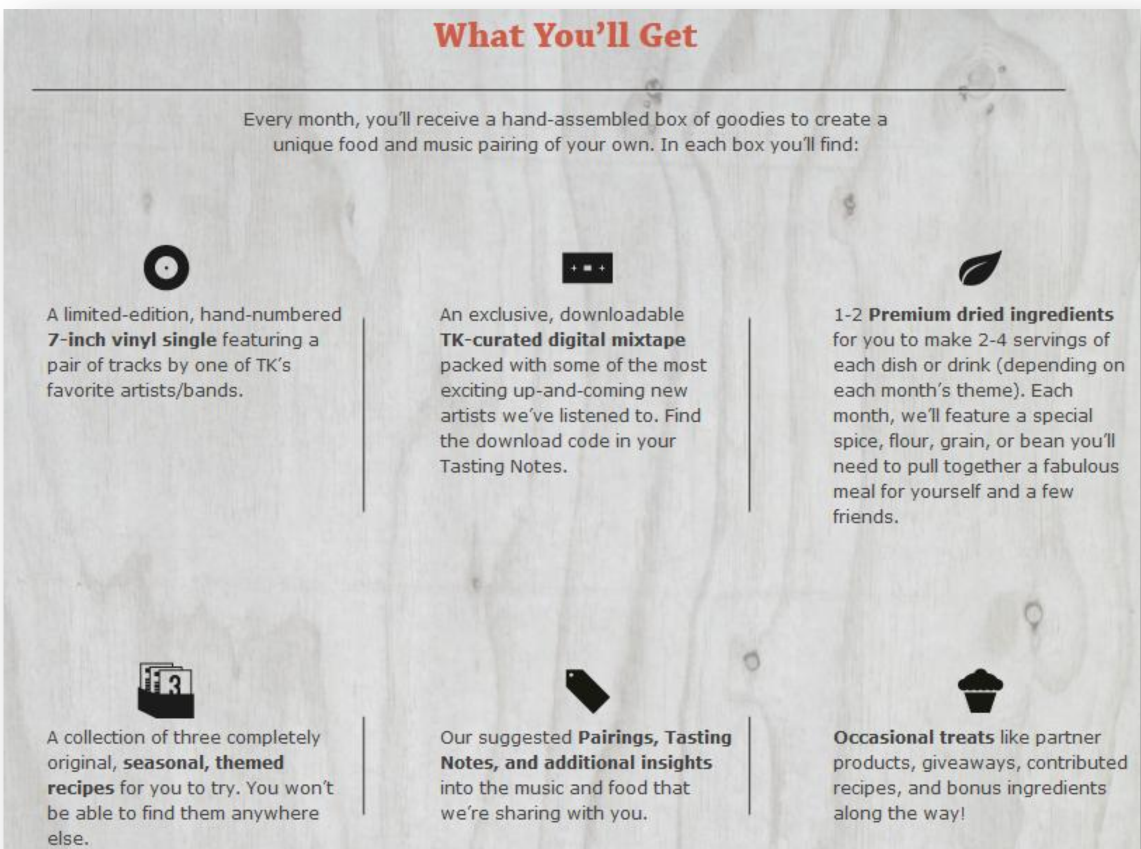


Figure 15 Kitchen Turntable's "What You Get" page

For $25 a month, Kitchen Turntable delivers a box that includes a record, a mixed tape, recipes, dry ingredients for the recipes, suggestions for pairings, and occasional treats. This example of a solution-oriented offer is targeted to busy people who don't have time to shop. And targeted within that group is a specific audience – music lovers who like to cook. Similar to a tactic used by fast food restaurants (a toy for a child) this offer also includes a surprise. For the right customer, this is the perfect bundle.

For this pricing strategy to succeed, it's imperative that businesses create bundles for which the perceived value exceeds the asking price. If the right value is offered to the right customer at the appropriate price, a sale is more likely to be made.

Consumers appreciate the simplification of the purchase decision and benefit from the joint performance of the combined products.

7 Segmentation

Businesses adopting a Segmentation pricing model will offer a product or service but at different price points for different customer groups. This pricing strategy has proven to increase overall profits and revenues, especially in industries with high fixed cost structures.

How it works

Assume a business has a product priced at $10. Some potential customers may view this price as too costly and therefore never convert. For other potential customers, the perceived value of the product may be higher so they may be willing to pay $15. If the business offers only the $10 price, it stands to lose $10 for each potential customer not willing to pay that price. Furthermore, the business stands to lose an additional $5 for each customer that would have paid more, for a total loss of $15.

However, if the business were to offer three prices, $5, $10, and $15, it stands to be able to convert $15 per transaction from the higher price segment, and $5 for each purchase from the lower price segment, totalling $20 for two sales where they could have had none.

At first glance, it may only seem that this strategy may not work, but consider the airline industry. Market segmentation allows airlines to offer a broad range of prices for the same seat on the same flight. The seat is the same, but the price varies with the type of customer making the purchase. This is pricing based on customer segmentation, and it can have an enormous impact on the bottom line.

Ways to segment

Here are some of the popular ways to use the Segmentation pricing strategy.

- Purchase channel – Online vs. in-store. Customers who purchase online can be offered a lower price because the cost of service is lower.

- Time used – Many resorts charge different prices for their vacation packages depending on the time of year. Frugal travelers will travel to sun destinations in late March for the better deal, while other travellers will pay more to get away from the January deep freeze.

- Time of purchase – Many items are priced higher before the holidays (when demand is high) and drop in price afterward. In the fashion industry, fashion-conscious buyers will pay a premium price to wear the latest styles as soon as they're available, while those on a budget will wait for the end of season clearances.

- Location – Theatres and concert venues charge based on how close, or far, the concert or movie goer is to the stage.

- Volume –The larger the order placed, the smaller price per unit paid.

- Attribute or feature – First class vs. coach, or hardwood vs. laminate.

- Service offering – A plane ticket that is non-refundable is usually less expensive than one that is fully refundable.

How it can go wrong – things to consider

While a Segmentation pricing strategy can be very powerful, it can present challenges that reduce its impact on success. Below are some considerations.

- Dilution: With a Segmentation strategy, there is always the possibility that a customer who would pay the higher price point will rationalize buying at the lower price point.

- Backlash: If a business isn't careful, higher paying customers may not see the value they were expecting from the premium priced product or service, and will feel they are being taken advantage of. It is imperative that businesses be sensitive to perceived value when creating and promoting segmented prices.

- Stagnation: Some businesses make the mistake of implementing a particular pricing strategy and then forgetting about it. To be successful, a business should constantly be conducting research and exploring new ways to add value to their products and services.

Used properly, a Segmentation pricing strategy can be very effective and lucrative for businesses. However, it is not right for every business. Similar to the tiered strategy, market analysis is critical to success.

Conclusion

Choosing and implementing a pricing strategy is probably one of the most important business decisions a company can make, however, even with a pricing strategy in place many businesses are not reaching their full potential. Errors in pricing can lead to low customer retention rates and lost revenue, and can even have a negative impact on the company's image and brand reputation.

To select the right pricing strategy – one that helps a business realize its financial goals, as well as support the brand, and is consistent with the reality of the marketplace – in-depth market analysis should be conducted followed by a well-defined, systematic approach to setting, adapting, and changing pricing.

About the Author

Steve Adams, CEO of Fusebill, possesses over 20 years of experience in leading high-technology and software companies, most recently as Vice President and General Manager for j2 Global. His expertise in subscription billing comes from years of building and extending large scale billing systems for SaaS companies.

Steve helped propel Protus into one of the fastest growing companies in Canada, with over 555,000 subscribers, before it was acquired by J2 Global in 2010. Steve is a graduate of the University of Waterloo and the Ivey School of Business.

About Fusebill

Fusebill automates invoicing, billing and collections for subscription based companies. Ideal for both B2B and B2C businesses, its customers span many industry sectors, including software–as-a-service, digital media, and communications. Customers rely on Fusebill to reduce their costs, speed their cash collections, and extend their customer lifecycles.