ABOUT THE AUTHORS

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Joe Andrews is sr. director of product and solution marketing at Zuora and has experience with subscription pricing and packaging for technology companies. Previously, Joe led product marketing for VMware cloud services and held several marketing leadership roles at Intuit.
Look around and you’ll see the rise of consumer and business services built around subscriptions and pay-per-use purchase models. Think about the services you subscribe to today – do you use Netflix? Spotify? Amazon Web Services? Subscription and recurring revenue business models are the new norm.

A recent survey by the Economist showed that 80% of companies are seeing a change in how their customers want to access and pay for good and services and 50% of these same companies are changing their pricing models as a result.
In the product world – you grew by shipping more units. Today, in the subscription world, it’s about actively driving 3 growth levers, all built around actively managing your relationship with your customers:

- **Acquiring new customers**
- Increasing the value of your customers over time – i.e. customer lifetime value (CLV)
- Reducing churn so you keep more customers and the revenue they bring over time

Pricing and Packaging plays a critical part in all three of these growth levers. Particularly given that your focus in a subscription business is building and monetizing customer relationships, companies need to think about how to adopt more than a “set and forget” approach towards pricing that may have worked in the past.

Now, let’s get started on your subscription pricing journey.
THE PRODUCT WORLD VS. THE SUBSCRIPTION WORLD

The world of “products” and “subscriptions” are two strategically different worlds. In the product world, production expenses and desired profit margins determine price. In the subscription world, prices and packages shift to fit customers, unlocking new ways to build long-term revenue relationships. To be their most effective, pricing and packaging should be used as strategic weapons, not afterthoughts.

In the product world, you have “cost plus” pricing. You build something and you know your manufacturing and sales costs – let’s say $50, and you price it to customers at $75 so you make a profit margin. If you sell thousands of the same product, you could price it less and make it up in volume. Or if you believe a customer segment exists that will pay a
premium or not afford it, you create a premium-featured version (Lexus vs. Toyota) or a cheaper version (Corolla vs. Camry).

Or in the software world, there’s no manufacturing cost – your cost is based on software development and sales.

So instead you target a price point that’s base on what a customer is willing to pay. You can determine this through extensive research. You may only set your price every year or so since it’s hard operationally.

In the product world, the pricing model for enterprise software is called a “perpetual license model”, meaning the customer pays (in theory) to own the software forever. You then sell a support and maintenance contract that would be renewed every three years. So in effect, the sales person would only engage with the account every three years.

Should you care if your customer is using the product? Well, technically yes, but it’s hard to track this until you go back to the customer three years later to sell them a new contract.

But in the subscription world, pricing is fundamentally different. It’s based on usage, or consumption. The value the customer receives from your service is
based on how much they use and the value they receive. What if Salesforce charged everyone a flat fee of $500/month, regardless of how many users they put on the system? That wouldn’t make sense.

So you now have a new way to measure the “value” your customer gets from your offering. And as this value builds over time your revenue grows. You can actually measure usage, letting you be responsive to your customer needs.

And then you can optimize your “packaging,” which is the set of features or capabilities built into the product offering.

In the Subscription world, pricing and packaging is more strategic and the primary basis for competition.
THE SUBSCRIPTION PRICING JOURNEY
In the Subscription world, pricing and packaging is the most important tool you have.

Here at Zuora, all of our inquiries with new prospective customers start with a discussion around pricing and packaging. Subscription businesses now have many choices available for how to price. Time is of the essence because in a subscription business pricing is a tool you want to evolve rapidly.

To fully leverage this weapon, there are a lot of pricing strategies to consider – and this introduces more opportunity and choice to your business, but also more complexity.

The challenge is where do you focus and start?
You can think of pricing in the product world as being 2-Dimensional – there are attributes for what price you charge and what product capabilities or features you deliver. But in the subscription world it’s really 3-Dimensional, because you add the attribute of time. Is your subscription term monthly, quarterly, annual? Multi-year? What if the product functionality changes during that subscription term?

Now consider the strategic growth levers:

To drive customer acquisition, how do you offer promotions during that term?
To increase customer value, how do you offer upgrades, bundle multiple offerings and cross-sell new services?
To reduce churn, how do you enable downgrades to keep customers who may want less but still pay you for something?
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**Where do you focus and start?**

This is a typical subscription pricing journey we see that many businesses go through with regards to evolving their pricing and go-to-market strategy:

- Start with a simple plan on a fixed recurring price plan – think when Netflix started at $10/month.
- As you add new products, focus on driving upgrades with additional customer value and experiment with billing frequencies (monthly, annual, multi-year). Then explore product add-ons and bundles (think french fries and value meals).
- Then companies gather more insight on customer segments and needs – this leads to tiers (editions) with different feature sets and price points. At this time companies may think about usage pricing – does it work for their customers and offering?
- In the pricing optimization phase, companies start to be more aggressive about their testing – doing packaging concept tests and A/B price tests – for example, does a $25/month price point generate more MRR than a $20 price point (the test is: will a 25% price increase offset the decrease of customers)?
- And lastly, companies that enter international markets need to content with pricing in multiple currencies, and in some cases regional price lists.
Despite the infinite number of options, there are four primary pricing models.

THE FOUR BASIC PRICING MODELS
Four basic pricing models

One-time price model
This is the traditional pricing model. Netflix started this way, with a one-disc-per-person plan. It’s simple: you sell one product for a one-time price to one customer at a time. While technically not a subscription, this model still might be needed by a subscription-based business for a set-up fee or the purchase of equipment that the subscription requires.

Fixed recurring model
This model is a smart bet if you’re launching a new service — it’s what services like Amazon Prime use. You provide a single product for a single price, and charge on a recurring basis. When you’re ready, you can add more products. It’ll still be simple to manage because every product has a distinct price.

Per unit / per user model
In this more advanced pricing model, what you charge the customer is based on one of two things: the number of units consumed or the number of users with access. For the number of units used, gigabytes of data are a good example. For the number of users, think about how Salesforce sells seats today.

Usage model
The most complex of the subscription models, this type of pricing is used primarily by IT and Cloud Services companies like Amazon Web Services. The beauty here is that you can enable customers to pay only for what they use, which makes them happier and less likely to churn. It’s instantly responsive, so when customer usage changes, the price reflects it. Everyone strives towards a usage model and this is where disruptive models start.

Based on a recent poll of 200 subscription businesses, the most popular pricing models are fixed recurring (50%) and per unit or per user (35%). A much smaller group has a usage-based model (9%).
In the hundreds of companies we’ve talked to, some basic approaches to pricing have emerged. Here are the most popular pricing profiles and some suggestions to think about to improve your pricing for each one:
“Set it and forget it”
A popular approach with traditional companies, this model seems relatively easy to implement. But in reality, it’s the most time-consuming and costly structure to set up. Plus, it’s the most difficult to test. And you can’t really ever forget about pricing. If your prices don’t respond to market influences, you’ll miss opportunities for revenue and growth.

Rx: Dust off the cobwebs. Get ideas from industry disruptors, customers, prospects, notable successes and notable flame-outs. Then test—it doesn’t have to be all or nothing.

“Let’s make a deal”
This is a trap that companies selling to large enterprises often fall into, because big deals require lots of customization. Your sales team sets the prices for each customer, so every deal is different and you don’t have standard pricing. This makes it tough to establish what works. And impossible to project future revenue.

Rx: Start to look for patterns. Identify segments of customers with certain buying preferences; establish pricing tiers, then test and track.

“Playing defense”
Your ultimate goal is to price yourself lower than the competition, and you put lots of energy towards competitive intelligence around pricing. This means you also cede the market to your buyers, who simply hold out for the best number. This happens all the time in parity products like fuel and airlines. But it doesn’t have to keep happening.

Rx: Create true differentiation for your products. Research to find out what buyers are willing to buck up for, and explore ways to add value through packaging innovation.

“Playing offense”
You know how competitors are pricing, but that’s not how you play. Instead, you look at customer value drivers and clear points of differentiation, then significantly raise or lower the price and the value you offer. This is bold, but you may be missing the point if you’re not taking market context into consideration.

Rx: Get more feedback and get more sophisticated in approach. Fine-tune innovations and offerings to better match customer preferences and behavior patterns.

“The disrupter”
You’re unafraid to change your price frequently, optimize your bundles and packages, exclude certain customers, include others, and then do it all over again. It’s likely you’re in the mobile carrier business. And it’s a definite that you understand how critical it is for your invoices to be clear, simple and transparent customer communications.

Rx: Don’t get comfortable, ever. Continue to analyze data, get feedback and test to create the best scenarios for your customers and your business.

In the same recent poll of 200 subscription companies, over 21% of all participants have a “set it and forget it” profile and almost 44% are “let’s make a deal,” meaning pricing is set on a deal by deal basis through the sales team. This point further suggests an opportunity to be more pro-active in determining pricing strategy with market and customer input.
PROMOTIONAL STRATEGIES TO DRIVE GROWTH

Revisiting the 3 subscription growth levers, one of the keys to rapidly acquiring new customers is to use a free promotional strategy. The objective is to acquire as many new customers as possible with the lowest marketing cost. The free offer is a way to lure many new prospects to try your service. Then, you have the opportunity to demonstrate your value and convert them to paid customers. The two most popular promotional strategies are free trials and freemium. Subscription businesses typically experiment with both, and usually one is better for your business.
Free trial
A free trial offers the full product experience for a limited time (e.g. 30 days). It lets you show prospects how great your product is and is a great way of qualifying prospects. There’s an expectation that the user will have to either pay or stop using your product at the end of the trial. Get it right and they’ll stop shopping and commit to you. Conversion rates are typically higher: 10-20% is best practice.

Freemium
A freemium offering is a feature limited or stripped down version of your product that you offer for free forever. The prospect makes no commitment to ever buy anything when they sign up and starts to get value immediately. This makes the freemium model great for driving massive numbers of new users. But the challenge is convincing your free customer to pay you. You must show value in your premium products that will convince them to upgrade. Conversion rates tend to be much lower as a result: 3-5% is typical best practice.

Which model is right for you?
There is no single easy answer, but some of the key considerations are:


2. Clear differentiation between free and premium offerings: This will make it more feasible to do a freemium model.

3. Viral benefit of free users: If you’ll get more and more free users from your initial ones spreading the word, then freemium may be right for you. If not, then you lose one of the benefits of freemium.

With both models, it’s critical to focus on the onboarding experience – can your users get started right away without any help and be successful in what they’re trying to do?

It’s also important to understand your cost to deliver service. If you get thousands or millions of free users, what’s your infrastructure / hosting cost? What conversion rate is required to make it worthwhile?
TESTING AND ITERATING YOUR PRICING STRATEGY
Part of pricing and packaging flexibility is being able to iterate quickly and easily.

Your objective is to make your business better. You need to learn and evolve your business model and pricing strategy. The best way to do that is to rapidly test and iterate, rather than spending a long time planning between test cycles.

In the same recent pricing poll, over 40% of all participants have not changed their pricing at all in the past 12 months and a further 35% have only made 1 or 2 changes. This suggests great opportunity for those companies to be more agile in their subscription pricing.

What drives the need for pricing and packaging iteration?

- Responding to the market and customers
- Competitive response
- You may want to introduce periodic price changes to capture new value being delivered in your product or to keep up with inflation
- You want to launch new products
- You want to launch new features
- You want to expand to new international markets
- Or you want to run marketing promotions

* The key is to recognize the need to iterate and be flexible with your pricing and packaging.
What are the requirements to rapidly test and iterate?

You have to start with conversations with your prospects and customers to get a directional idea of what you want to change – is it a simple price change? Or is it a new product edition?

Then you have to test it in the real world – if it’s a price change, do an A/B test. Having a Relationship Business Management platform like Zuora lets you set this up in minutes. Then you have to be able to measure results.

Key considerations for how you roll out and communicate the changes.

First, you have to manage changes within your existing subscriber base e.g. you may want to grandfather in your loyal customers if you do a price increase. Otherwise, you may drive customers to leave.

Second, you need to cover the operational processes to support existing customers e.g. bulk updates of customer records, data migration, etc.

Third, you have to effectively communicate changes to the market to avoid PR disasters.
We’re Zuora, the global leader in Relationship Business Management solutions, helping companies in every industry transition to the Subscription Economy. Enterprise leaders and high-growth companies alike use Zuora’s multi-tenant cloud platform to launch, scale, and monetize their subscription services.

Our experts have uncovered 9 keys that are foundational to the success of running a subscription-based business. Of these 9 keys, pricing and packaging are the first, and a critical consideration. This playbook was created to help you support your business with transformative pricing and packaging, and find your own success in the Subscription Economy.