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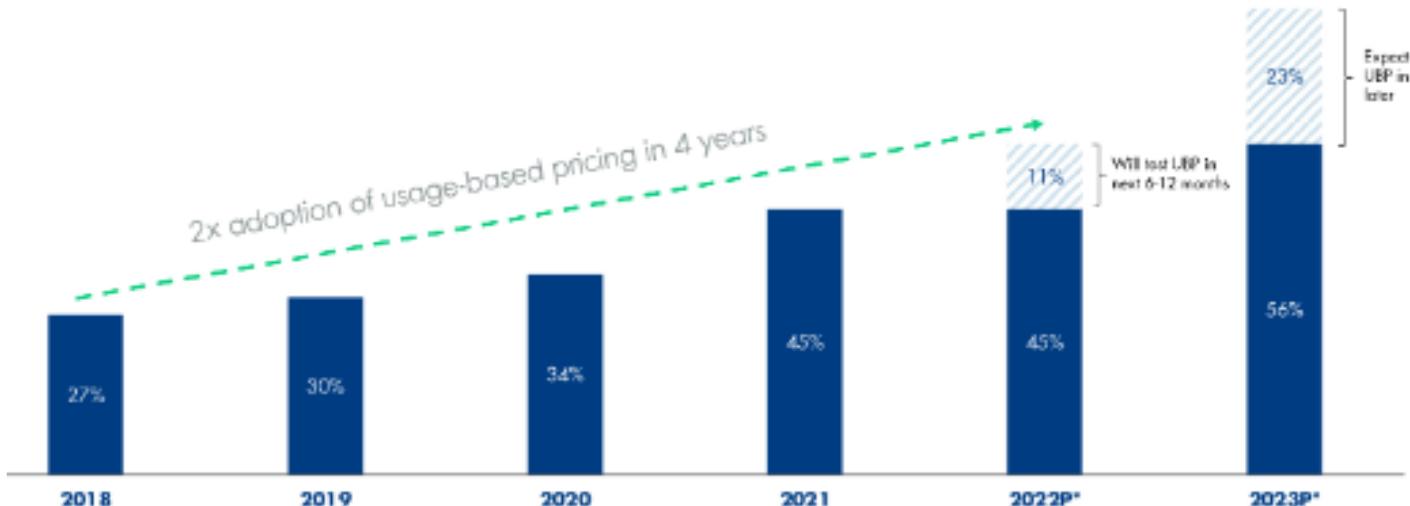
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## USAGE-BASED PRICING IS GOING MAINSTREAM

Usage-based pricing over time



# Usage-Based Pricing Model- What SaaS Companies Need to Know



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Pricing is a significant challenge for many software company leaders. And rightly so, because the right pricing model could be the only thing standing between your company and great profit. And statistics prove that **98% of SaaS companies** witness their success rates based on the choice of their pricing models.

We live in a digital age where businesses and people are more connected than ever. This connectivity level has given companies insights into what consumers buy, how

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as a risk.

## What is Usage-Based Pricing?

Usage-based pricing is a business (SaaS) pricing model that enables consumers to pay only for what they use and when they use them. The cost is based on consumption, and customers are charged on a “per-use” basis. For instance, users can be charged depending on the number of API calls requested or subscribers reached.

With usage-based pricing, consumers are charged at the end of a monthly billing cycle based on product usage. Think classical phone plans before unlimited data or minutes and texting. If you have a billing cycle where you use a product less, your charges become less, and vice versa.

For example, the SMS service at [Twilio](#) scales up “whether you need 1 or 100,000 numbers.” This billing structure shows how usage-based pricing can enable users to plan and get charged for exactly what they need before payment.

On the other hand, [Amazon Web Services](#) has been using a usage-based pricing model since its inception. They offer price points on the frequency of access alongside data stored. AWS has seen the benefits as the model has helped them attract and retain an outstanding market share which was at 34.2% as of 2019

It is a relatively new alternative to the traditional subscription fee and upfront purchase pricing models and is rapidly becoming common with SaaS products. According to a published [report](#), the adoption of usage-based pricing in 2021 exceeded that of both 2020 and 2019 combined.

If these trends continue, usage-based pricing will become the industry's norm as early as this year.

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trajectory of this pricing model.

Other critical points from the report include:

- Companies that employ usage-based pricing record an average of 137% net dollar retention.
- The adoption rate for the usage-based pricing model has doubled in four years, from 27% in 2018 to 56% in 2022.

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pricing.

New Relic, a public cloud observability company, launched its usage-based pricing model in July 2020. Recently, it doubled down on the pricing model, choosing only to pay sales reps based on users' actual consumption rather than recurring subscription commitments. This decision seems to be paying off as the company has witnessed a spurt in both data retention and account growth, the two best indicators the business tracks closely.

Similarly, startups like Cypress, pre-IPO companies like Kong, and even longstanding companies like Autodesk introduced usage-based pricing in 2021.

According to the [State of the Cloud](#) annual report by Bessemer Partner Ventures, usage-based pricing has been on the rise because it aligns perfectly with product-led growth. Companies employing the model deliver more flexibility to their users and share the benefits of success and scale.

### 3 Key Components of the Usage-Based Pricing Model

Implementing a consumption-based pricing model is often impossible unless you accurately break down your product usage into usage units. Having the right data

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thousand, or million units.

- **Mediation**

Companies use a mediation engine when they need to filter data and normalize it for rating and billing purposes, like in the case of **Voice Over IP (VoIP)**. The raw data is structured and filtered, and the result is billed on call duration, transfer of MB of data, number of SMS or MMS, and pricing of video usage.

- **Billing**

Apart from the mediation engine, you can use billing to measure usage data throughout the billing cycle. The data is then used to create pricing strategies, including price, billing plan, promotions, discounts, and how to charge.

## Usage-Based Pricing Versus Subscription Billing Models

Advanced technology and a seasoned, refined understanding of its usage have increased consumer expectations in the relationship between users and vendors. However, not all companies are good active listeners.

Let's look at the difference between usage-based and subscription pricing from both a user's and vendor's point of view regarding software.

In subscription billing, customers are expected to choose to pay a recurring monthly fee of a specific amount pre-determined before the software purchase. The recurring fee typically depends on license cost multiplied by an estimated unit number of that license required for the coming year. From the user's perspective, they benefit by receiving the service or product regularly. Because pricing remains the same cycle to cycle, there are fewer shocking cases that can come to the final bill.

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for the same product or service type.

With usage-based pricing, on the other hand, consumers are granted the power to regulate their usage with software providers measuring that usage and billing the user accordingly.

Usage-based pricing goes beyond simple recurring subscription billing by charging users based on how they use your product. For instance, Google Cloud Platform uses a pay-as-you-go billing structure with no upfront purchase fee, no termination charges, and billing tiers that vary based on product and usage.

The fulcrum of the agreed-upon contract between the customer and the software company becomes more centered with an improved equitable exchange of value—both the vendor and the user benefit. Aligning revenue with usage puts the software provider on notice that payment by the user requires a constantly innovated and differentiated service or product that customers will value and enjoy. Companies that pay attention to this detail will benefit from increased revenue growth and a more loyal customer base.

Beyond a billing or revenue business model, consumption now becomes the central focus of a company committed to ensuring customers are successful and recipients of the value of their services and products—a real win-win.

Data shows that usage-based pricing can and often co-exist with traditional subscription billing.

The advantage of combining the two pricing models is that companies can transform mediocre revenue into significant profitability. Hubspot, for example, offered three subscription packages initially, struggled with churn, and reported very low revenue. In 2011 they launched usage-based pricing, and today, the

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~~Usage-based pricing is now the driving force behind the current economic model.~~

Think of Airbnbs and Ubers, which have defined a shared economy. With consumption-based pricing, such companies can deliver services and bill the customer based on variables such as distance traveled, time, nights reserved, or peak travel time.

The excitement around consumption-based pricing in the SaaS world is there for a reason. Businesses implementing its use, including hybrid solutions, whether startups or mature, outperform their competitors. This billing model helps customers derive value from services or products. Other beneficial reasons why companies are switching to usage-based pricing include:

### **Increased agility**

For SMBs and startup companies, the lowest tier of a business offering usually meets their needs. However, as the business grows and scales, access to more services and products may be necessary. With usage-based pricing, companies can easily adapt and bill customers for additional usage.

In addition, usage-based pricing allows businesses to anticipate users' future needs. By metering product usage, companies can track and analyze service or product usage data and use the information to send real-time, personalized customer promotions based on interests. For example, a digital newspaper subscription service can track the number of article pieces a reader clicks. If the consumer exceeds their monthly allowance, the newspaper can offer the user a-la-carte pricing for each article piece above the subscription amount.

### **Affordability**

The usage-based pricing model allows customers to have options aligned with the anticipated value of the service or product. [Amazon Web Services](#) offers various products priced like EC2, so the user pays for only what they use. This has made

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The usage-based model enables companies to collect feedback on how customers use their products. You can easily find features that appeal to your customers and the ones you should improve on. This makes it easy since you just need to look at the revenue data to figure out what components of your SaaS software product are high in demand.

### Higher investment magnet

The 2021 OpenView survey found that almost **42% of seed-stage** SaaS businesses use the consumption-based pricing model. From a distance, the income may appear to be more volatile than other billing models. But a closer look at the figures proves that companies using this pricing plan are growing faster, trading higher multiple revenues, and retaining more revenue. These are all factors that attract investors.

### Less Commitment

When an on-demand product is available in smaller increments and without a significant upfront investment, customers are more likely to try the product. For example, when music was available on CDs, customers had to buy an entire CD to access a single song. But now, music subscription is streaming, and you can buy a single song and add it to your collection. While this benefit creates opportunities for new customer personas, it also fulfills the customer's need to avoid the burden of commitment and ownership.

Usage-based pricing may not fit everybody. However, it can be quite a powerful and valuable component when it's a match with your business.

## Consider Whether Usage-Based Pricing is Right For Your Business

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