DEMYSTIFYING USAGE-BASED PRICING

How to Evaluate and Implement
Value-based Pricing for Your Business

TLDR; The Complete Scope

When Segment, a customer data management platform launched its offering, it was free for the first six months. Co-founder and former CEO Peter Reinhardt in an interview said - "We reluctantly sent an email asking our top 15 customers to pay $120 a year for the product. One of the customers wrote back 'Guys, this price is so low that I may have to stop using your product because there is no way you're going to be around in a year. You better raise your price.'" And that was a wake-up call for the company. Segment then went on to consult a sales advisor. As they walked in to close their first enterprise deal, Mitch - the sales advisor, told Peter to ask for $120,000. "I was like, 'Mitch, that is 1000 times more expensive than our public price listing. I don't know what you're smoking. I cannot go in and ask for a 1000x price increase.' He was like, 'If you don't ask for it, then I quit as your sales advisor.'

Deciding not to lose Mitch on his first day, Peter chose to play along and ask the customer for $120,000 a year. After a few rounds of negotiation, he ended up with an $18,000 deal, 85% lower than their ask but a staggering 150X increase on what they were charging customers. Segment later went on to be acquired by Twilio for an impressive $3.2 billion and has over 20000 customers, including IBM, Domino's, and Vista using their platform. "It was a huge awakening for me. The value we were attaching in our minds was on a cost basis. We had no understanding of the value that we were providing to customers. In B2B sales, value is what you should sell on, and value is what matters to the customer. They couldn't care less what the costs are. So that was a huge learning experience," said Peter.

Like most SaaS companies, Segment was leaving a truckload of money on the table due to its pricing. In the early stage of a business, the entire focus is on finding product-market fit and pricing for most founders is like throwing spaghetti at the wall and seeing what sticks. So most products inevitably are underpriced. Pricing significantly impacts your company's growth and should continuously evolve as the product matures. As you scale, there is enough customer feedback to create a more data-driven pricing strategy. A successful price increase helps you acquire the right customers who will engage and use your product more and are less likely to churn. It significantly improves the lifetime value of a customer and, in turn, the LTV: CAC ratio.

SaaS companies can experiment a lot on how they package and price their products. Taking a value-based approach can not only hasten customer acquisition but also helps in getting the right customer in and improves monetization. One of the easier ways to align your product value with the customer's value perception is by pricing based on usage-instance instead of asking them to commit to subscription plans. This also reduces entry barriers and increases the potential for adoption.

The 2nd edition of OpenView's State of Usage-Based Pricing report indicates that three in five SaaS companies now have some form of usage-based pricing, up from 45% in 2021. And it's not usage-based or subscriptions. Many companies are moving towards a more complex, hybrid pricing model that offers usage-based pricing in addition to traditional subscription plans or offering a usage-based subscription plan to cater to evolving customer needs.

If you're a CEO or a SaaS leader wondering where usage-based pricing is finding its ballooning relevance, the potential impact it can have on your revenue, and how to get started, this guide is for you. The following sections will explain why usage-based pricing is becoming the holy grail for SaaS businesses and how it is evolving from being an acquisition strategy to a revenue growth lever.

By the end of this guide, you will be able to

Understand

the integral tenets of usage-based pricing and how it might impact your business

Determine

if usage-based pricing is relevant for you

Get Started

with an operational framework for usage-based pricing implementation

Debunk

common misconceptions around usage-based pricing

Learn

from the experiences of leading SaaS businesses who have successfully implemented usage-based pricing themselves

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THE SHIFT FROM CAPABILITY TO VALUE-BASED SAAS BUYING

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Technology can help reimagine your entire value proposition

During the 2008 recession, the advent of SaaS rapidly transformed software buying from the era of on-premise software. In fact, by replacing software ownership with multi-tenancy rentals, SaaS significantly reduced the cost of capability ownership for businesses.

Naturally, with SaaS ubiquity and the cost-efficiency of software, purchase decisions could shift from discussions around the 'cost of capability ownership' to the 'business value of the capability owned.' It means your customers are more informed about the features you bring to the table and the degree of impact caused by your offerings.

What's more, customers now want more flexibility and options when it comes to pricing. With another recession looming large, companies are rethinking their growth strategies, focusing on cash generation, improving profitability, and extending their cash runway.

Customers increasingly weigh-in on every dollar spent and want to move towards a consumption-led pricing model where they pay for what they use instead of shelling out money on features they never end up using.

According to research by Bain & Company, 80% of customers report better alignment with the value they receive with consumption pricing. Moreover, nearly two-thirds of software companies say usage-based pricing acquires more customers and increases their revenue share with existing customers.

"Usage-based pricing is a win-win for both software vendors and their customers. For the vendors, you scale with your customer. Better alignment with customers' organic growth reduces the pressure on sales teams and helps build a healthier business. So that makes usage-based pricing a fundamentally superior economic model. For customers, greater transparency - since they only pay for what they consume - and the ease of dialing up/down usage dramatically shrinks the barriers to software adoption."

Tejeshwi Sharma
Managing Director
SEQUOIA

The Evolution of Value-led Decision Making

Value-led purchase decisions are significant monetization levers for SaaS businesses. Closely aligning product and business scale with customer growth brings new opportunities to re-engage and incentivize customers beyond just the 'point of sale.' This makes the product/service stickier and more durable, and makes it easier for the sales team to justify the product's ROI to the prospect.

At the same time, discussions around business value also shift the power in SaaS purchasing cycles from the vendor to the end user-

Tilted Balances: Shift in Power from Vendors to Buyers in SaaS

1. **More transparency in usage and pricing**
   Free trials and transparent pricing are no longer differentiators:

   ~75%

   of SaaS businesses offer free trials

   >70%

   of SaaS businesses are transparent on pricing

2. **Greater control over buying process**
   The buying process often involves more than one function, and new decision-makers enter in the last

   5-10%

   of the software buying process

3. **Democratic access to competitive intelligence**
   Today, buyers are completing

   >60%

   of the evaluation before engaging a vendor

4. **Shifting value from seat-based to outcome-based**

   Today's SaaS businesses are geared around operational efficiency. With growing competition, vendors must be vocal about their solutions' efficacy and convenience. For customers, therefore, the value of software doesn't always scale with more people/seats but in how efficiently it solves a problem.

5. **Flexibility in product usage**

   With custom integrations and the rise of APIs, customers can determine where and how SaaS platforms fit into their business.

Flat-fee models limit the ability of a SaaS business to monetize growing product capabilities beyond the initial offering, while seat-based pricing models still depict SaaS platforms as process-driven, not outcome-driven.

A business that onboards a SaaS platform allocates the subscription across various teams within the company. An infrequent user of the SaaS platform ends up paying for a lot of undelivered value.

Flexible consumption models like pay-as-you-go (PAYG) or usage-based pricing (UBP), on the other hand -

Limits overspending

on new SaaS purchases by tying product value directly to business usage value

Scales

feature usage as and when required - unused products don't get billed for

Monetizes customer usage

in proportion to their growth

Limits churn

by decreasing payment load on non-utilization

Growth of Flexible Consumption Models

According to OpenView,

3 in 5

SaaS companies offered some form of usage-based pricing in 2022

VS

45%

in 2021

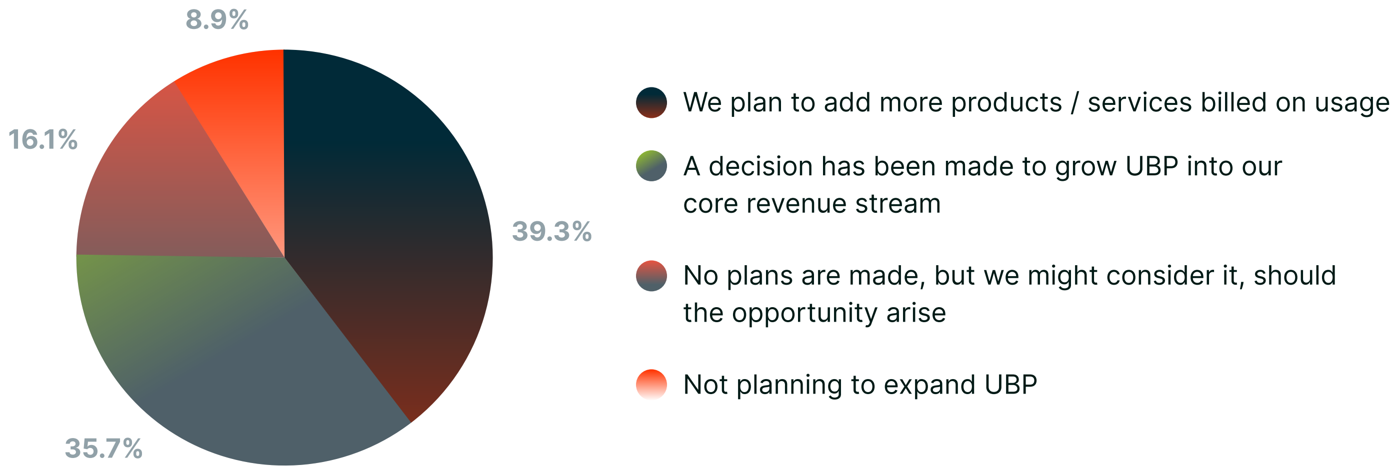
While still an evolving discipline in SaaS, flexible consumption models are increasingly becoming the go-to pricing model. According to Chargebee research, 63% of SaaS companies are exploring usage-based pricing models. A shift in value orientation and increasing focus on customer-centricity is driving the adoption of usage-based pricing, offering more flexibility and granularity in pricing to customers

“Pricing is a unit of value. However, we're starting to see that the value you get from a product isn't necessarily tied back to the user. Since the way that people use software is changing, the metric that businesses assign to the price is also changing and is driving the momentum towards a value metric based on consumption.”

Curt Townshend
VP of Growth
OPENVIEW

An internal survey by Chargebee also indicates that **74% of SaaS companies will likely offer more products on usage-based pricing in 2023.** More than 35% of those companies want to turn usage-based pricing into their core revenue stream.

UBP Expansion Plans



Pricing Optimization

How would you describe the pricing of your products and services billed on UBP?

Lead UBP Adoption

14%

We think we have hit the sweet spot

53%

Finalized, but we keep on experimenting with new ideas

Considering UBP Adoption

32%

Still highly experimental

"Usage-based pricing helps companies achieve and maintain high levels of net dollar retention since it allows for a natural 'land-and-expand' growth. The advantage of having such NDR is that it creates a sustainable organic growth flywheel that consistently drives higher overall revenue."

AJ Malhotra
Managing Director
INSIGHT PARTNERS

OpenView's latest benchmark study on usage-based pricing showed that (as of Jan. 2023) public usage-based SaaS companies fared better than the broader SaaS Index on all the key metrics. A single percentage point increase in net revenue retention leads to a 28% average increase in valuation over five years.

Comparison of Usage-based Public SaaS companies to the broader index*

	Usage-based	Broader SaaS Index	Difference (%)
YoY Revenue Growth (TTM)	17%	13%	**+31%**
Net Dollar Retention	125%	114%	**+9%**
Revenue Scale ($, in millions)	$917	$597	**+54%**
Rule of 40	36.5%	36.2%	**+1%**

Usage-based pricing outperforms

Usage-based businesses see continued growth at scale, driven by best-in-class net retention

Source: OpenView - The State of Usage-based Pricing

WHAT IS USAGE-BASED PRICING?

02

Usage-based pricing is a flexible, consumption-based pricing model wherein customers only pay for products and services used within a defined billing cycle.

Traditionally, this monetization model is adopted when a business has a precise unit of measurement for how much of its product or service a customer uses. For instance - AWS charges customers on the usage of their cloud-hosted servers by the minute. A product can typically be used in myriad ways - through API calls, data transfer, the amount of time a program is run, and more. Therefore, to accurately *define* and *measure* usage, you also need a **value metric.**

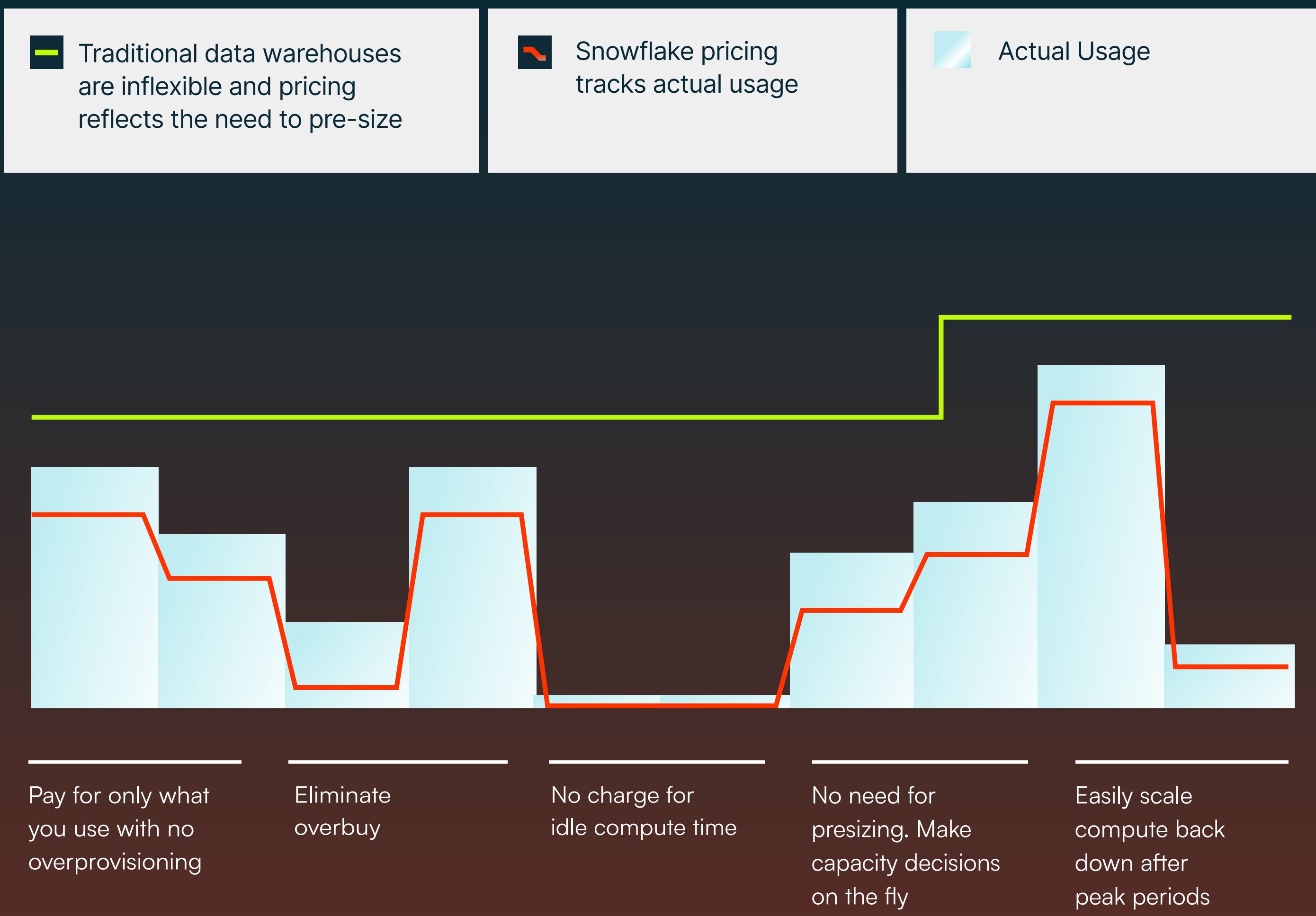
Value metric is a mix of your customers' *perceived value* and the *intended price* point for a particular product. As one of the most critical building blocks of pricing, landing on a value metric requires thorough experimentation and customer feedback.

> **“The key to finding success in the usage-based pricing model is ensuring what you are charging should correlate as closely as possible to the value your users extract from your product. Pricing, therefore, is a percentage of that value creation. If you land a value metric that scales revenue with your customer's success and feels like a natural extension of their perception of your product, you will likely see higher adoption rates and better conversion.”**

Shekhar Kirani
Partner
Accel

Usage-based pricing is among the more popular forms of value-based pricing. While its applicability still depends on the *kind of business* and the *tech stack* you have, it is closest to the most fundamental way your customers define *value* and *success* from your product - their *consumption/usage*. In most cases, if you choose the right pricing metric that aligns with your customer's target outcomes, their overall cost increases with their success, and then they don't mind paying a higher price.

Take the example of data cloud company Snowflake which charges users based on computing resources consumed-



Source: How Usage-Based Pricing Delivers a Budget-Friendly Cloud Data Warehouse

Selecting Your Value Metric: Types and Considerations

Usage Can Be Tracked Across Multiple Value Metrics

Via tracking on-platform customer presence	**Via tracking data calls**	**Via product/service metric assessment**
User pageviews	API Calls	API Flow/Throughput
User sessions	Data processed	Total integrations
Unique users added	Data stored	Recurring/Concurrent integrations
	Items/content accessed or downloaded	Tracked orders
		Instance/CPU hours used
		Queries launched

Complexity variance in usage-based pricing

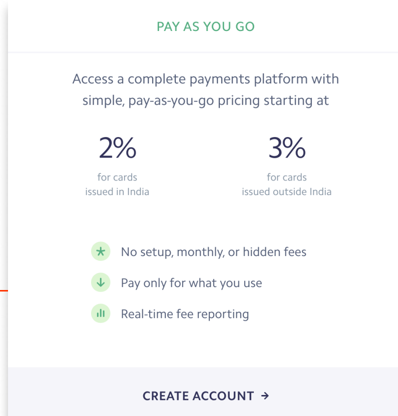
Depending on the number of products and how different the value metric is for each usage-based pricing can have varying degrees of complexity.

> **"For companies with multiple products with different value drivers, you need to ensure that the value metrics you choose are intuitive and straightforward to understand, such as total revenue processed, number of customers contacted, or amount of data processed. Customers want predictability, especially when it comes to costs. The more complicated your pricing is, the harder it becomes to understand and predict, eventually leading to lower usage or churn."**

Tejeshwi Sharma
Managing Director
SEQUOIA

One of the simplest usage-based or metered pricing varieties is the 'per-unit pricing' model. They are typically optimized for companies that sell services for either a category of products or different products with similar value metrics like data/bandwidth for a VoIP phone company.

Global payment processor Stripe, for example, bills their users on the number of successful transactions processed-



Stripe's PAYG model charges businesses for each successful transaction instance

On the other hand, CRM Pipedrive has many varied features to offer its customers. Each feature has a distinct use case and a significantly different product-value proposition

	Essential	Advanced	Professional	Enterprise
Manage leads and deals				
Lead and deal management	✓	✓	✓	✓
Open deal limit (per company)	3,000	10,000	100,000	Unlimited
Customizable pipelines	✓	✓	✓	✓
Products catalog	✓	✓	✓	✓
Custom fields	✓	✓	✓	✓
Custom field limit (per company)	30	100	1,000	Unlimited
Leads inbox	✓	✓	✓	✓
Deal rotting	✓	✓	✓	✓
Data import and export	✓	✓	✓	✓
Merge duplicate data	✓	✓	✓	✓
Track communications				
People and organization management	✓	✓	✓	✓
Mentions and comments	✓	✓	✓	✓
File attachments	✓	✓	✓	✓
Contacts map	✓	✓	✓	✓
Calendar view and activity management	✓	✓	✓	✓

Pipedrive's plans have a varied range of service offerings which could make usage-based pricing extremely complicated

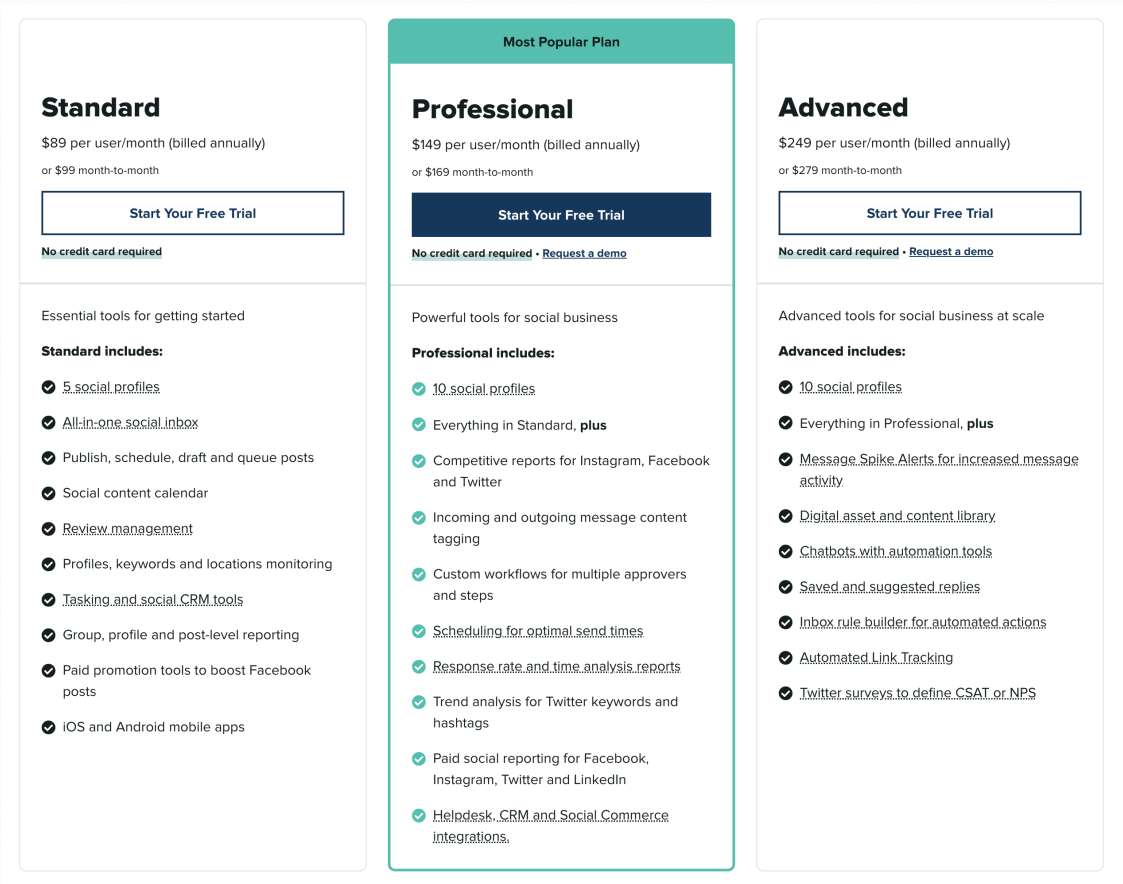
Charging customers on a unit basis for these distinct features would require usage tracking and analytics for individual features, complicating billing for the company and its customers. It would also increase the billed price defeating the purpose of cost efficiency.

Instead, leveraging a ***'subscription tier + overages'*** model helps tap into additional value from usage without being budget-heavy for customers.

Is Usage-based Pricing Right for Your Business?

While businesses with solid product-led growth (PLG) motion have leveraged the usage-based pricing model well, sales-led and hybrid companies are equally likely to employ some form of usage-based pricing. Subscription businesses are increasingly adopting tiered-pricing models that ensure new low-ticket customers can be onboarded with minimal features. They eventually moved up the pricing tiers as their needs grew.

However, when setting pricing, many businesses operate on a set of assumptions. One of them being - that product owners can can accurately determine their product's *value chain*.



For example - users in the social media management tool Sprout Social's "Standard" plan would have to upgrade to the "Professional" package if they wanted to generate competitive reports for their social media handles. It's irrespective of whether they wish to opt out of any additional features or even need to add five new social profiles.

Sprout Social assumes that any customer that qualifies from their standard plan to the professional plan would either need or use a host of additional capabilities in the upgraded tier. While this makes tracking usage a lot simpler (minimizing tracking individual feature use), the assumption might only be partially accurate.

Usage-based pricing resolves this challenge of customers being charged despite the non-usage of a product or feature, making pricing more aligned with their perceived value of your product. SaaS platforms that see more significant usage as the customer scales (e.g., payment processors) find a more natural growth cycle. For them, moving to a usage-based model taps into this incremental usage and delivers better returns for the business.

Benefits of Usage Based Pricing

Better Product Experiences

Offer end-users the flexibility to curate their own product experiences, with an integrated revenue and billing management solution.

Lower barriers to adoption of products
Allows customers to start at a low cost, directly link price to value received and allows more users to access software

Expanded product offerings
Customers can access a variety of products and services as required

Increased revenue
Flexible product offerings (discounts, rolling credits, commit now and pay later) allows for increased revenue

Better Strategic Outcomes

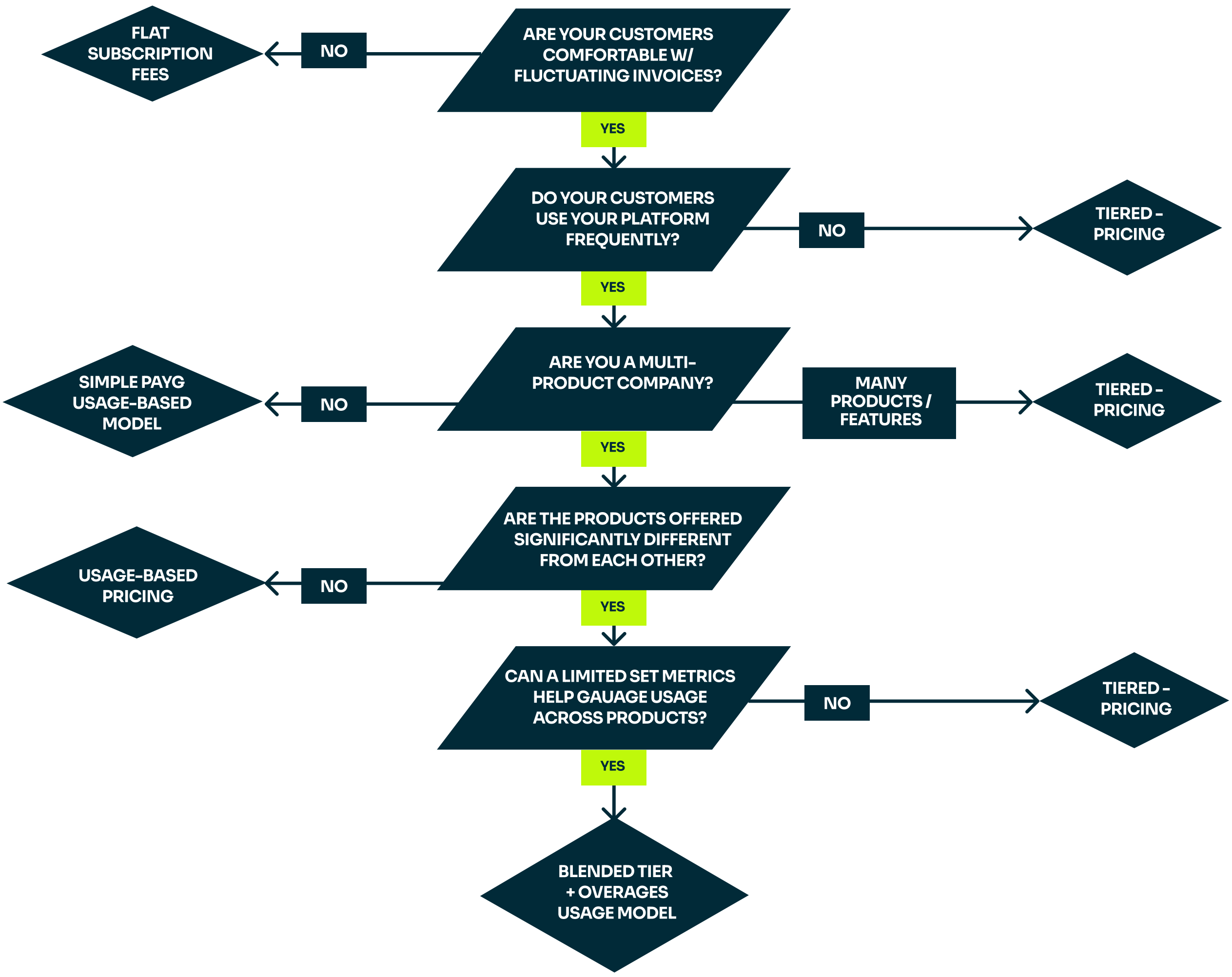
Focus on data monitoring capabilities to accurately track increased customer interaction

Customer insights for better relationship management
UBP features consistently among growing companies with best-in-class CAC and Net Dollar Retention

Business insights for strategic decision making
Continued access to information better informs business decisions

To determine if usage-based pricing is the right way to go for your business, the following framework can be helpful

Is Usage-based Pricing Right for your Business?



Optimizing for Industrial Fit

Usage-based pricing requires robust analytics and telemetric capabilities (data wrangling across multiple customer touchpoints within your ecosystem, data cleanup to remove parsing errors and establish context, and data translation into a 'ratings' tool).

Conventionally used by telecom, VoIP, or affiliate industries with strong alignment on trackable metrics (in this case, data/bandwidth usage), more SaaS companies have now forayed into either a native or a blended (tiered + overage on use) form of usage-based pricing. While infrastructure companies predominantly used usage-based pricing, it is now being adopted by companies across the tech stack, be it middleware or applications.

Businesses and products that lend themselves to usage-based pricing are usually linked to revenue and come with high-intensity usage growth.

Usage-based Companies are Everywhere

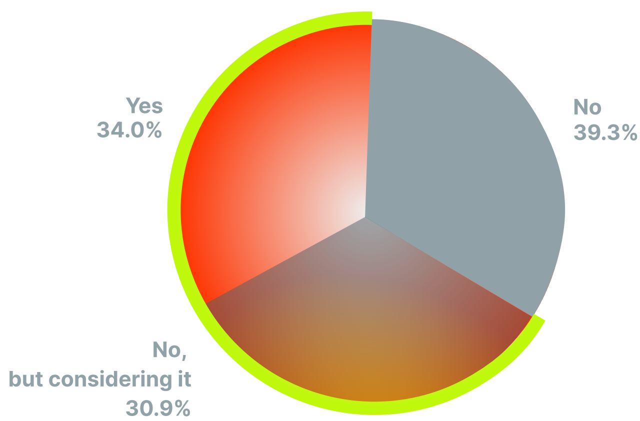
Infrastructure	Middleware	Application	Vertical App
snowflake	stripe	slack	PROCORE
Google Cloud	PLAID	checkr	toast
DigitalOcean, C3.ai	zapier, Postscript	eventbrite	mindbody
Azure	POSTMAN	webflow	yotpo.
elastic	STYTCH	momentive	LUNCHBOX
CLOUDFLARE	MessageBird	TripActions	shopify
New Relic.	twilio, Auth0	HubSpot	AUTODESK.
SENTRY	SendGrid	chargebee	project44
sumo logic	attentive	hotjar	klaviyo
fastly	contentful	Jasper	PARTSTECH AUTOMOTIVE E-COMMERCE TECHNOLOGY
aws	twilio	copy.ai	ServiceTitan
		INTERCOM	

Source: OpenView - The State of Usage-based Pricing

Optimizing for Company-size Fit

SaaS companies across the board are increasingly adopting the usage-based pricing model. Research by Chargebee found that usage-based pricing adoption is now a strong consideration among businesses from their early-stages. Companies within the $3-$25M revenue segment showed an active intent and openness for usage-based pricing adoption.

Early-stage companies are increasingly open to UBP Adoption



$3M-$25M (65%)

"We advise companies to critically assess whether their business model is suited for usage-based pricing and make the shift sooner than later. Ideally, companies need to make that call when they reach a revenue of $5 million rather than $100 million because convincing various stakeholders - customers, sales, customer success, and others - of the value of usage-based pricing can be challenging as your business scales."

Tejeshwi Sharma
Managing Director
SEQUOIA

However, the applicability of usage-based pricing is more a question of how accurately and efficiently you can track individual touch points across your entire product ecosystem than your company size.

Multi-product companies like Snowflake and Datadog - (both public), are built exclusively around a usage-based pricing model. Server observability platform Datadog has built usage-based billing for a product roster of 25+ (and growing) product lines. To simplify telemetry, Datadog monitors just three touchpoints:

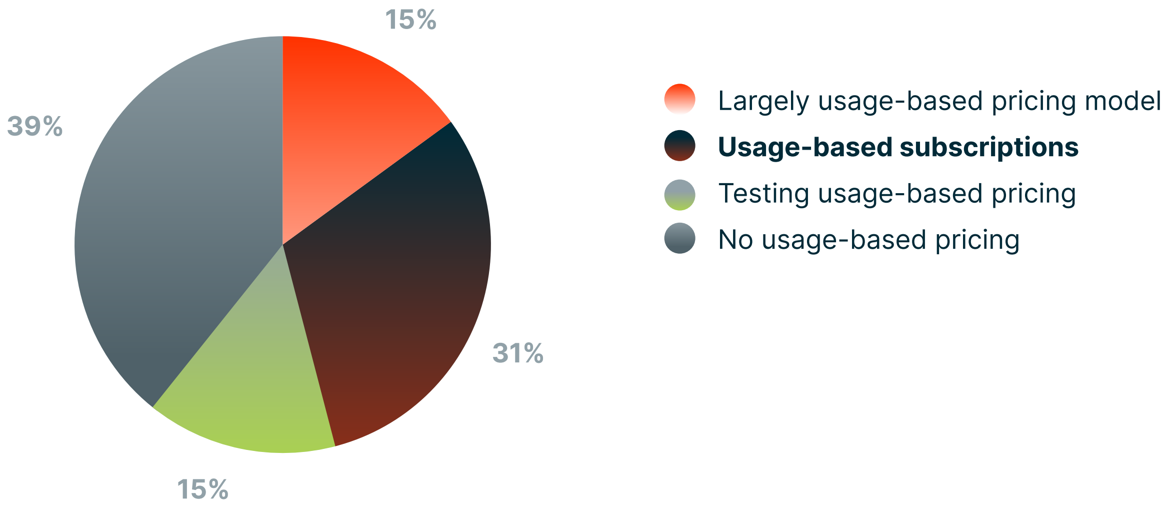
- **Instance triggers -** to track the number of times an application code is triggered
- **Unique user triggers -** to track the number of new devices added or new hosts monitored
- **User sessions -** to track hourly usage of services

By building relevant telemetry, Datadog bypassed *billing and analytics complications* across multiple products, multiple plans, and for multiple customers.

However, having operated on pure-play subscription-based pricing for decades, many SaaS businesses were accustomed to the billing simplicity and revenue predictability it brought. But now with multiple go-to-market motions, revenue streams and growing customer expectations, SaaS companies are moving towards hybrid pricing models to achieve better monetization. With businesses like Datadog proving that the usage-based pricing model is implementable in multi-product businesses, the ***hybrid pricing model*** is now on the rise.

According to OpenView's recent report on usage-based pricing, **46%** of the SaaS companies surveyed either offer usage-based subscription plans or are testing usage-based pricing with subscriptions. OpenView believes that number will continue to increase in 2023 as hybrid pricing models will increasingly help companies win more deals and meet customers where they are.

Adoption of Usage-based Pricing



Source: OpenView - The State of Usage Based Pricing

"Buyers are more comfortable adopting a hybrid pricing model since it is more predictable and, therefore, easier to budget than a fully usage-based model. For vendors, it helps drive consistent revenue while allowing them to tie product value with customer outcomes."

Curt Townshend
VP of Growth
OPENVIEW

Types of Usage-based Pricing

Prices based on usage

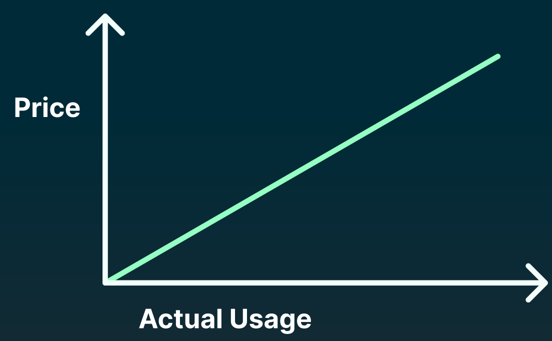
Post-paid

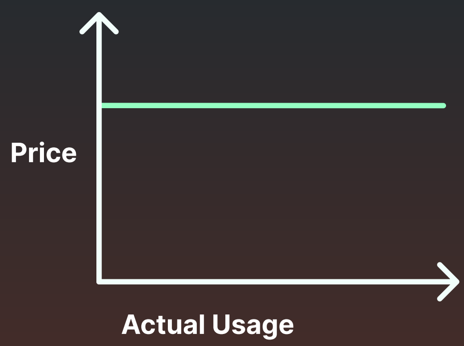
PROS

- The 'no commitment' clause can help sales conversion

CONS

- Lack of predictability scares business buyers
- Not synchronized with budget cycles
- Hard to recognize revenue





Prices and volume agreed up front, no penalties in contract

Prepaid

PROS

- Totally predictable
- Synchronized with budget cycles

CONS

- No monetization path for growth in-contract
- Typically hard to upsell

Prices and volume agreed up front, additional volume charged as overage

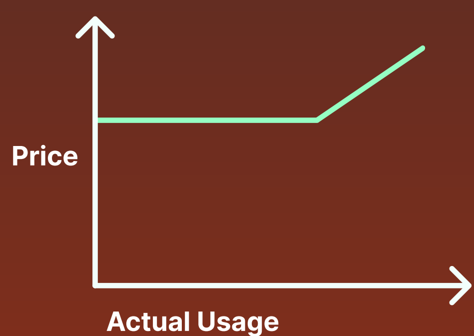
Post-paid

PROS

- Provides predictability, with a fall back for monetization

CONS

- Overages can be a difficult conversation



Source: Insight Partners

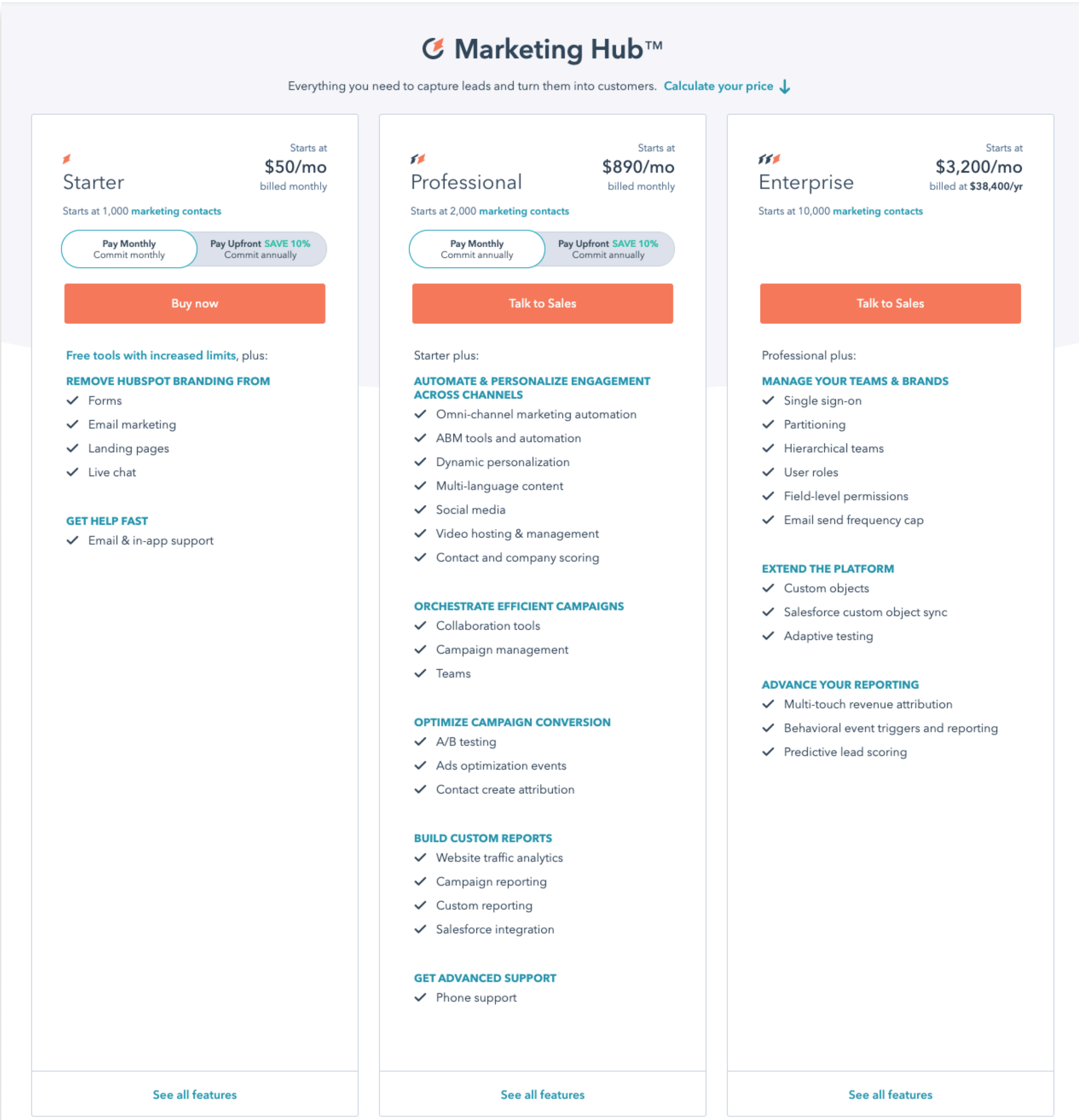
Usage-based Pricing Can Optimize for Recurring Revenue Predictability

One of the strongest deterrents for SaaS businesses from adopting usage-based pricing is letting go of the recurring revenue predictability that their annual subscription packages bring.

While revenue predictability can be a challenge when it comes to usage-based pricing, there are two ways to mitigate this unpredictability -

Adding Usage-based Pricing to Tiered-subscriptions

Take HubSpot's market tool pricing for example -



Since the numerous products on offer have distinct value metrics, tracking usage across all touchpoints becomes complex. HubSpot simplifies billing experiences with tiered pricing. You can add extra marketing contacts under each plan without shifting to a higher tier, helping companies scale up without significantly higher costs.

In this instance, HubSpot calculates the usage of additional marketing contacts to contextually scale up pricing instead of shifting customers into a new tier, which might bring in some resistance.

While the tiered pricing setup helps HubSpot determine recurring revenue, it still cuts closer to the customer's budget, and costs increase as and when the customer needs to scale, building a better correlation between pricing and value metrics.

Commitment Drawdown Over a Tenure-horizon

Drawdown is a novel way to convert pre-agreed contract commitments into ad-hoc credits for customers to leverage at their own pace. It helps balance SaaS' need for predictability with customers' need for flexibility in their consumption and expenses.

Datadog allows customers to commit a defined amount (say $1 million) and then decide a tenure across which they will spend the committed amount. In this case, customers can spend zero dollars over the first six months - to account for seasonal business inertia or business delays and then scale their product usage as the business grows.

> **"To drive predictability in revenue, it helps to pair usage-based pricing with recurring revenue streams. It also helps to choose a small set of usage metrics that will grow steadily over time through different economic cycles as opposed to more volatile usage metrics."**

AJ Malhotra
Managing Director
INSIGHT PARTNERS

HOW TO START BILLING YOUR CUSTOMERS ON USAGE

03

Setting up a usage-based billing system requires you to do more than reprioritize your revenue modeling or transform your platform infrastructure to accommodate changes. It also requires you to think about a potential shift in cultural and strategic values you want to weave into your revenue and cash-flow discipline.

Usage-based billing can quickly become very nebulous. So operationalizing usage-based pricing can be challenging. It requires combining usage data and information about pricing and plans to calculate the billing amount. Some companies use manual spreadsheets or homegrown systems to bill customers. While this is not only incredibly complex, it is also time-consuming, error-prone, and difficult to scale as the complexity of the business increases. You need a robust billing system to take this information and generate invoices, manage collections, recognize revenue, and generate critical metrics.

"It is complicated to deploy usage-based pricing. To solve that complexity, you need vendors who can provide more value and help operationalize your billing stack because it becomes more challenging to build a solution in-house."

Curt Townshend
VP of Growth
OPENVIEW

More importantly, it requires regular updates every time you change your pricing, eating into your developer's time that could have otherwise been used to scale your core product capabilities or launch new products. So for most businesses, building a custom solution can become counterproductive. What's needed is a scalable platform that can manage multiple products and pricing models and make your billing operations efficient.

"To future-proof your business, you need to provide flexibility to your customers on how they transact with you and how you drive revenue predictability. Every growing company will eventually have a multi-product strategy, each with its own pricing model. Having a subscription management platform as your revenue growth engine helps aggregate and seamlessly manage multiple pricing models, billing complexities, proration, and varied customer requests."

Shekhar Kirani
Partner
Accel

Considerations Before Proceeding with Usage-based Billing

Additional Load on Telemetry and Analytics

Metered billing only works if you accurately pinpoint specific tasks that users regularly undertake and assign an appropriate dollar amount to them.

For some companies, the product may be too complex for a metered billing charge to make sense.

If you cannot track usage across all your products with a limited set of KPIs or if your products have different value metrics that are complex to track, subscription pricing instead of usage-based pricing might be the best way to go.

Revenue Ambiguity

While multiple ways to maximize revenue predictability exist, it can be challenging for usage-based businesses to determine future customer usage.

If your overhead costs are fixed, and you switch to metered billing, you'll still have the exact outgo even when usage drops. Of course, this also means you could experience months of high usage where your outgo remains the same, but there is little predictability.

On the other hand, if your company's overheads are directly tied to total customer usage (e.g., data pipelines, ETS, etc.), then your associated costs will fluctuate with that usage. So revenue will be directly proportional to your cost outgo.

While a blended subscription model with elements of value-based billing (on overages/add-ons) might resolve some of the ambiguity, businesses looking to adopt usage-based pricing must be comfortable with some degree of unpredictability.

The Need for Cultural Realignment

Incentivizing the sales process is more straightforward in the subscription-billing model. Since extended contracts translate to higher customer LTV, sales teams are typically incentivized based on contract tenure or the upfront contract value.

Since usage-based pricing leans on your customers utilizing your product more, sales and customer success need to be incentivized based on a customer's product usage instead of just the upfront contract value.

Transforming your pricing strategy requires more than remodeling your revenue management or invoicing modules. It also requires company-wide alignment and involves a considerable cultural shift. The key is encouraging sales reps to participate in the entire customer lifecycle actively. Offering upsell/usage-based incentives can ensure your pricing transformation strategy is a more rewarding experience for your sales folks and help build long-term relationships with your customers.

"For usage-based pricing to work, you need to transform from being an 'enabler' to an 'active consultant' in your customer's journey. This means finding perfect alignment between sales, marketing, and customer success, along with providing customers an active voice in the evolving product roadmap."

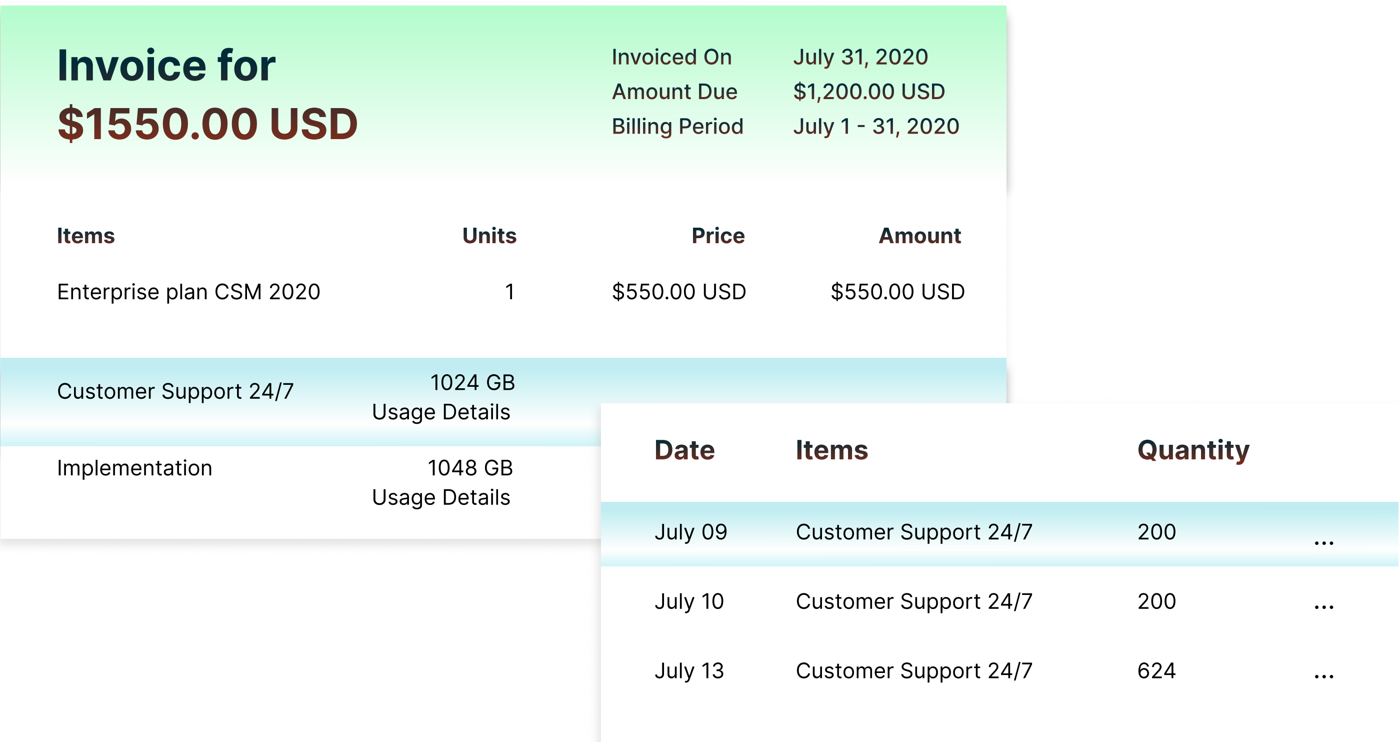
AJ Malhotra
Managing Director
INSIGHT PARTNERS

Pricing Discontentment due to Sticker Shocks

Without guardrails, usage-based pricing can cause friction when the billing amount exceeds the budget. While the aim is to maximize value-based usage, customers could use your product more than they initially predicted, translating to sticker shock.

One way to mitigate sticker shocks is to implement usage throttlers - wherein customers can determine usage thresholds. Before an instance where usage is about to exceed the defined threshold, the customer is notified of their usage limits and will have an upfront idea about any excess in the invoiced amount.

Invoices should be capable of showing detailed accounting information to establish trust. It is essential to display the exact usage metrics and provide a detailed dive-down on usage data in your invoices so you don't end up with unhappy customers.



Components of a Usage-based Billing System

"A billing system is a bit of an octopus. It has its tentacles in so many different places, from the product itself to pretty much any major system that the company has: the CRM system, the ERP system, any sort of customer-facing communication system."

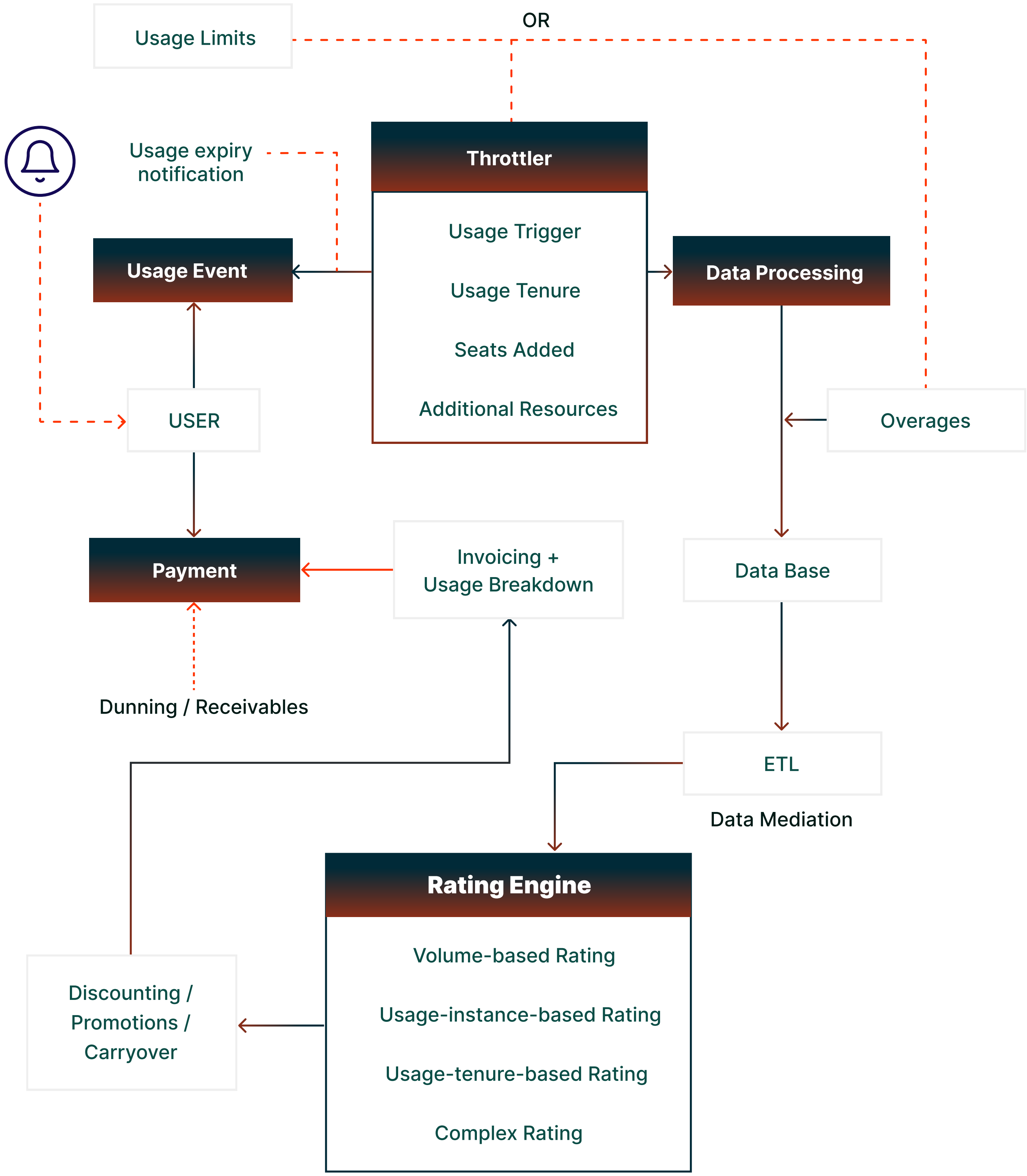
Bogomil Balkansky
Partner
SEQUOIA
in conversation with **protocol**

A typical usage-based billing system has two components: a *rating engine* and a *billing system*. The rating system collects usage data and assigns a value to each usage event before processing it. The billing system then invoices it and ensures the amount is collected.

Beyond the traditional challenges of periodic invoicing, proration, tax computation, and revenue recognition - consistent with SaaS subscriptions, the metered billing model requires additional moving parts to determine -

1. **Customer-product interaction events**
2. **Degree of product usage/consumption**
3. **Variability in charge values for multi-product SaaS contracts**
4. **Data harvesting and storage**

A Representational Usage-based Billing Ecosystem



The Continuous Evolution of Usage Rating

According to Balkansky, usage-based billing is primarily a data-wrangling/processing problem because businesses need to collect sizable amounts of data on customer usage accurately. That's why it is critical to have a ratings system in place before you transition to usage-based pricing.

Many businesses conflate invoicing and rating. However, the two elements categorically differ.

Rating is the process of assigning a specific value to each usage event - this can mean indexing value metrics separately to usage triggers (like API calls) and consumption thresholds (like time spent on the product) to determine the overall value of customer usage.

On the other hand, invoicing is parsing this information through additional business rules- like proration, cost amendments, or discounts based on contractual agreements - to provide an integrated product cost to the customer at the end of the billing cycle.

Rating precedes invoicing in metered billing conditions and requires a few components/abilities:

- **Data processing and interpretation -** the ability to accurately collect usage variables across different products and users and then accurately index them against their respective value metrics
- **Ability to understand disparate value metrics -** a deep understanding of the difference in value metrics across each usage component to correctly index usage across touchpoints
- **Rating-formulae -** the ability to apply a predefined formula based on the method of interaction your customer has with your product (in the case of Stripe, this means - using a percentage and mark-up on each card transaction processed, while in the case of Datadog, this would mean multiplying usage hours/credits with the defined value metric)

This data is then processed and sent to the invoicing and billing technology to provide an aggregated cost figure to the customer.

A Microscopic View on Data Collection

"64% of companies highlighted data mediation, which is a part of the processing step, as a key requirement."

Chargebee Research

We must supplement the growing rating ecosystem with more robust data transparency and collection. But as customers use disparate tools, each communicating with others through a myriad of network operations, data collection, processing, and storage become a significant challenge. Especially since, a typical SaaS buyer today has a high number of interconnected tools in their tech stack.

Reduce Costs **Increase Productivity**

80

Average number of SaaS apps used

21

Average number of custom* SaaS apps used

*(e.g. an app developed internally, but hosted in AWS is a SaaS model for internal users)

Companies estimate that **70% of the business apps they use today are SaaS-based. By 2025, they expect 85%** of the business apps they use will be SaaS-based.

Source: State of SaaSOps [2020] | BetterCloud

There is a growing need to set operational standards to gauge interconnected SaaS networks and products, streamline data collection, and minimize billing issues like charge deduplication.

Tracking API-call Instances

Ensure that your billing component can handle API callbacks to provide optics into product / feature usage triggers across separate plans.

Yousign's suite comprises two products -

The Yousign app

offers companies an e-signature solution to have their commercial, legal, and financial documents signed.

The eSignature API,

sold to enterprise dev teams, is an entire signature service that can be directly integrated into their applications.

When Co-founder and CTO Antoine Louiset wanted to unify billing for disparate products, he decided on a hybrid pricing model, one that could -

Charge

on a per-user basis for the app, based on the size of teams within a customer organization.

Charge

based on the volume of signatures consumed by enterprises.

Chargebee's deep integration with Yousign's database enabled the collection of data across both - seat-based (per-user) transactions within a team and the number of signatures consumed based on API/code callbacks on each signature instance. As a result, **Yousign was able to grow revenue by 2x.**

PRICING AS A GROWTH LEVER

04

According to McKinsey & Co. research, determining appropriate pricing consistent with customers' perceived value of the products or service can generate 2-7% of sustained margin improvement with initial benefits in as little as 3-6 months. SaaS vendors need to align their pricing models with the value they create for customers. Automation, AI, and AP are tied to outcomes, so the value of software doesn't scale with more people or seats.

In its earliest stages, SaaS businesses focus on finding PMF rather than building out the pricing strategy. Many SaaS companies hence tend to underprice their products to drive early adoption and initial value creation.

On the other hand, a business has to deal with constantly changing market dynamics. New competition, predatory pricing from competitors, technological intervention, and more continuous shifts in the exchange rate, are still external stimuli that might not accurately reflect your customers' perceived value of your product.

"Remember: Pricing often reflects your optics of value, not your customer's."

Many businesses will break their preconceived notions of their value metric (which determines their pricing) with experimentation. Ascertaining the value metric lends a clear sense of direction and informs pricing strategy for businesses. Case in point - video engagement platform Livestorm began with metered pricing in 2021 to lower the barriers to entry for customers dealing with the economic uncertainty of COVID-19.

The company blended its tiered subscription model with usage-based billing elements. It calculated usage on monthly active contacts - counted as the number of contacts that interacted with a Livestorm session (registrants, attendees, etc.) during a month.

Livestorm found that customers with the highest monthly active contacts exponentially grew their usage. At the same time, net cancellations fell from customers who did not feel obligated to pay for lack of usage, resulting in faster revenue growth.

Usage-based pricing also helped them gradually uncover the inherent value of their product. The company tracking customer usage found that its pricing was "too low to be credible." Feedback from usage data helped them **increase prices and see margins jump 95%** with a growing sales volume.

Finding the right value metric and getting their pricing right based on it even helped them beat existing incumbents on large enterprise deals. And that's something that didn't happen very often before the company switched.

"Usage-based pricing breaks down monolithic pricing structures. It helps to improve monetization since companies can now charge for a composable set of features. Usage audits also help you understand what features are scalable and generate value. You can differentiate based on the packaged set of features that come together to solve the problem. For instance, you can price enterprise-grade features higher and have a more basic offering for startups."

Shekhar Kirani
Partner
Accel

Dynamic market conditions influence not only a brand's growth prospects but also, correspondingly, its value metric. This means that usage-based billing is also a dynamic concept. **85% of Chargebee's internal survey respondents indicated that they are still iterating on usage-based pricing**.

Be prepared to talk to many customers and track several metrics to see how usage behaves over time. Also, be ready to use more than one metric and combine usage with other pricing approaches. Approximately half the SaaS businesses that deploy usage-based pricing do it with different pricing approaches. And more importantly, ensure that you have a scalable tech stack that allows you to experiment with different pricing models, support different go-to-market motions, and target distinct audiences.

"Whether purely usage-based or a hybrid pricing model, businesses want to experiment more and target different markets differently. So you want a certain level of customization and change in pricing that you need to build for, and you don't want your tech stack to be the reason you can't do that customization."

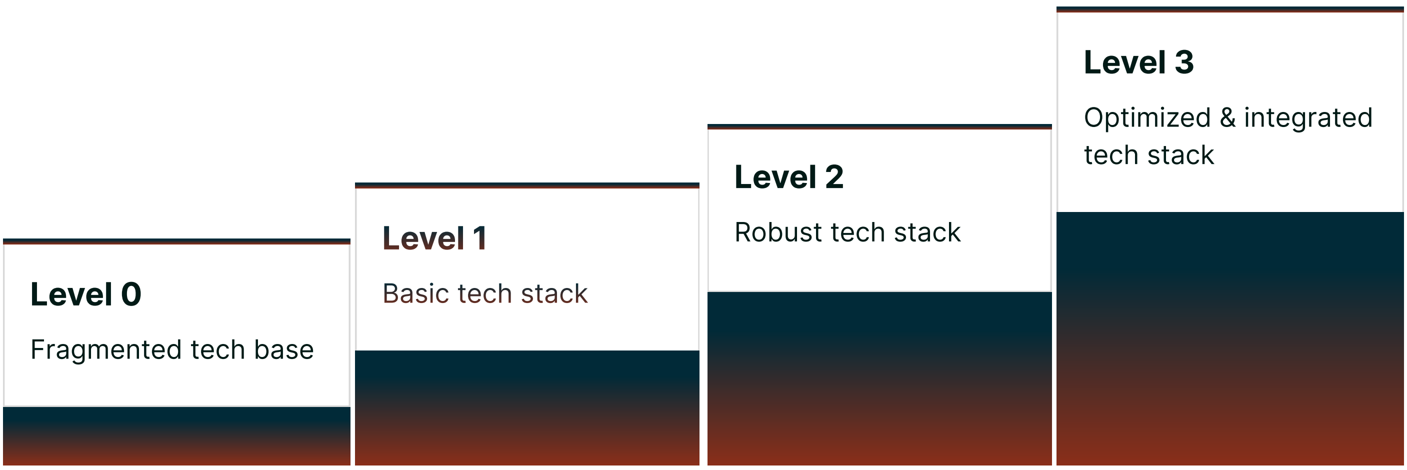
Curt Townshend
VP of Growth
OPENVIEW

Transforming existing pricing systems to usage-based is a constant, iterative process that demands an analysis of your existing tools and revenue systems. Infrastructural transformation is also a function of any SaaS company's technological maturity.

Here's a framework from McKinsey & Co. below that will help you understand the impact of tech capabilities on scaling pricing strategies:

Higher levels of tech maturity can help the pricing function achieve more impact

Tech-maturity model



Potential Impact

• Decentralized data log, usually reliant on ERP systems • Multiple offline solutions • No automated models • Multiple manual processess • Limited, generic performance management	• Basic pricing systems that partly centralize data • High-level pricing analytics • Basic, mostly manual performance management & reporting • Generic & infrequent training programs	• Most if not all pricing tools are connected • Automated pricing alerts • Price-setting simulations based on advanced analytics • Price performance management	• All commercial tech tools fully connected • Most if not all processes automated • AI and advanced analytics models • Closed loop with digital marketing & sales tools

Capabilities

Source: Digital pricing transformations: The key to better margins | McKinsey & Co

Pricing Transformation Checklist

Transforming your pricing strategy requires more than remodeling your revenue collection, billing, or invoicing modules. It also requires company-wide alignment on how an altered pricing strategy works for the business, a platform-readiness check with product and engineering teams, and training your customer-facing teams, like sales and marketing, on the nuances.

Use the handy checklist to help you tick all the boxes when planning your shift to usage-based billing.

Usage-based Billing Transformation Checklist

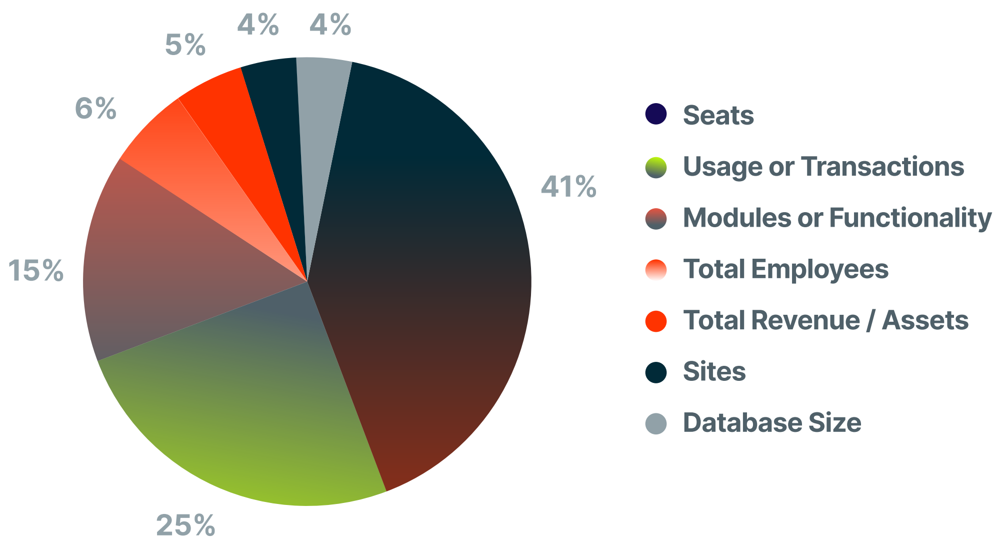
Engineering & Product	Cursory analysis of existing tech-stack	Identifying a central value metric	Evaluate and select the right billing infrastructure
Sales, Marketing, & CS	Fragment sales incentivization for deals and upsells	Prioritize PLG-led upsell messaging	Train AEs and CSKs on post-purchase product experiences
Billing & Invoicing	Ensure data-collection across customer interaction nodes	Build & determine overage tracking	Ensure invoices cover detailed usage records

USAGE-BASED PRICING FOR THE WIN

05

Results from a 2021 private SaaS companies' survey by KeyBanc Capital Markets show usage-based pricing is now the second-largest revenue model after seat-based pricing.

UBP is Now the 2nd Largest Revenue Model



Source: 2021 SaaS Survey | KeyBanc Capital Markets

This increasing migration to usage-based pricing is thanks to an array of potential revenue opportunities untapped by previous means of product or service monetization. Usage-based pricing is also a means to deepen customer relationships. Since they optimize the product for outcomes rather than intended use cases, they can tangibly exhibit better ROI and inherently a more customer-centric revenue model.

Like Segment, many businesses will break their preconceived notions of their value metric (which determines their pricing) with experimentation. Ascertaining the value metric lends a clear sense of direction and informs pricing strategy for businesses.

With 85% of respondents to Chargebee's internal research indicating that they are still iterating on usage-based pricing, it is clear that it will find its way into many companies' pricing models. Eventually, every subscription business will end up with some kind of consumption-based pricing model, and you definitely don't want to be left behind!

By

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