IN THE SPOTLIGHT

Consumption Pricing: Are You Paying for What You Use?

By Shiv Kumar, Chartered Marketer and Pricing Specialist

This is a tricky question to answer. Whether you bought a $2 pen or signed a multi-million-dollar deal, this query hinges on the mind. Being a marketer who decides on pricing as part of the marketing mix, this question intrigues me personally. A 2014 IDC report* indicates that 96 percent of enterprises admitted to wasting money on unused software/“shelfware” that accounts for 21 percent of investments. Paying for what you use or consume exists in few utility services—such as electricity, phone, gas, taxi and hotels—but with the advent of cloud technologies that enable businesses to track usage, we need to have a clear consumption-driven pricing mechanism.In every sphere of life, we pay for more and consume less. This article raises critical aspects of consumption-driven pricing and seeks answers to questions such as:

• Are traditional pricing models (market driven, cost plus, value pricing) capable of addressing it?

• How should the current practices of volume pricing change to address consumption?

• Is pay-as-you-go pricing cheaper than prepaid pricing?

Inadequacies of Traditional Pricing Models

Pricing is a key ingredient in the marketing mix. Traditionally, market-driven pricing, cost-plus pricing and value-based pricing are used by organizations to determine pricing. Market forces such as competition, purchasing power and supply-demand situations drive market-based pricing. The inside-out method of determining the costs and marking up to calculate prices are followed in the cost-plus and time-and-materials pricing models. Value-based pricing is a strategy that sets prices primarily on the value (perceived or estimated) to the customer and their willingness to pay.None of these pricing models address the nature or quantum of consumption. Even the most disruptive businesses haven’t taken a shot at it. For example, Airbnb disrupted the hospitality business, though it did not question why it specified a 24-hour minimum booking. According to the American Hotels & Lodging Association (AHLA), about 41 percent of business travelers stay just one night in a hotel. Some key questions around this statistic would be:

• How many of us have stayed for more than 12 hours inside the room during a one-night stay? Then why is the minimum booking for 24 hours?

• Do all flights or trains that we take arrive by noon? If no, why is there a noon check-in time? This reduces consumption as most travelers head out to their business activities once they land, so there is no way they could check in and relax a bit before heading to their meetings. This results in a late evening check-in after their meetings and an early checkout to catch their morning train or flight. In short, we end up paying for a lot more than what is consumed.

• Does this pricing model help optimize space availability, specifically in the cities that are short on hotel properties? If there is a business event or social gathering, most hotels are sold out in no time. By blocking 24 hours per unit, most of the rooms remain unoccupied though sold.This example articulates how the current pricing model is not mapped to the consumption need, nor does it solve a capacity constraint based on consumption. If we look at most other products or services, this pattern of pricing prevails. The traditional pricing models are not equipped to handle the consumption or simply negate this need.

Volume Pricing in the New Consumption World

“The more you buy, the less you pay per unit” is an economic basis that is used by marketers for pricing products or services. The slab-based volume pricing and/or buy-two-get-one promotional pricing follow this principle as well. Volume pricing experts often try to trigger the need after the point of satiation by lowering prices, which goes against consumption-based pricing. The pay-as-you-go model of the cloud world is hugely touted as consumption-driven. While it has its merits, most cloud product/service organizations offer annuity pricing models** to collect full-year payments in advance, making it a “pay and then go” model. Though the annual (volume) prices are lower than the monthly prices, it puts the onus of predicting the usage volume on the customer, thereby increasing shelfware.Volume pricing is not present in some of the most quoted cloud business models. For example, an Uber ride costs same for a person who hires a taxi once per month as it does for a person who hires one every day. However, you see the market-driven pricing that increases the Uber price rate by 50 percent or even double during peak demand time.A couple of important points arise:

• Base price: Which is right—pay-as-you-go or pay-and-then-go pricing?

- Consumption-based pricing should ideally be paid after use rather than based on prediction, which triggers shelfware.

- New technologies, including Internet of things (which can track your free refrigerator space), can help address such pricing in near future.

• Volume price: A consumption-based volume pricing should become a norm.

- Whether it is multiple Uber rides in a given period or frequented stays in Airbnb, as usage increases, the price should decrease.

- There can be a periodic reset to avoid prices dropping below cost.

Is True Pay-as-You-Go Pricing Cheaper?

A closer analysis of utility organizations’ pricing and pay-as-you-go cloud models reveal consumption-based pricing may not be cheaper per unit.Moving away from a possession-based model to shared models allows for a reduction in capital expenditure and moves it to a recurring operating expenditure, thereby spreading the ownership costs over a period. Cloud companies who have operated on market-driven pricing and focused on the anchor prices set by pioneers or competitors often ignore the ownership and refresh costs, eventually leading to a struggle to make profits. Consumption-driven pricing models will help mitigate the risks of organizations by identifying the consumption needs, the infrastructure to support those needs and the volume of consumption before arriving at the right price. This may increase the price per unit, but it will also:

• Reduce the overall spend by customers by eliminating shelfware costs

• Reduce prices as the quantum of consumption increases in a given period

• Improve sustainability by reducing waste and inefficiencies and allowing genuine use of resources

• Increase customer satisfaction levels and willingness to pay

It is a win-win proposition for both organizations in the consumption economy to become profitable and for consumers, who end up paying only for what they use.

Summary of Consumption Pricing

Consumption is the new unit in the cloud world and shared economy. It addresses the gaps of the traditional pricing models, allows organizations to monetize properly and enables consumers to pay only for what they use. It is right for both the consumers and businesses, and it fits the cloud era. And while it may increase price per unit, it will reduce the overall spend dramatically and improve sustainability of resources, which is ultimately a higher cause.

**Source: The Software Budgets, Waste & Shifts in Software Licensing Report, IDC research 2014*

***Source: Refer pricing chart in cloud product offerings such as Office365 or WebEx or Insurance companies*

+ *For more detailed impact of cloud business models and IOT on marketing, read our Fluid Marketing* (http://augentia.com/whitepaper.html) *white paper.*

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