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PRICING ADVISOR

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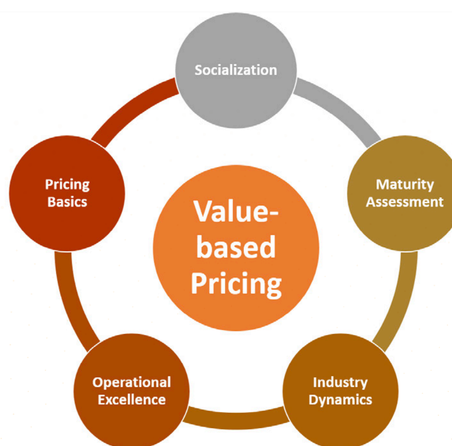
Five Areas to Explore Before Embarking on Value-Based Pricing Programs

by: Stephan Liozu, Ph.D., CPP

In this article, the author presents best practices for initiating an organizational transition towards value-based pricing. Stephan M. Liozu, Ph.D. (sliozu@gmail.com), is the Founder of Value Innoruption Advisors, a consulting boutique specialized in value-based pricing, industrial pricing, digital and subscription-based pricing. He is also an Adjunct Professor & Research Fellow at the Case Western Research University Weatherhead School of Management. He is a Certified Pricing Professional (CPP), a Prosci® certified Change Manager, a certified Price-to-Win instructor, and a Strategyzer Business Model Innovation Coach. He has authored six books: ***B2G Pricing*** (2020), ***Monetizing Data*** (2018), ***Value Mindset*** (2017), ***Dollarizing Differentiation Value*** (2016), ***The Pricing Journey*** (2015), and ***Pricing and Human Capital*** (2015). Stephan sits on the Advisory Board of LeveragePoint Innovation and of the Professional Pricing Society. Liozu will also lead a workshop on ***"Value Realization: Your Next Competitive Advantage"*** at the PPS Spring 2022 Pricing Workshops & Conference in Chicago on April 27.

There is a consensus among scholars, consultants, and practitioners: value-based pricing is a progressive and customer-centric pricing methodology. It focuses on the customer's needs, the customer's perceived value, and the customer's willingness to pay. I started researching value-based pricing in 2008 one year prior to embarking on my Ph.D. journey. I had some experience with the approach, but I did not fully grasp the complexity of designing and executing it across an entire organization. Since then, I have researched value-based pricing, experimented with variations of it, and executed it multiple times. Every project I have worked on is different, challenging, and feels like a learning experience.

To this day, I remain convinced that value-based pricing is not for every organization and that it is impossible to deploy it in its purest form. There are always adaptations, exceptions, and sacrifices to make.



As a value-based pricing consultant, I am often approached to help organizations get started. I run into leaders who are willing and eager to start the hard value and pricing work. They often start with some training and a mini-pilot project. They quickly realize that it is harder than they thought for a variety of reasons. They reflect, regroup, and then do something else! The methodology is straightforward to understand, but its implementation runs into severe organizational and external headwinds. It brings me back to the fact that not every company is going to require value-based pricing, be ready for it, or be mature enough to deploy it.

▶ CONTINUED ON PAGE 2

IN THIS ISSUE:

4 Understanding Revenue Changes

7 How to Leverage Loss Aversion/Prospect Theory for Pricing Negotiation

8 Pricing Transformations in 2022

Before getting started with the deployment of any value-based pricing activities, I propose that there are five areas to explore and some basic activities to conduct prior to experimenting. Let us review them one-by-one:

1. **Heavily socialize concepts of value and pricing across the organization:** because value-based pricing is much more than a pricing strategy and because it touches all go-to-market functions, there is a large amount of socializing on the methodology and approach that must be completed internally. All relevant functions (sales, marketing, pricing, finance, technical, application engineering, and others) must be exposed to some basic knowledge and information about the topic.

a. Collect industry and peer benchmarks: what are companies in your ecosystem working on? Are there companies already focusing on value-based strategies? Looking at your key industry verticals, are there consulting or industry reports focused on value and pricing?

b. Introduce basic pricing and value concepts: it is essential to inject basic concepts of pricing and value across the organization through an intentional socialization program. You can work with your training and development team on this or do it yourself as you interact with the teams. Bring the outside in and invite a couple of guest speakers at your next pricing meeting. The key is to start having discussions internally about both topics.

c. Evaluate the appetite through the leadership chain: are your leaders interested in making a change in pricing orientation? Is there an appetite for change in the C-suite?

d. Articulate and evaluate an intense sense of urgency: gather some of the pains the business is experiencing to prepare a business case for change. Gather industry statistics on the impact of value-based pricing and connect that to your organizational pains. Be ready to use that when leadership asks you for your opinion.

2. **Conduct a thorough value-based pricing readiness assessment:** this is an essential exercise prior to doing anything. There are prerequisites to starting value-based pricing and the need for data is great. I have developed a value-based pricing readiness assessment organized around the six steps of the methodology that can highlight some of the strengths and weaknesses that you must address during your project planning.

a. Establish the baseline of where you stand today: know where you are starting from and track progress by repeating the assessment every 12 to 18 months. Showing you are succeeding is important. Make effective use of a pricing dashboard to promote progress.

b. Prioritize action based on current maturity: start with the critical part of the process and the critical gaps. Slow down until these gaps are filled. Do not try to do too much at once.

c. Study your internal capabilities: there are certain capabilities you cannot do without. If your team does not understand concepts of customer segmentation or competitive analysis, you will need to develop these muscles before you can get started. That takes time and effort, but it is worth the investment.

d. Design a project scope that you can manage: this is an area in which I see too many mistakes. Some leaders try to do too much at once and they develop a scope that is too big for a first effort. Make sure you size the scope of your first project correctly. It needs to be the right project to show the right success story. It also depends on the result of your maturity assessment. If your organization has the right maturity, then you can scope and scale faster. If not, take baby steps and slowly increase the scope of projects over time.

3. **Fully understand your industry dynamics:** some industries are more competitive than others. Industry structure and dynamics play a critical role in enabling or stopping value initiatives. You must understand your place in the industry to gauge whether or not you are in an advantageous position to become a value player.

a. Customer consolidation: if your customer base is extremely consolidated, it might be difficult to quickly transition to a value-based pricing approach. These customers have power, and they might dictate the type of pricing they want to see. You might still be able to use value-based pricing for innovations or services, but powerful and large customers typically act like professional buyers with strict guidelines.

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b. The role of trade channels: doing value-based pricing when you deal with trade channels can be challenging. You have to do twice the work. You must bring channels on board and have dedicated value programs for them. They can function as value bottleneck and stop you from pricing on value to the end customers. That requires a dedicated channel approach.

c. Competitive landscaping: before embarking on value-based pricing, you also need to be sure you are in a competitive position to do so. What is your industry structure? How many competitors do you have? How many of them are price-focused competitors? I recommend the preparation of value maps to gauge the current position you occupy in the competitive landscape. If you operate in a competitive environment where price wars are a regular occurrence, it might be difficult to be the only supplier moving to a value-based approach. Going at it alone is courageous, but you need to know if you can stay in the game for the long run as your volume levels might decrease.

d. Relative pricing power: it is equally important to gauge your current level of pricing power. Have you been able to make a price move in the past? If so, what was the impact on sales volume? Some industries are extremely price-sensitive, and any variations in price lead to changes in volume. You might have to start value-based pricing programs with new products or services and leave the core alone at the beginning.

4. Evaluate your level of operational excellence: one of the key prerequisites of transforming towards value-based strategies is having outstanding operational excellence. Anything short is an open door for issues with your customers, especially with their procurement teams. They will be the first ones to remind you that you have issues and you do not deserve the premiums they pay.

VALUE-BASED PRICING REQUIRES DISCIPLINE IN EXECUTION. DELIVER WHAT YOU PROMISED AND EXTRACT THE PREMIUM YOU DESERVE

a. Supply situation versus competitors: if you have very long delivery lead times versus your competitors, you will have to account for this in your differentiation analysis. Remember that value-based pricing considers your true positive and negative differentiation. You need to be realistic and transparent in showing your true relative position.

b. Operational performance of your current offers: are your products and services truly differentiated? Do you have performance issues during the installation or the deployment phases? Quality and program issues are detrimental to the successful deployment of value-based strategies. Buyers are good at gathering these incidents and documenting them for your next visit. They will ask for compensation.

c. Overall level of customer satisfaction: many of your customers have scoring mechanisms for their vendors. They track key performance indicators and publish reports on a quarterly basis. How good are your net promoter scores and customer satisfaction scores?

d. Perceived performance on value intangibles: in some industries where products might be commoditized, the differentiation comes from intangible value drivers. Some of these drivers include ease-of-doing business, levels of innovation, longevity in business, degree of partnership orientation, etc. Intangible value drivers in some cases surpass tangible ones in the customer ranking.

5. Think about getting better at doing pricing the way it is done now: is value-based pricing the first thing you

CONTINUED ON PAGE 4

PPS PRICING ADVISOR FEBRUARY 2022

Five Areas to Explore Before Embarking on Value-Based Pricing Programs

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IN THIS ISSUE: Understanding Revenue Changes · How to Leverage Loss Aversion/Prospect Theory for Pricing Negotiation · Pricing Transformations in 2022

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For all other inquiries, including subscriptions and PPS membership information, please contact:
Professional Pricing Society, 3535 Roswell Rd., Suite 59, Marietta, GA 30062 USA
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should implement within your organization? That is a key question. Besides conducting a value-based pricing readiness assessment, have you conducted a pricing capabilities assessment to understand when you are in your pricing maturity journey?

a. Review your current pricing process: before starting on a value-based pricing program, focus on fixing your current pricing process. If you are doing cost-plus or competition-based pricing, do that better. Improve your pricing discipline by fixing your discounting guidelines while slowly socializing concepts of value. I find that this is a much better way to get started with a pricing project.

b. Study basic pricing KPIs: develop a basic pricing dashboard to evaluate your short-term profit leaks. Address these leaks right away to improve business performance.

c. Establish pricing guidelines through a task force: work with finance at establishing new pricing guidelines that can be deployed in the pricing process and with the salesforce in a matter of few weeks.

d. Show impact with a ninety-day rolling action plan: showing short-term pricing impact is a strong and rational way to get started. It puts pricing on the map with top leadership and opens the door for further discussions on what could be done. For many executives, value-based pricing is very theoretical, and they cannot understand the short-term impact. Focus on making an impact with pricing first and then convince them that you can do much more.

There is a reason only 20 to 25% of companies have embraced and integrated value-based pricing as a primary pricing orientation. Many companies tried, failed, or stopped. Others have been on a journey for many years. These value-based pricing champions have adopted and integrated some imperfect form of value-based pricing. It is all right. There is not a right or wrong pricing approach. There is no perfect pricing method either. Value-based pricing is dynamic, advanced, and challenging. It is not for every company. Before you officially put this methodology in your pricing roadmap, make sure it fits well with the activity sequence, with your industry dynamics, and with your culture. If not, focus on other pricing initiatives first. There may be a better time or a better set of conditions to get started.

Understanding Revenue Changes

by: Tim J. Smith, Ph.D.

Management deserves clarity from their revenue variance analysis, especially if the variance analysis is used in making compensation, budgetary, and personnel decisions. In this article, the author provides examples of best practices in performing and delivering these analyses. Tim J. Smith, Ph.D., is the founder and CEO of Wiglaf Pricing, an Adjunct Professor of Marketing and Economics at DePaul University, Academic Advisor for the Certified Pricing Professional (CPP) designation, and the author of ***Pricing Done Right*** (Wiley 2016) and ***Pricing Strategy*** (Cengage 2012). He can be reached at tsmith@wiglafpricing.com. Smith will also lead a workshop on ***"Pricing in Economic Shocks"*** at the PPS Spring 2022 Pricing Workshops and Conference in Chicago on April 27.

Managers focus highly on revenue. Increases are good and decreases are bad. But what drives those increases and decreases?

Most executives will blandly state that revenue is largely the result of volume, and that sales volume and revenue are often conflated. However, revenue is the product of both volume and price. As such, there are two key approaches to improving revenue: increase volume or increase prices.

But which impacts revenue the most? How do you prove it?

Revenue variance analysis, part of the larger profit analysis discussed in recent academic papers, is under renewed scrutiny. There are four different approaches to a revenue variance analysis. While each sums up to the same change in revenue, they disagree on what drove the change.

To demonstrate, we will examine a simple case of a single product

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in a single currency under the full knowledge that more complicated equations can be used to examine multiple products in multiple currencies and under various levels of scrutiny. Fortunately, such added complexity is unnecessary to demonstrate our claim.

Unresolved Revenue Change

The change in revenue is simply the revenue in the current period less than in a reference period, preferably of equal duration. When no attempt is made to resolve this into the impacts of changes in price and volume, we have simply a metric of the change in revenue.

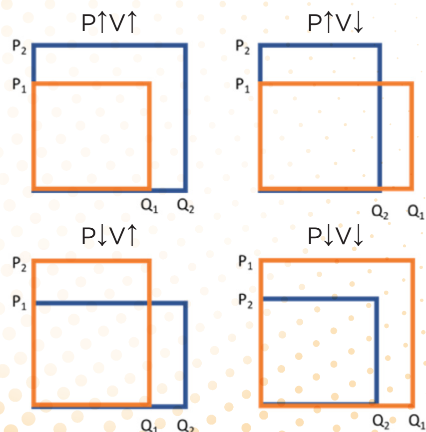
Using the subscript 2 for the current period and 1 for the reference period and denoting prices and volume with P and Q respectively, we find the change in revenue ΔRev.

$$\Delta Rev = P_2Q_2 - P_1Q_1$$

When both prices and volumes are changing, four different situations arise which would change the revenue.

(1) Price and volume both increase denoted as P↑V↑.
(2) Price increases while volumes decrease denoted as P↑V↓.
(3) Price decreases while volumes increase denoted as P↓V↑.
(4) Price and volumes both decrease denoted as P↓V↓.

Actual Change in the Shape of Revenue



Graphically, the change in revenue is the difference between the size of the two boxes shown. The blue box is the current period revenue, and the orange box is the reference period revenue. In two cases, the blue and orange boxes completely overlap. In the other two, a rectangular area is not contained in either box.

Unresolved Joint Variance

In a simple approach, this change in revenue is attributed to changes in price and volume as well as the joint variance in both. Unfortunately, the joint variance has no clear managerial meaning and, worse, doesn't send a consistent message.

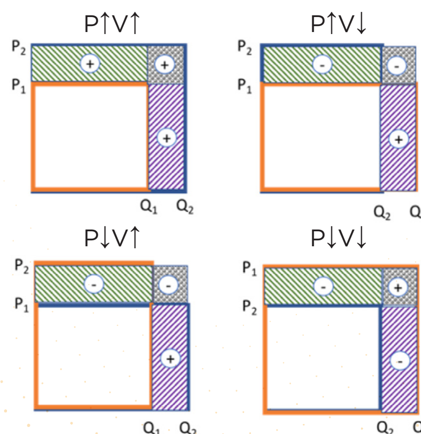
Defining the change in price and quantity as $\Delta P = P_2 - P_1$ and $\Delta Q = Q_2 - Q_1$, respectively, we write:

$$\Delta Rev = P_1\Delta Q + \Delta PQ_1 + \Delta P\Delta Q$$

In this approach, the first term would be attributed to the impact of volume changes, the second to the impact of price changes, and the third cross term would be the joint variance.

Examining our four different cases, the challenge of the joint variance becomes clear.

Unresolved Joint Variance Impact Attribution



In the graphic, the purple box illustrates the impact of volume changes, the green box illustrates that for price changes, and the grey box illustrates that for the joint variance.

Algebraically and as shown graphically, the joint variance is positive in two instances: P↓V↓ and P↑V↑. While having a positive joint variance when both price and volumes increase is expected, reporting that same positive joint variance when both price and volumes are down is problematic. What should managers think when they see a positive joint variance and nothing else? That revenues are up or down?

While the joint variance can be algebraically defined, it has little to no meaning for managerial decision-making. For this reason, most people have dropped this approach.

Unbalanced Impact Attribution

As a historical standard approach, the joint variance is removed by measuring the impact of price and volume changes and alternating the period of reference used to define the impacts. We are left with simple attribution of the change in revenue to impacts due to changes in volumes and prices, but the lack of balance results in excess attributions in some cases and under attributions in others.

$$\Delta Rev = P_1\Delta Q + \Delta PQ_2$$

In the unbalanced approach, the first term is attributed to the impact of volumes and the second to the impact of changes in price. Graphically, our four different cases are shown on the next page.

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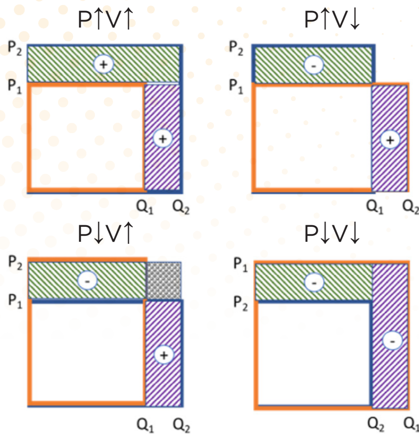
Unbalanced Impact Attribution



For P↑V↑, the previously unresolved joint variance is now completely attributed to the impact of price changes. But, for P↓V↓, that same previously unresolved joint variance is being completely attributed to the impact of changes in volume. Why should pricing get extra credit when things are good and few demerits when things are bad? Or why should sales get little credit when things are good and all extra demerits when things are bad? This is not only inconsistent, but it can also lead to bad decision-making as well.

Let us also consider the intermediate cases. When P↑V↓, the impact previously attributed to the joint variance is completely removed, which seems appropriate. But when P↓V↑, that same impact previously attributed to the joint variance now becomes attributed to both the impact of changes in price and volume. Why should we accept zero accounting of this joint impact in some cases and double accounting in others?

The over and under attribution of impacts may lead executives to bad decision-making. It would be nice if the attribution was at least done consistently. Fortunately, it can by relying on mirror symmetry.

Mirror Symmetry Impact Attribution

As demonstrated in a recent research article, a balanced approach to making attributions is delivered through mirror symmetry.

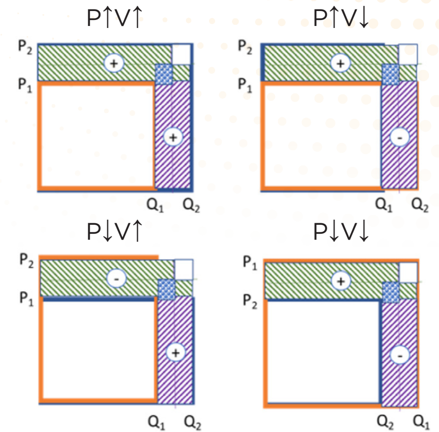
Defining the average price and volumes across the two periods as $\bar{\bar{P}} = (P_2 - P_1) / 2$ and $\bar{\bar{Q}} = (Q_2 - Q_1) / 2$, respectively, we write:

$$\Delta Rev = \bar{\bar{P}}\Delta Q + \Delta P\bar{\bar{Q}}$$

As before, the first term is attributed to the impact of volumes and the second to the impact of changes in price.

Graphically, our four different cases are shown below.

Mirror Symmetry Impact Attribution



As one can see, all cases lead to the same approach of making attributions under this mirror symmetry approach. Management deserves clarity from their revenue variance analysis, especially if the variance analysis is used in making compensation, budgetary, and personnel decisions. The unbalanced approach, though currently common and historically practiced, clearly has some significant shortcomings, oddities, and biases. The mirror-symmetric approach is a much overdue update delivering consistency, clarity, and beauty. Now that is understandable.

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How to Leverage Loss Aversion/ Prospect Theory for Pricing Negotiation

by: Raymond Augustin

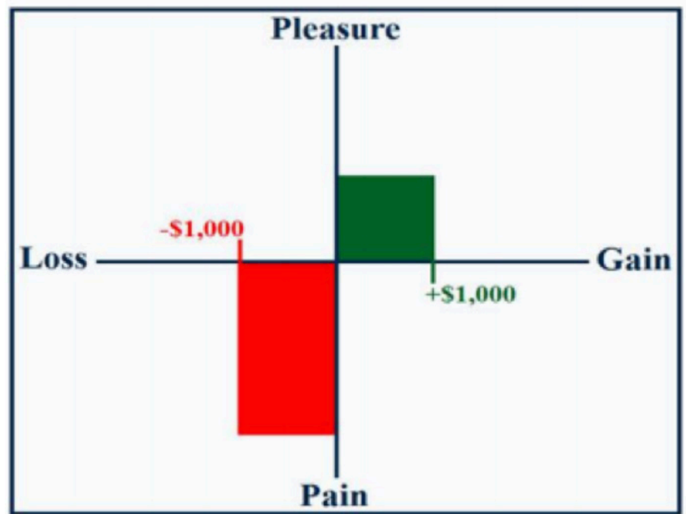
In this article, the author explains the psychological phenomenon of "loss aversion" and how it can be applied in pricing strategy. Raymond Augustin is a recognized thought leader specializing in pricing strategy. He has, as the COO of Virtual Procurement Services (VPS), provided guidance to dozens of healthcare organizations and tribal gaming operations on purchase price methodology and analytics. Raymond is the co-founder of the Group Savings Organization (the GSO). He has an active interest in the research of the psychology of price and pricing motivations. He can be reached at raymond.augustin@miami.edu.

What is Loss Aversion?

The emotional pain of losing is twice as impactful as the emotional joy of winning. Loss aversion is an identified preference of bias in our thinking and evaluation process that is used to describe why the pain of losing something is psychologically about twice as powerful as the pleasure of gaining something. This phenomenon was observed by Tversky and Kahneman and published in their seminal work. For this reason, we think it is better not to lose $20 than to find $20. It is also why when our team is favored to win, but loses, it is more psychologically crushing than the joy of your supported underdog's victory.

Source: Amos Tversky & Daniel Kahneman "*The Framing of Decisions and the Psychology of Choice*"

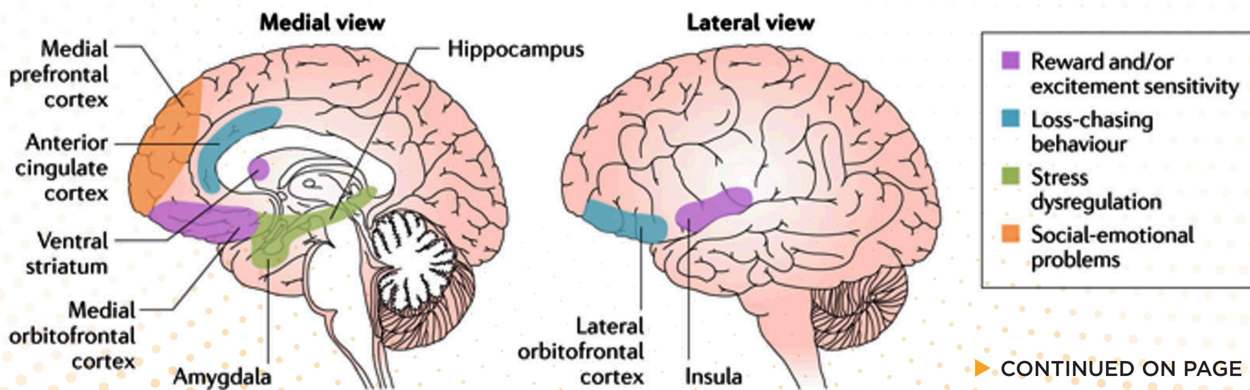
Loss Aversion: Losses are Twice as Painful as Gains are Pleasurable



There are 3 specific regions in our brain that contribute to this loss aversion:

- Amygdala
- Striatum
- Insula area

When we are faced with a potential loss, the anxiety-inducing and stress-activated Amygdala kicks in, which stimulates an emotional reaction for loss that is similar to its equivalent for fear. The Striatum then assesses the situation to see if this is – or is close to – a scenario that has been seen before to determine if there are approaches to mitigate any possible loss. The Insula region then provides the impetus for moving forward with those alternatives and **there is a direct correlation between the increased sense of loss and the Insula area's activation.**



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How can sales teams use this when price is an issue?

The most prevalent use of this cause and effect is to create **scarcity of either product or of time**. When you use urgency to sell, you take "tomorrow" off the table altogether. The sale price is only available during "x" period, or this product will not be available after that "limited time." Utilizing quotes or proposals with end dates for the pricing therein is a gentler (and more subliminal) method of applying this type of pressure. Coupled with an announcement or 'rumor' of a price increase, this then becomes a full-fledged application of loss aversion on the customer.

The other approach is the **'try and buy'** or **'POC'** (proof of concept). The vendor is able to get the product into the hands of the prospective customer to be used by a wider audience. Studies by Peck and Shu have confirmed that merely touching an object results in an increase in perceived ownership of that object. After just a few weeks, the thought of returning this item becomes a pain point along the lines of prospect theory (i.e., losing something they had vs. not getting something they did not possess to start with). Car dealers have always been good at this with their "test drives," and companies like Carvana now offer "7 days to see if your car truly fits into your life."

Some other not so subtle ways that seem to work:

- Coupons
- Pre-orders
- 2 for 1 (or BOGO)
- Doorbuster specials

Sales professionals practice this in a more sophisticated way by having the customer budget at the line-item level for the item(s) they are selling. Research shows that people do experience loss aversion about their outlay when they are spending money they have already allocated (on paper or mentally) for a specific purpose.

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Pricing Transformations in 2022

by: Kyle Poyar and Steven Forth

In this article, the authors look back at the accuracy of their pricing predictions for 2021 and look forward to predicted pricing trends for 2022. Kyle Poyar (kpoyar@openviewpartners.com) is a Partner at OpenView. Kyle helps OpenView's portfolio companies accelerate top-line growth through segmentation, value proposition, packaging and pricing, customer insights, channel partner programs, new market entry and go-to-market strategy. Steven Forth (steven@ibbaka.com) is Co-Founder of Ibbaka. Steven is responsible for Ibbaka's strategic direction and key relationships. He is an expert in marketing strategy (segmentation, targeting, revenue models, pricing) human and organizational performance, learning and knowledge management. Named one of the top 10 pricing authorities in the world by OpenView, Steven has helped companies from Fortune 500 to startups drive returns and increase profits.

Welcome to the third edition of the Pricing Transformations series. In this article, we look back at 2021 and forward to 2022, measuring how our past predictions have stood up to another tumultuous year and laying out what you can expect in 2022.

You can read the first two installments in this series here:

- Pricing Transformations in 2020
- Pricing Transformations in 2021

Let's begin by looking back at the year 2021. Here's how we did:

- **The continued adoption of product-led growth (PLG) best practices:** we give ourselves a 5/5 on this one. Product-lead growth continues to be one of the best ways to rapidly scale

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a software company, and best practices are increasingly shared and understood. (See: The Ultimate Product-Led Growth Resources Guide.)

- **Pricing models must be adaptable:** 4/5 on this. We took off a point as there are still too few people who understand pricing models well enough to make them adaptable. The operating environment remained fluid in 2021, with some sectors doing well while others continued to struggle with the pandemic and the measures in place to manage it. At the same time, the first signs of a return of inflation began to put pressure on pricing models.

- **Usage-based pricing gets normalized:** 5/5 we are on a roll. 2021 was the year that everyone was asking about usage-based pricing and more and more companies began to experiment with it. (See: The Usage-Based Pricing Playbook.)

- **Pricing for social change:** 2/5. The importance of pricing as a way to nudge people towards more responsible decisions remains controversial. Take carbon pricing. It has been normalized in some countries, but it is still a partisan issue in the United States. 2021 was not a breakthrough year for pricing for social change. Given the lingering impacts of the pandemic and the rising specter of inflation, the impact of pricing on community value will likely remain below the surface for most companies in 2022 but this remains a long-term trend. Science, conscious consumers, and next-gen founders will drive ESG innovation in 2022. (In case this is important to you, read more here: Weaving Social Consciousness into Corporate Identity – Community Value Drivers.)

- Join Steven's research by taking a short survey: Growth Strategies in 2022.

Now onto pricing transformations for 2022. We've come up with five predictions for what's to come.

Companies push usage-based pricing even further

Usage-based pricing (UBP) was an undeniable trend in 2021. 45% of SaaS companies said they had some form of usage-based pricing, up from 34% in 2020. A majority of the UBP holdouts expect to either test or launch UBP in the coming years.

Here's the catch: most companies only dipped their toes into usage-based pricing rather than diving in headfirst. These companies might have introduced a new usage limit for their free plan or for an entry-level paid subscription, for example, rather than testing a more disruptive pay-as-you-go offering.

It's easy to understand why companies would want to tread carefully. Fully embracing usage-based pricing rather than traditional seat-based subscriptions is analogous to making the transition from on-prem to SaaS in the first place. It requires rethinking everything, from billing and revenue forecasting to the role of Account Executives to how to drive a customer success mindset across the entire organization. Plus, companies face significant change management hurdles if they choose to migrate their legacy subscription customers onto a new pricing model.

But as SaaS companies see success with their initial usage-based pricing experiments, we expect to see many of them embrace usage-based pricing as part of a true business transformation.

Thankfully, there's an ever-growing number of vendors who are building technology to make this transformation a little easier. Emerging vendors include Amberflo, Monetize360 (funded in October 2021), Octane (funded in August 2021), Metronome, M3ter, and many more. Meanwhile, the federal government is lending its support to usage-based pricing by amending its GSA schedule to allow agencies to "pay by the drink.'"

With more readily available tooling, a growing number of buyers, and an ever-expanding list of success stories, 2022 will be another banner year for usage-based pricing adoption. (See Usage-Based Pricing: Behind the Scenes of New Relic's Transformation.)

Customer Value Management will supersede customer success

One of the most important changes sparked by the subscription economy, and the move to software as a service, has been the shift from customer support to customer success. Customer success introduced many techniques from customer experience management to help design the experiences that would lead people to use the service and then renew when the time came. The customer success leader is often the person who owns the renewal number.

As we shift from static subscriptions renewing at fixed intervals to include usage-based pricing, this will not be enough. We will need to focus on the value generated by that usage.

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This means we need to move from customer success to customer value. Good usage-based pricing is based on the usage that ends up in something of value to the customer: not just clicks, but the completion of value paths (the sequence of actions that ends with something of value to the user). Someone needs to be responsible for defining these value paths, tracking them, and making sure that they are being completed.

This is the role of customer value and the customer value manager. Many value promises are made by marketing and sales. Many value assumptions are made by product management. The customer value manager is responsible for connecting promise to reality. Usage-based pricing is a powerful way to get everyone focused on what is creating value and how it is being delivered.

Inflation will dominate conversations on pricing strategy and tactics

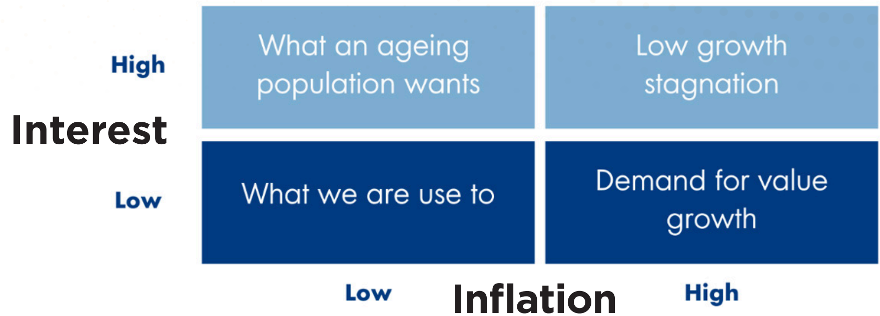
U.S. inflation rates peaked at 13.5% in 1980 but have been under 6% since 1983. In 2020, inflation was only 1.23%. In December 2021, inflation was estimated at 6.8%. Saxo Bank, tongue in cheek, suggests that U.S. inflation could go over 15% in 2022 (See Outrageous Predictions).

Not many people think we will see double digit inflation, but something near 10% has become quite possible. How will this impact your pricing?

Before you answer that question, ask what will happen with interest rates. The common assumption is that central banks will crank up interest rates as they try to get inflation under control. Maybe. But during the low inflation/low interest rate cycle, governments amassed huge debts. High interest rates will suck up government revenues. Governments are likely to resist this.

If there was ever a time for scenario planning, this is it.

Inflation and, possibly, higher interest rates are an opportunity to rethink how you create value and how you capture that value in price. (See pricing and inflation – how to respond.)



There will be pressure to raise prices to at least keep up with inflation. That could mean price increases of as much as 10%. This would be a very large price increase and the impact on demand would have to be considered. Be careful not to trigger a downward spiral where price increases contribute to inflation while driving down demand.

Before a reactionary price increase, stop, do some analysis. Ask:

1. How will inflation impact our customer's business and business model?
2. How might this impact differ across segments or industries?
3. How will higher interest rates impact our costs and our suppliers' costs? Is it worth raising prices in every scenario? What will the impact be on customers?
4. Can your product be positioned to help your customers manage inflation or interest rates? (i.e., if your product normally helps reduce operating costs, can it also lead to deferred capital investment?)

We'll take the "SaaS" out of "SaaS pricing"

SaaS pricing is a fairly new discipline. After years of neglecting pricing, SaaS companies have finally woken up to the importance of hiring dedicated software pricing experts and teams to help them navigate this important topic. Such teams are well-versed in different SaaS value metrics, methods of conducting pricing research, and how to implement pricing changes across a sales team.

All of that is great to see, and we don't want it to go away anytime soon. But now "SaaS" is just one piece of the puzzle. Software companies have rapidly diversified their revenue streams into new and (sometimes) uncharted territories, including pay-as-you-go, payments, FinTech, data services, professional services, marketplaces, lead generation, hardware, and more.

Just look at Toast, the restaurant technology company that IPO-ed

▶ CONTINUED ON PAGE 11

in 2021. Toast generated $823M in revenue in 2020. Of that revenue, only 12% came from subscription software. The remainder predominantly came from FinTech (78%) and hardware (8%).

Toast isn't a rare outlier either. Similarly, Shopify, Bill.com, and MINDBODY generate substantial revenue outside of software subscriptions. HubSpot's stock price jumped 16% in a matter of days upon the company's announcement of new B2B payments and commerce functionality.

In 2022, "SaaS pricing" will become, well, "pricing." Being successful will require going back to core pricing principles like measuring customers' perceived value of a given product or service.

Top-tier talent will take this change in stride as pricing becomes a C-level and even Board-level priority for SaaS companies large and small. Now is the chance for that VP promotion or opportunity to build a best-in-class pricing team, but earning it won't be easy. (See Inside Toast's IPO.)

Pricing strategy will be about increasing company value and not just revenue or profits

On many pricing projects, there is a tension between volume, revenue, and profit optimization. The same price will not optimize all three. This basic fact of economics causes a lot of strife in management teams and with their investors. What if this is the wrong question?

IN 2022, "SAAS PRICING" WILL BECOME, WELL, "PRICING." BEING SUCCESSFUL WILL REQUIRE GOING BACK TO CORE PRICING PRINCIPLES LIKE MEASURING CUSTOMERS' PERCEIVED VALUE OF A GIVEN PRODUCT OR SERVICE.

Rather than asking how to optimize an operating metric, like revenues and ARR or profit or volume and market share, we should ask how price can maximize the value of the company over time. The conventional way to define this, the one used by most investors, is Net Present Value (NPV) or the present value of future cash flow. This means that revenues, profit, and risk are all important. Pricing strategy should optimize NPV.

Inflation decreased the present value of future cash flow. We were able to largely ignore inflation and assume low interest rates for the past generation. If that is no longer the case (the jury is still out), our pricing strategies and not just our tactics will need to change. When calculating NPV, the discount rate gets multiplied by (not just added to) the inflation rate. Think about that for a while and see what happens to your value when inflation gets up near 10% (although we are not saying that it will).

In 2022, investors, boards, and executives will be asking their pricing teams how they can increase value. There are three levers, and all three need to be considered as a system: revenue growth (from new customers and existing customers less churn), profits, and risk (measured using the discount rate).

In 2022, pricing decisions need to be explicit on the intended impact on revenues, profits, and risk. Will we be right? What did we miss? We'll see you back here in January 2023 to see how we did.