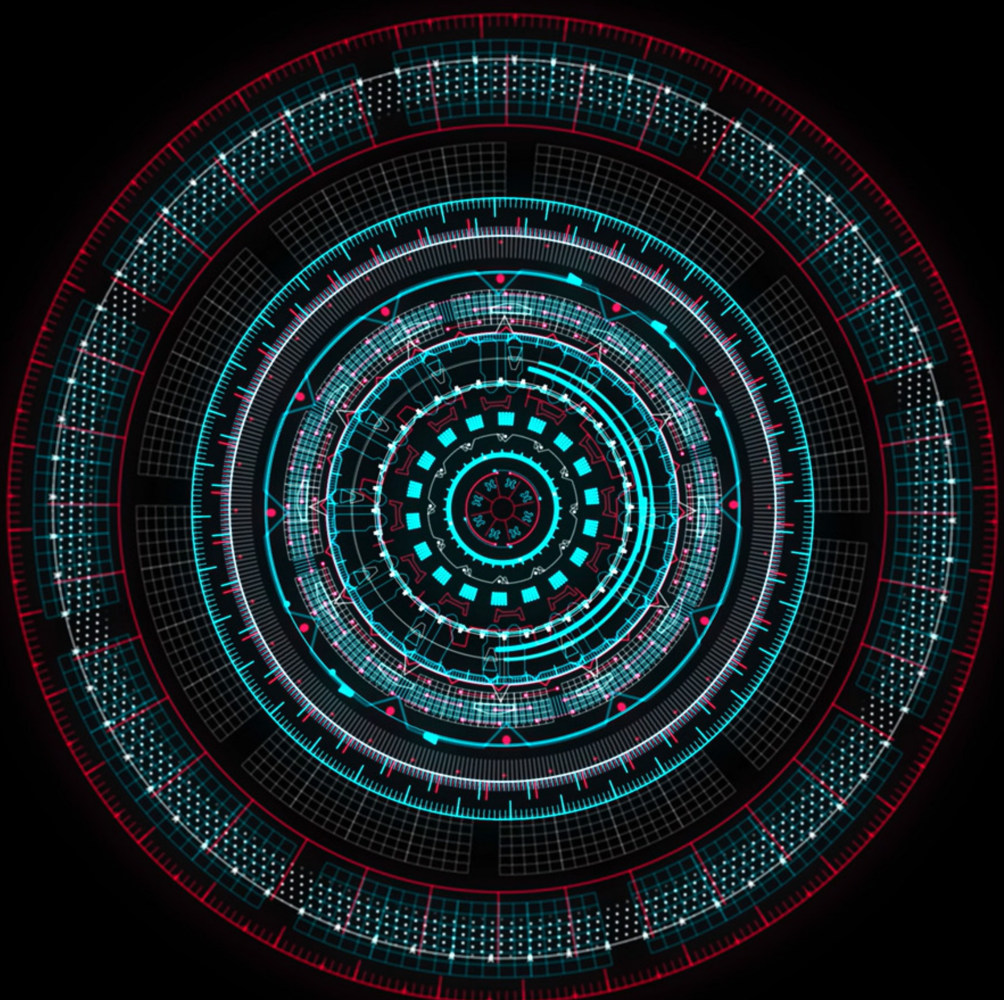


Demystifying the cloud consumption model

Benefits of consumption-based pricing for your business

Consumption-based pricing is the next evolution in monetization models. Moving beyond subscription to cloud consumption models is becoming increasingly popular with customers and anything-as-a-service [(XaaS)]() providers in a post-COVID-19 pandemic era. **Customers gain flexibility and control** over their spending by only paying for what they use. They can also try a service knowing that **a long-term commitment is not required**. Service providers gain another tool to expand their customer base and minimize customer churn by matching value to billings.

Diversifying with consumption

While subscription models remain popular and relevant in the marketplace, they are not the only compelling monetization model available. Consumption-based pricing models, alternatively known as “usage-based” models, allow customers to access a product or service but only pay for what they use. The particular product, service, and industry—along with the way usage is monitored and translated into a cost to the end user—can improve customers’ perceived value of the service relative to the cost. The greater the perceived value, the lower the risk of churn.

Recent changes in the procurement cycle are driving a shift toward consumption-based pricing that has seen significant growth. Over the last five years, consumption-based monetization adoption among B2B SaaS companies has significantly increased, from 27% in 2018 to 45% in 2021.[1]

This increased adoption rate of consumption-based pricing is largely driven by three factors:

Value transparency:

Better correlates cost and outcomes for customers to evaluate return on investment (ROI) and inform/justify future spend

Reduced barriers to entry:

Supports an organic, land-and-expand growth rate by not forcing customers into an all-or-nothing decision

Flexibility to scale up or down quickly:

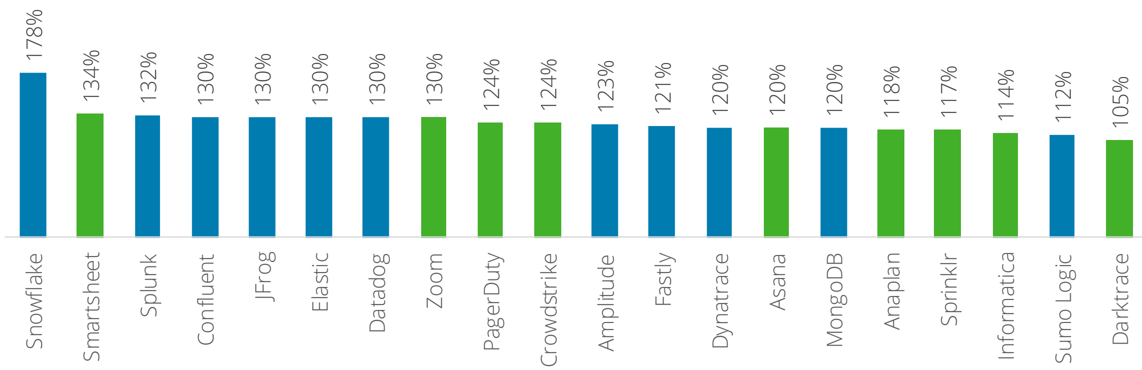
Easier to pilot and expand to new sets of use cases and user groups across an organization

Software companies which have deployed consumption-based pricing models appear to be benefitting from the move. Recent trends, executive interviews, and Deloitte analysis (figure 1) show 38% faster growth in year-over-year (YoY) revenue for usage-based companies versus the broader software-as-a-service (SaaS) index. The companies also tended to outpace their peers on key metrics such as annual recurring revenue (ARR). Further, 10 of the top 15 companies by net dollar retention (NDR, which measures how the ARR metric fluctuates period-over-period) have a consumption-based pricing model. Overall, the B2B SaaS market saw NDR increase to 102% in 2022, up from 99% in 2021.[1]

Figure 1.

Software companies are increasingly adopting consumption-based pricing, and these companies tend to outpace peers on ARR and market performance.

10 of the top 15 companies by NDR (among recent IPOs) have a consumption-based model



Usage
User / Host

Consumption and usage-based pricing seem attractive primarily because of:

- Organic land-and-expand growth rate, by **not forcing customers into an all-or-nothing decision**
- **Easier to pilot with and expand to new sets** of use cases and user groups across the organization
- **Better correlation of cost and outcomes** for customers to evaluate ROI and inform / justify future spend

38% **faster growth**

in YoY revenue for usage-based companies vs. the broader SaaS Index

50% **higher EV/Rev**

of usage-based companies vs. the broader SaaS Index

Source: Deloitte analysis, OpenView Partners[1], company filings as of April 2022

Consumption-based monetization expands customer base

The deployment of consumption-based pricing models is typically executed in three layers—each with specific considerations (figure 2)—and in multiple variations. Based on the nature of a company's business objectives (e.g., improving key metrics such as total contract value [TCV] and annual contract value [ACV], or expanding their customer base) a combination of pricing features can be layered to create a unique pricing approach that fits the needs of a business.

Layer 1: Core pricing

Baseline pricing for consumption. Examples include:

- Pure consumption model based on usage, typically post-paid
- Upfront commitment with a discount on each consumed service unit (e.g., minimum consumption level to be met to receive discount)

Layer 2: Overage management

Additional pricing to account for overruns on usage and associated costs. Examples include:

- No penalties for overage (same rate as core pricing)
- Penalties beyond commitment as a multiple of core pricing

Layer 3: Predictability management

Alternative pricing for consumption with features to reduce overspending. Examples include:

- Upfront credit purchase (draw-down based on consumption); also referred to as pre-paid
- Rollover of unused commitment
- Throttle usage beyond threshold

Figure 2. Consumption-based pricing models: Typical elements to consider

When applicable, companies adopt variations of consumption-based pricing to fit their customers and products, with many opting for hybrid options

Typical elements to consider

Core pricing	Pure consumption ("utility" model)	Utility with Discount with upfront commitment	Fixed utility price + overage price	Base rate for usage + utility model ("taxi" model)	Utility bands (e.g., 0-100 meetings, 100 – 500 meetings)
Overage management	No penalties (same rate as core pricing)	Penalties beyond commit as a multiple of core pricing	Standard pay-as-you-go rate beyond commit	Headroom model (e.g., up to 10% overage per period without penalty)	Budget-based by user/team (large accounts)
Predictability management	Upfront credit purchase (draw-down based on consumption)	Rollover of unused commit	Throttle usage beyond threshold (mobile network model)	Alert-based systems (e.g., warning before overage kicks in)	Human-driven and automatic freezes

Our recommended principles

1. Showcase how **spend is closely tied to usage** – and as such – value
2. Set pricing on a **clear, utility measure** (e.g., per GB, per meeting, per attendee)
3. Ensure **revenue follows usage** of the product (as opposed to pre-sale)
4. **Set initial spend at $0**, where possible, and scale up from there
5. Prioritize buyer and user **transparency and control**

Source: Company website and investor filings, executive interviews, Deloitte analysis

From the three layers, customers can select the combination of pre-paid and post-paid pricing structures that best fits their organization's needs. Various combinations can be created for different products, sales channels, markets, or other criteria. (For most companies, consumption is likely not a one-size-fits-all monetization approach.)

One approach is a **custom pre-paid usage monetization model**—think of paying in advance for 100 hours of query computation in a cloud-based database and depleting the 100 hours by executing data queries. A pre-paid usage approach could combine layers to create a bespoke solution:

Layer 1 – Core pricing:	Upfront commitment
Layer 2 – Overage management:	No penalties on overage
Layer 3 – Predictability management:	Rollover of unused commitment

Note that the predictability management tier is proving popular with budget-conscious customers who are looking for built-in mechanisms to prevent overspending.

Another approach is a **custom post-paid usage monetization model**—think of paying for data storage based on the terabytes of data stored on cloud-based database servers.

Layer 1 – Core pricing:	Post-paid consumption based on usage
Layer 2 – Overage management:	Penalties based on overages
Layer 3 – Predictability management:	Throttle usage when thresholds exceeded

An underlying technology architecture that enables a service provider's front and back office to work in concert provides the critical foundation for any subscription- or consumption-based pricing business. A scalable and flexible tech stack can accommodate fluctuating transaction volume and changes to sales, billing, and finance processes. Mature sales and configure, price, quote (CPQ) tools can ensure that quote, order, and contract data origination is accurate and comprehensive. Billing and revenue management systems with native subscription billing and revenue management features can help automate invoicing and revenue recognition to support high-volume businesses and reduce risk of manual intervention. Other tools—such as entitlements and licensing engines—can support provisioning of software access to end users.

Finally, introducing consumption-based pricing requires an important new metric: usage. An organization needs to define how usage can be quantified, how it can be monitored, and how that data can be used to determine billing and revenue. Different solutions can be deployed to appropriately monitor usage metrics and data that are then used in other parts of the process (e.g., usage metrics that inform how revenue is to be recognized).

Consumption-based SaaS

A leader in cloud-based data storage engaged Deloitte to transform their end-to-end, lead-to-revenue cycle. The client, whose primary monetization model relied on consumption monitoring, encountered challenges with tracking usage for their product offerings and recognizing revenue in accordance with new accounting standards.

The solution entailed developing a technology stack that included a new, cloud-based revenue recognition model—that when coupled with upstream systems—enabled an automated revenue recognition process for consumption-based monetization.

The project team also leveraged upstream sales data to define the appropriate accounting treatment for various business scenarios.

The solution automated and improved the quality of revenue accounting processes and unlocked key revenue data—not previously available—to enhance management, operational, and financial reporting.

The enterprise-wide impact of consumption monetization

Implementing a consumption-based pricing business model involves much more than changing how a service provider issues an invoice or how a customer evaluates available products. It has far-reaching organizational impacts that leaders must consider within the context of the company's strategic vision, product offerings, current economic environment, consumer trends, and competitive climate. Among impact areas:

People and mindset. Anticipate the evolving needs of the business and team members, as new processes and technologies generally require a mindset shift and leveling up of team member skillsets. Adopt new technologies, understand changes to sales processes, and leverage new data and data flows that enable the teams' work.

Sales and sales compensation. Evaluate a consumption model's impact on the company's sales metrics and sales compensation model; revise key metrics and sales comp calculations to reflect consumption-based revenue forecasting.

Product and pricing. Introduce new products for consumption-based pricing; redesign or develop product pricing and discount structures.

Customer success. Support existing and new customers as they adopt a consumption monetization model; proactively share FAQs, request customer feedback, and promptly fulfill requests to meet customer expectations.

Accounting. Identify and configure new billing triggers for invoice creation; ensure that revenue recognition conforms to new performance obligations (per ASC 606/IFRS 15 guidance); redesign or develop key reporting metrics and revenue forecasting methods to meet finance department needs.

Technology stack. Rationalize the existing tech stack to meet requirements of consumption-based pricing requirements; evaluate existing systems and new vendors to identify best-fit solutions; source or develop usage monitoring mechanism to enable billing.

Whether an organization has already deployed subscription- or consumption-based pricing or is currently contemplating the expansion of its monetization models, evaluating the change's enterprise-wide impacts—and how to address them—should be part-and-parcel of the strategic decision-making process.

Where to go from here

Will subscription-based pricing maintain its popularity or might consumption-based pricing become the new model of choice? As of late, there is a shifting sentiment toward the perceived value received from a service that requires a recurring payment.[2] Is the end user receiving a benefit equal to or greater than the cost? Companies continue to evaluate cost-cutting measures, especially sources of recurring costs, amid the changing macroeconomic climate. Given this scrutiny, introducing a complementary consumption pricing model can present an opportunity to retain customers who may otherwise defect from their subscriptions in an effort to reduce cost. While some products and services are certainly fit for subscriptions (e.g., wireless cellphone plans, cloud-based data storage, etc.), others may deliver more value and reduce customer turnover under a consumption-based pricing model.

Adding a consumption-based pricing monetization option can reduce barriers to entry, broadening the customer base. Further, it may allow customers who tend to be more impacted by economic downturns (as the travel and hospitality industries were during the pandemic) more flexibility to limit spending on cloud-based software and service solutions when needed and flex back up when the outlook allows for it.

Subscription-based pricing models have an overwhelming presence in the Technology sector and continue to expand into retail and consumer industries, automotive, hospitality, and even the airline industry.[3] The complementary introduction of consumption models represents a new avenue for service providers to address current and emerging customer needs, help reduce churn and retain customers, and diversify and expand their customer base. Now is the time to explore consumption-based pricing to complement your existing pricing models.

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Endnotes

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