

Pricing Models

Establishing Optimal Pricing Structures for Your Service Provider Business



At a Glance

When it comes to pricing models for managed services, one size definitely does not fit all. However, it's not uncommon for executives to continue to employ the same model that they've always used, whether or not it's a good fit for their current engagements. This strategy brief offers an overview of the different pricing models service provider executives and sales teams can choose from. The document describes each model, including how they are calculated, and then outlines their pros and cons, so you can make sure your team is using the model that makes the most sense for your business and your customers.

Introduction

Delivering pricing to a new prospect can be a nerve-wracking experience for any service provider executive, and for good reason. The reality is that a lot is riding on pricing, and the pricing decisions made today can have very long-lasting repercussions. If you set your pricing too high, you may scare off prospects and significantly limit or negate adoption of your services. On the other hand, if you price too low, you can set your business up to lose money for the life of the customer contract.

In setting their pricing structures, service provider executives have several pricing models to choose from, particularly if their organization offers services relating to system operation. While several alternatives exist, too often service provider executives either aren't aware of all the options, or they stick with the same approach regardless of how it is actually working for the business.

The reality is that no single model will be optimal for every service or service provider. This strategy brief offers a high level overview of some of the most common pricing models, and it provides insights into the respective tradeoffs to consider in choosing among these different options.

Model 1: Per-Device Pricing

When an organization employs per-device pricing, the recurring charge is based on the specific number of devices covered for a given time period. In many service provider organizations, this model is the first one adopted, and the model remains in widespread use today.

This model is often used for monitoring services, with a provider offering monthly pricing based on the number of devices monitored. In these cases, pricing can vary depending on the type of device being monitored. For example, the per-device rate could vary depending on whether the vendor is monitoring a storage system, router or server.

Here are some of the positives of per-device pricing:

- **Simplicity.** Both for the vendor and customer, per-device pricing is very straightforward to calculate and understand. The service provider simply has to track how many devices are being monitored or supported at any given time.
- **Support for standardization.** Per-device pricing lends itself to establishing standardized, line-card pricing for a given service, with fixed per-unit prices for all the device types that can potentially be supported.

While it has been around for quite some time, this pricing model can still be effective in many cases, particularly asset-intensive customer environments that have a large ratio of devices to employees. For example, a per-device pricing model may be a great fit in a business that has a ratio of five devices for each employee, where the norm in many organizations is to have 10-30 employees for every device.

On the other hand, per-device pricing can also present some downsides:

- This model isn't a good fit for many offerings, particularly emerging offerings like software as a service (SaaS).
- This model wouldn't be a good fit for a managed help desk offering, a service in which the costs are largely driven by the number of users being supported.
- As they grow increasingly accustomed to cloud-based offerings and pricing, many customers prefer to pay on a per-user basis.

Model 2: Per-User Pricing

Per-user pricing represents an increasingly common model, one in which vendors charge based on the number of users of the solution or service. Per-user pricing can be based on a maximum number of concurrent users, or it can be based on the total number of users

within the customer organization that can work with the service. Originally driven by the advent of cloud-based applications, this is an effective model for many offering types.

Service providers can calculate per-user pricing in the following manner:

- First, they start by referencing the per-device pricing method, and totaling any relevant device-based charges.
- Next, the provider would divide that total by the number of potential users.
- Then, they would add any services that are being enumerated on a per-user basis. For example, this could include a per-user fee for email security or mobile device management.

The resulting total would constitute the per-user price that would be furnished to the customer in a quote. Assuming the customer does sign on, the service provider would track the number of users on a regular basis, and as that number expands or contracts, make corresponding updates to the monthly charges that are invoiced.

The advantage of per-user pricing is that it is easy for the service provider to calculate and easy for the customer to understand. The downside is that this approach can sometimes be misunderstood. Often, service provider leadership wants there to be a so-called “magic number” to charge under all circumstances. However, there isn’t a magic number for infrastructure-based managed services. Depending on the customer organization and industry, the nature of the infrastructure in place can vary substantially, which can lead to a significant variance in terms of the cost of delivering the service. Trying to lock down on a single per-user fee that is independent of the client’s infrastructure and how it can evolve, is a sure recipe for money-losing services.

Model 3: All-Inclusive Pricing

All-inclusive pricing refers to the practice of giving the customer a single price for the entire list of services provided. Service providers offering all-inclusive pricing would add up the fees for services being offered for each device and for each user. The total cost would ultimately be offered to the customer or prospect with no itemized breakdown on the pricing for specific units of the service.

The upside of this approach is that it is simple to calculate and simple for the customer to understand. On the other hand, the downside to this approach is that a service provider can be exposed to substantial fluctuation in service profitability or loss, depending on how the clients’ infrastructure and organization evolves. For service providers that adopt this pricing model, it is critical to track ongoing infrastructure changes and adapt ongoing billing to reflect these changes.

Model 4: Value-Based Pricing

When vendors adopt a value-based pricing model, they set their pricing based on a calculation of the cost savings the service delivers. There are a couple positive characteristics associated with this approach. First, by setting pricing based on tangible and intangible savings that the service can provide, it is possible to charge a higher rate and extract more revenue from each customer. As a result, this pricing approach has the potential to set the stage for a more profitable customer engagement than other pricing models.

On the other hand, this pricing model can be the most challenging to do correctly. Quite simply, you won’t be able to train a sales representative for a week and reasonably expect them to be able to do value-based pricing quotations. Establishing value based pricing requires gaining visibility into the customer organization, which is essential in

calculating the total cost of ownership of a function and the ROI of the service.

While indirect costs can have a very significant role in these calculations, they can be very hard to determine. Indirect costs can include system downtime, loss of use, loss of revenue, loss of productivity and so on. Gaining visibility into these kinds of costs requires the prospect to be forthcoming on a range of topics. Many prospects won’t be willing to disclose this kind of information with a prospective vendor. Further, even if they are willing, they may not know all the areas in which their business is being hit by indirect costs.

For example, in many organizations, employees from a number of different departments can come to rely on specific individuals for assistance—even though those responsibilities are not in their official job description. An employee in accounting may become the de facto SAP expert and spend a lot of time responding to the issues and questions of employees from across the organization.

These types of arrangements can be very costly for a business because a key employee can ultimately be contending with significant ongoing distraction. In these cases, a service provider could offer a significant cost savings by eliminating this distraction for the employee. However, the contacts a service provider interacts with may not be aware of these kinds of informal arrangements, or they may not be willing to discuss them with any prospective vendors. In addition, it may only be after the client has engaged with a new service provider that they discover these types of situations exist.

Establishing value-based pricing can require significant investigation and relationship building with the prospective customer, so this approach is far more time-consuming, which adds to the cost and duration of the sales cycle. Depending on the nature of the opportunity and the customer, the larger

up-front investment required to establish value-based pricing may not be worth it. However, if you can uncover these kinds of indirect costs, you can establish a much stronger value proposition and higher pricing.

Contracts and Negotiation Considerations: Ensuring Your Business Isn't Exposed by Change

No matter which pricing model you elect to work with, it is critical that the contracts you establish with customers are aligned with the models employed and are equipped to contend with change.

To protect your business, you need to ensure that changes in customer organizations don't result in your organization being locked into a money-losing relationship. When changes to employee infrastructures or head count result in a higher cost structure or workload for your business, you need to be able to pass those higher costs onto the customer. On the other hand, if the customer's environment or employee count contracts, they'll want to ensure that they'll see savings that are commensurate with these changes as well.

It is for these reasons that service providers must clearly communicate and document the implications of changes with customers. This includes establishing effective language in contracts that will cover for significant changes, and detailing the corresponding pricing changes that would occur.

For example, if your organization is offering per-user pricing, the price quoted would need to become void in the event that significant architecture changes occur in the client environment. If your service includes the monitoring of internal servers, and the customer moves its servers to an externally hosted cloud environment, your organization may incur significant cost and effort to accommodate that change. Plus, this change may necessitate a different cost structure over time. Your organization has to have the flexibility to revise pricing to align with these realities.

Likewise, you should account for potential changes in employee counts as well, and establish rules for pricing changes that may need to be instituted. For example, if due to a reduction in force, a client wants to reduce the number of users by 50 percent, the service provider should be able to adjust rates. For example, a service provider could elect to take away a volume discount that was originally offered based on the assumption of an employee count that was twice as high.

Conclusion

No matter which pricing model you employ, you need to start by doing the investigation needed to enumerate the specific elements involved, whether that is devices, users or the totality of the organization served and the services rendered. Typically, devices and users will be the easiest variables to enumerate, which is why it can often make sense to

kick off a new outsourcing engagement with user- or asset-based pricing. When it comes time for a customer to renew a contract, this can be an opportunity to consider moving to value-based pricing. After the customer relationship has been established and your staff has gained insights into the client's environment, you may have the information needed to develop a compelling value proposition with value-based pricing, which can help foster a more strategic and profitable partnership in the long term.

About This Document: Developed by the CA Service Provider Center of Excellence

This document has been written by the CA Service Provider Center of Excellence team and is intended to provide our service provider partners with the guidance they need to address some of their most pressing challenges. Our team has rich expertise in service provider businesses, strategic consulting, technical deployments, sales and marketing. Our documents are informed by the Center of Excellence team's extensive experience over the past ten years in helping build successful service provider businesses and by interviews with some of our most successful service provider partners. This document is provided for informational purposes only and on an as-is basis. The guidance and results described herein are based on the unique experiences of our staff and partners, and may not be applicable to all organizations.

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