BlueMineGroup
Taking innovation to market

"Free" Pricing: Models and Strategies

by Michael Lurie and Dan Zagursky

When *Wired* published an article titled "Free!: Why $0.00 is the Future of Business" in its March 2008 issue, it brought further attention to a popular trend: information-based products and services are increasingly being given away for free.

This "free pricing" trend has been enabled by the fact that the marginal cost of the Internet's underlying technologies – storage, bandwidth, and processing power – have been converging to zero. Consequently, the cost of adding an additional customer has become negligible – allowing companies to price their offerings at zero. Chris Anderson, the author of the Wired article, notes that "everything web technology touches starts down a path to gratis…" These trends have created a "free-ality" which information, digital media, software, and web services companies must recognize in today's hypercompetitive marketplace.

At the end of the day, other than for non-profits, there is obviously no such thing as free pricing for businesses. There are, however, alternate revenue models that can prove very effective in helping companies aggregate customers and create value. In our view, there are four models that companies can consider – three are revenue models, and one is an asset model.

Four "Free Pricing" Models – Who Pays

- **Revenue models**
    - **Subsidy Model – all customers pay**: customers buy a free product and a paid product, the paid product subsidizes the free product;
    - **Upgrade Model** – **some customers pay**: customers who upgrade to the paid (premium) product pay for customers who get a free (basic) product; also known as "freemium" model;
    - **Advertising Model – vendors pay** for customers' attention, customers get a free product;
- **Asset Model – acquirers pay:** all customers get free products; the company builds a customer base as an asset, and realizes value on the sale of the company.

Subsidy Model

In the subsidy model a certain product or service entices you to pay for another one. While this model is similar to the upgrade model, the main difference is that in a cross-subsidy each customer is buying both the free/cheaper product and the more expensive product. Conversely, in the upgrade model, the paying customers are subsidizing the non-paying ones.

The cross subsidy has been part of marketing strategy for many years especially in the retail industry. Some examples are:

- Loss leader – e.g. diapers and baby formula are competitively priced to attract parents to buy higher margin products during their store visit.
- Complementary asset and consumable – e.g. the razor/blade and printer/ink models.
- Creative bundling – e.g. grouping and pricing of automobile options.

Upgrade Model

At its core, the upgrade or freemium model counts on the small percentage of paying, premium version users to subsidize the majority of non-paying, basic version users. The objective is to offer and continually introduce compelling features in the basic version, but structure a premium version that improves functionality and/or includes more features.

When estimating what percentage of users will upgrade to the premium version entrepreneurs fall into what venture capitalist and entrepreneur Josh Kopelman calls the "the penny gap" – the trap of assuming a constant elasticity in price. In reality, there is a large drop-off of demand when going from free to any paid amount meaning that the hardest part is getting your users to pay anything at all. Empirical studies have been conducted to demonstrate the effect of charging even one cent versus nothing at all.

An example of the freemium model is online music. An artist can give away its music online for free because there are zero marginal costs with respect to distribution. This "free" version is available to everyone. The goal is for musicians to up-sell these users through their music and other free community sites into attending concerts or purchasing merchandise – activities which lead to higher profits for musicians.

There is also evidence of the freemium model in the "offline" world despite the fact that the marginal costs are not zero. One such service is tire service and repair shops that offer free repair for flat tires to anyone so that the customer can be up-sold to buy replacement tires at a later time. This system is functional because tire repair has disproportionate value to the customer in relation to the marginal cost of repair incurred by the shops. The shops have determined that they can garner a great deal of loyalty from customers who received free tire repair.

Advertising Model

If a company is not charging its end-users for its product or service, it must find a party who is willing to pay and deliver (at least, perceived) value to both its customers and end-users. As the supply of enabling technologies becomes nearly unlimited – what marketing guru Seth Godin calls "the scarcity shortage" – companies must look to acquire other valuable (scarce) assets such as attention, loyalty, or reputation.

The advertising-supported model is one in which a product or service is given for free in return for ads to be displayed. As described by Anderson, this model is a version of a three party system. Traditionally the media model is an example of this – a magazine's main source of income comes from the space it sells to advertisers based on the profile of its readers. In reality, advertisers are its customers since readers pay a heavily subsidized price for a subscription.

Similarly, a well-known advertising-supported model in online media is Google – it gives away services such as search and email to its end-users because advertisers bid for their ads to appear on search pages. Beyond its own site, Google has enabled other sites to monetize their user base through AdWords. More broadly, Anderson observes that Google has created a way to measure and monetize scarce elements "reputation (PageRank)…[and]…attention (traffic)."

Other revenue models that incorporate three parties – whether or not advertising is used – could be included in this category.

Asset Model
The asset model is not a revenue model per se, but rather a path to exit for a venture. In this model, a company looks to build its user base, acquire valuable assets, and then looks for an acquirer or partner. This category is risky because of the high level of competition and the small number of companies with the resources to acquire such companies.

One prominent example is Google's acquisition of YouTube for $1.65B in late 2006. Before being acquired, YouTube had amassed a user base viewing millions of videos each day, but had not come up with a way to monetize its service. Only recently, Google started experimenting with ways to embed ads into YouTube videos.

Should Your Company Consider Free Pricing?
The central goal of "free pricing" is user acquisition - attention, reputation, community, loyalty, and traffic. In thinking of their revenue and pricing models, information-based companies today should give careful consideration to whether "free pricing" should be part of their value proposition.

To do so, use the following questions to think through your strategic options:

- *Are you able to offer free pricing*? Is your company's cost of adding an additional customer / user zero or very low?

- *Do you face market pressures for free pricing*? Are your competitors are offering one or more of the free pricing models?

- *Can free pricing be a unique differentiator for you*? Will adopting free pricing yield a sustainable competitive advantage?

Sources

Anderson, Chris. "Free!: Why $0.00 is the Future of Business". *Wired*. March 2008.

Godin, Seth. "The Scarcity Shortage". *Seth's Blog*, August 2007.

Kopelman, Josh. "The Penny Gap". *Redeye VC*, March 2007.

Additional Reading

Ariely, Dan. *Predictably Irrational*.

Behavioral economist Dan Ariely describes how people behave in an irrational way in a predictable manner. Among other topics, Ariely examines how people assign a higher perceived value to free products than they deserve.

Godin, Seth. "Three humps and a stick (on pricing)", Seth's Blog, June 2007.

A short blog entry by marketing guru Seth Godin that describes the challenges of pricing really low or high and moving from free to any price.

Seth Godin has authored best selling books on marketing such as *Permission Marketing: Turning Strangers into Friends, and Friends into Customers* and Purple Cow: Transform Your Business by Being Remarkable.

About the Authors

Michael Lurie is Founder and CEO and Dan Zagursky is a Manager with Blue Mine Group in San Diego, CA. Blue Mine Group is an innovation strategy firm, with extensive experience in pricing strategy and revenue model development for new products and services.