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[Essentials of Software-as-a-Service \(SaaS\) Business.](#)

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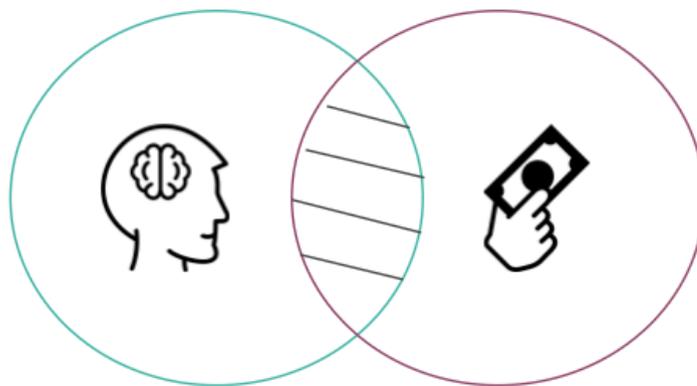
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## 3.8 The Psychology behind Effective Pricing

In this lecture, we will talk about behavioral economics, which merges psychology with economic decision-making. This field explores how emotional factors and cognitive biases subtly influence how people make choices. Behavioral economics is particularly relevant in the context of SaaS pricing, where understanding these psychological factors can significantly enhance a company's strategy.

For example, by carefully designing the presentation of pricing options, the structure of offers, and the wording around them, we can guide customer decisions more effectively. This isn't about manipulation — it's about aligning our products with how people naturally think and feel to create more effective pricing models.

### Behavioral Economics



#### **Decoy Effect**

- used to steer customers towards a particular choice

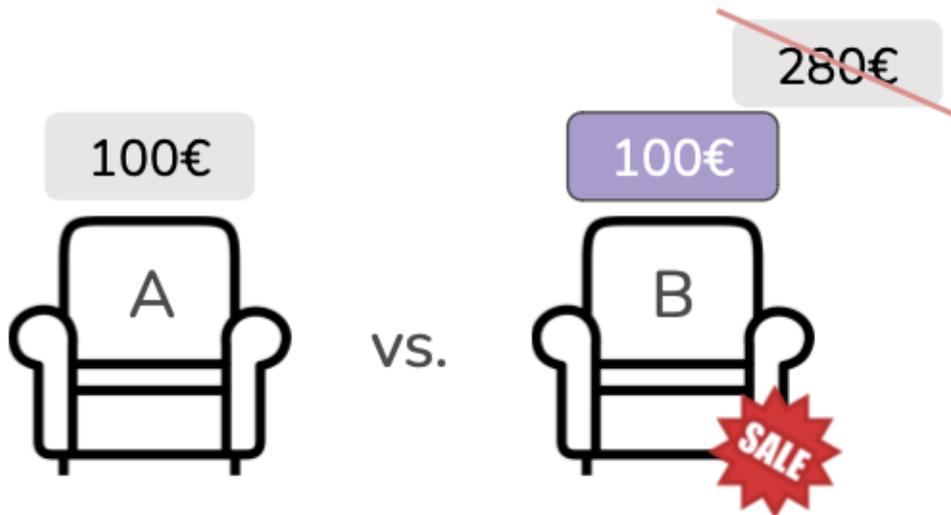


The first strategy from behavioral economics is called the Decoy Effect used to steer customers towards a particular choice. Essentially, it involves introducing a third option - the decoy - that is not intended to sell but to make one of the other two options more attractive. In the context of SaaS products, the decoy effect can be particularly powerful due to the flexibility of software pricing and package features. Let's say we are designing a 3-tier pricing strategy where we have the Basic plan that offers limited core features and costs 30€ per month. Next we have a Pro Plan, which serves as a decoy. This decoy is priced slightly below the Premium Plan to make it appear more attractive. The goal here is not to sell this plan, but to enhance the perceived value of the Premium Plan. For just a 14% increase in price compared to the Pro Plan, customers get significantly enhanced functionalities and services, making the Premium Plan appear as a high-value option. This setup persuades customers to see the Premium Plan as only marginally more expensive yet more valuable as it contains significantly more features.

Now we are going to look at the concept called “anchoring” where individuals give disproportionate weight to an initial piece of information (known as the "anchor") when making decisions.

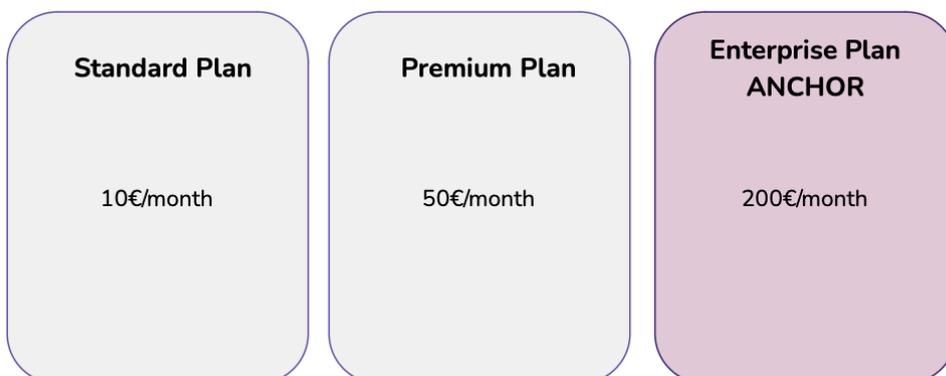
### **Anchoring**

- a cognitive bias where individuals give disproportionate weight to an initial piece of information (known as the "anchor") when making decisions.



Imagine you're entering a furniture store intending to purchase a chair, with a budget of approximately €90. Upon arrival, the first chair you see, Chair A, is priced at €100. This chair is slightly above your budget but falls within the price range you anticipated. However, your attention is quickly drawn to Chair B, which displays a striking price label. The original price of €280 is marked down to €100. This significant price reduction establishes a powerful anchor—it becomes the first significant and impactful piece of information that influences your decision-making process. Although both chairs are ultimately priced the same, the dramatic reduction from €280 makes Chair B appear as a far greater value. Consequently, influenced by this anchoring effect, you decide to buy Chair B, perceiving it as the better deal due to its initial higher price point.

Anchoring isn't just a phenomenon in physical retail but also applies in the realm of Software-as-a-Service. Let's see how we could design a pricing strategy utilizing this concept.



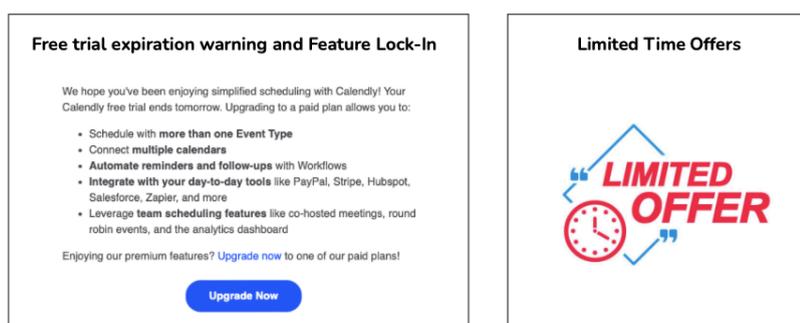
We introduce the Enterprise plan priced at 200€ per month. This plan isn't expected to be our bestseller; rather, it serves an essential function in setting a high price benchmark—the anchor for our pricing strategy. Adjacent to this high anchor, we offer more economically priced plans: the Standard and Premium, priced at 10€ and 50€ per month respectively. These plans are designed to be more accessible while still providing substantial value. The strategic use of the Enterprise plan as an anchor effectively shifts customer perceptions towards the Standard and Premium plans, significantly increasing their perceived value. As a result, these lower-priced options feel like smart choices, enhancing customer satisfaction and encouraging higher conversion rates.

### **Loss Aversion**

- *tendency to prefer avoiding losses over acquiring equivalent gains*

Another concept from behavioral economics is called Loss Aversion. It refers to people's tendency to prefer avoiding losses over acquiring equivalent gains. Loss Aversion is based on the observation that the emotional impact of losing something is typically more powerful than the joy of gaining something of similar value. In the SaaS industry, loss aversion can be cleverly applied to pricing and promotional strategies to encourage customers to commit to longer subscription periods or to upgrade their current plans.

Let's take a look at some applications:



- *Free Trial Expiration Warnings and Feature Lock-in*

Firstly, we discuss two closely related strategies used during free trials: Free Trial Expiration Warnings and Feature Lock-In. Firstly, we have expiration warnings. As the end of a free trial period approaches, companies send out reminder emails highlighting what users will lose if they do not upgrade to a paid plan. This could include loss of data and customizations made during the trial, or simply losing the ability to continue using the

product. Now, Feature Lock-In complements the expiration warnings. As the trial concludes, access to the critical features is restricted. The fear of losing these now-essential features significantly enhances the urge to convert from a free trial to a paid subscription.

- *Limited Time Offers*

Another strategy is introducing limited time offers where we create a sense of urgency that compels action. These offers are typically coupled with significant benefits, such as access to additional features or considerable discounts. The key aspect of these offers is their temporary nature — they are available only for a short period.

So we have covered several concepts from behavioral economics that influence customer's choices and improve conversions. In summary, the decoy effect helps steer customers toward preferred pricing tiers, anchoring sets a psychological price benchmark that makes other options look favorable, and loss aversion leverages on customers' stronger reactions to potential losses than gains. These techniques are not just about setting prices but about strategically shaping the customer experience to encourage deeper engagement and higher sales conversions.