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Pricing for Volatile Markets: Why scenario modelling works

By Tim Ham

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First, let's start with the good news: inflation is falling. Not only have we seen two months of marginal reductions, but the Bank of England expects inflation to drop sharply within the next six months and be close to its 2% target within two years' time.

The painful caveat, however, is that all this could change at the drop of a hat. The direction of the war in Ukraine is unclear, commodity prices are still extremely uncertain, and any number of what Donald Rumsfeld infamously referred to as 'unknown unknowns' could yet materialise to push inflation back to record levels.

This marks a pivotal moment for your business. Because if the market can change quickly, then so can the behaviour of your consumers and, most importantly, the strategy of your competitors. As conditions evolve, it can be easy to make a costly error in your response unless you have put the right planning in place.

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How to plan for a dynamic market

Six months ago, inflation was only going in one direction. While its impact has been horrendous, it was at least a bit more predictable. This meant many businesses' response was equally as easy to anticipate: Their costs were going up, so their prices followed.

Yet now we are starting to see deflationary pressures come into play. Commodity prices are going down, and in the context of the cost-of-living crisis, it could be very easy to get into a price war as you race your competitors back to the bottom.

Nobody wants to make a mistake. But that doesn't mean that doing nothing is an option. The question is: How do you plan a pricing strategy for such a volatile market? And more importantly, how do you avoid the knee-jerk reactions that could cost your company a lot more in the long term?

All too frequently I see companies under-pricing, over-discounting and delivering promotions that undermine their propositions. This reflects decision-making that is focused excessively on short term performance while neglecting to integrate competitor reactions into those decisions. But it is the nature of the planning process itself that leads to some considerations being neglected.

With the market as uncertain as it is, the biggest mistake many businesses will make is planning their prices based on a single prediction of how the year will unfold and placing too much focus on backward looking customer insights and price elasticities.

As comforting as it might be to take one view of your market, customers and competitors, the reality is that there are multiple possibilities for how each will change over the next 12 months.

That is why the most prudent thing you can do is plan your pricing strategy for different eventualities through scenario modelling.

Three questions. Three scenarios. Three plans.

It is impossible to anticipate every fluctuation in the market, but I would certainly suggest having a plan for three different scenarios: a pessimistic market outlook, an optimistic outlook and a neutral one.

Armed with three robust plans, you will find yourself less inclined to react rashly to changes in the market or your competition.

From working through the different strategies and the impact they will have on your pricing, to deciding the timing, communications and preparation required should changes be needed, scenario modelling can provide you with confidence to act rapidly as the market evolves.

We can examine the most likely changes that you need to plan for in each eventuality by asking three questions. Here, I've broken down the questions into nine separate variables that allow you to make a robust assessment of your pricing strategy.

1. What is the financial imperative?

2. How will your customers behave?

3. What is the competitive landscape?

1. What is the financial imperative?

Input costs:
In simple economic terms, what do you expect to happen to your input costs? Are they likely to follow the same inflationary pattern? We are seeing an evolution from commodity to wage-based inflation, and this creates heterogenous effects across companies.

Margins:
What impact will any changes in costs have on your margins? How will you need to adjust your pricing to ensure they don't get squashed? To what extent is there a short term imperative, or is there a need to weather the storm and plan on a longer term basis?

Brand position:
How would any price changes impact your long-term brand positioning within the market? It is often extremely difficult to change perception of your brand value if it is impacted by the wrong pricing strategy.

2. How will your customers behave?

Pricing expectations:
How would you define the nature and longevity of your customer relationships, and how does this impact their expectations on price? For example, if you're in a sector where spend is essential, customers are inevitably hit harder by price rises.

Price awareness and attitude:
To what extent is price a focus for your customers? Do they prioritise other factors such as quality or availability? What are the perceptions of what is fair with regards to pricing behaviours?

Price sensitivity:
How would you anticipate customer reaction to a price change? Are they likely to stop purchasing the product? Will they move to a competitor's product or downgrade to an own-brand label instead? The latter became increasingly common as inflation started to bite.

3. What is the competitive landscape?

Competition intensity:
To what extent is competition disaggregated in your market? This is important, because if it is concentrated then competitors will be more likely to respond in a predictable way to your own changes.

Competitors' strategy:
This is possibly the most difficult thing to anticipate, which can make it easy to ignore in favour of factors that are more easily quantified. But don't let the uncertainty put you off – consider their existing MO regarding promotions, whether they hold prices steady or opt for frequent changes, for example. Plan for three possibilities and work from there.

Competitors' reactivity:
If you do change your pricing strategy, how is your competition likely to respond? Historically, have they ignored your changes? Imitated them? Gone in the opposite direction?

Don't fail to prepare

When planning for three different outlooks, it can be tempting to simply choose the scenario you deem most likely and dedicate your entire thought process to this one eventuality. But it is important to give all three options the same quality planning time.

Mapping out each scenario means digging into the different variables with the right people, and that especially includes the people who understand your competition. A small team of experts is often more effective at scenario modelling than a room full of well-intentioned staff.

If your main competitor starts changing prices tomorrow, seeing that impact on short term performance could well set your nerves jangling. But if your experts have mapped out the consequences and found this strategy would have negative implications in the medium term, it may well stop you engaging in similarly over-competitive behaviour.

Uncertain market conditions can often result in hesitation when it comes to making big changes or investments. But just because you don't know which way the market will turn, that doesn't mean you can't plan to protect your value generation.

Scenario modelling of pricing moves can make all the difference to overcoming any inertia and allow you to be proactive even in the face of market volatility. And the earlier you start planning, the greater the likelihood that you will be able to make the right decisions when it changes direction again. It's important to remember your customers don't like uncertainty either, so for their sake and yours, the time to start is now.

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About Tim Ham

As CEO of the Pearson Ham Group, Tim has more than two decades of pricing expertise across a wide range of market sectors, including financial services, pharmaceuticals and retail. With an MBA from London Business School, Tim has a wealth of experience in helping clients improve every aspect of their pricing, including strategy, structure, capabilities, performance monitoring and level optimisation, as well as commercial model redesign, promotions and value communications.

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