Pricing

Watatreat

As marketing manager of Watatreat you are faced with two pricing problems for next year's marketing plan. The first concerns the worrying decline in sales of the company's main consumer product, the Clearwater. The other is the need to create a pricing policy for the new sophisticated filtration system, the Iceberg. This is the result of 3 years' detailed research and development, at a total cost of £0.6 million. It had been designed to service the growing demand for a product that could remove more complex and complicated compounds from consumer drinking water than had been previously possible.

Market trends

The Clearwater sold in a market sector dominated by five main products and six main retail groups, though independent outlets made up around 30 per cent of total volume. Over the last 2 years, sales revenues had declined from £837,000 to £760,000 with the following pattern of sales over the last 24 months - year January to December - in thousands of units: 25, 20, 25, 70, 80, 120, 180, 130, 110, 50, 15, 12; 30, 18, 47, 40, 85, 80, 120, 140, 120, 40, 20, 20.

The market sector had however grown over the last 2 years from an estimated £4.2 million at retail to £4.56 million in the last year and the decline in sales for Clearwater was accounted for by a substantial decline in market share. Market shares and (average market price) for the main brands over the last 2 years were as follows: Diamond: 10 (£21), 15 (£21), Crystal: 15 (£19), 15 (£20), Silent Spring: 20 (£17), 20 (£18), Flowmaster: 20 (£16), 20 (£17.5), Clearwater: 30 (£14.5), 25 (£16). It was evident that new market sector was starting to become established, the premium water treatment sector, occupied by systems that were capable of removing heavy metal contamination and pesticide residues. This was confirmed by the steady expansion of sales of West German products such as Gruft and Krypton. At retail, the market was still small, but had grown from £0.3 million last year to £0.5 million in the current. The market remained very segmented with a range of Japanese and American products selling in a variety of outlets. This market sector had become characterised by the fact that it was supplied through independent outlets that provided installation advice and support rather than the multiple channels that had characterised the development of the standard Clearwater model.

Clearwater position

The weighted market retail average price for the Clearwater sector had increased from 15.9, two years ago, to 17.4 last year, or nearly 9.5 per cent. Allowing for inflation, the market had not grown in the previous year, even though real increases in volume had been seen in the last 5 years. Price inflation in the water filter market during the previous 3 years were 5, 6, and 7 per cent respectively. The underlying rate of inflation forecast for the economy was 3.5 per cent and it was thought that disposable incomes were unlikely to rise significantly above 5 per cent.

The weighted market price for the sophisticated product was estimated to be around £85, though there were considerable fluctuations with prices ranging from £76 to £112. It appeared that prices were rising at about double the rate in the standard market in which Clearwater was established. Evidence from previous changes in the market suggested that prices would continue to rise at this rate for the next 2 to 3 years before stabilising at the overall inflation rate prevailing for the entire water treatment market.

Market evidence suggested that the Clearwater market was becoming more price sensitive. But there had been a decline in promotional expenditure by Watatreat accompanied by increases in investment by competitors. Overall promotional expenditure in the market was estimated to have been £400,000, £450,000, and £450,000 over the past 3 years, with Watatreat spending £100,000, £80,000, and £80,000 over the same period. The market was highly influenced by promotion with a 5 per cent advertising expenditure leading to a 7 per cent increase in sales, and 15 per cent to 12 sales improvement. All these figures assumed that the advertising expenditure was optimally spent. The draft marketing plan for Clearwater for the next year forecast an expenditure of £100,000, and though this could be changed, senior management were generally unwilling to see substantial increases in promotional expenditure because of the cash flow demands of the rest of the business, and the need to achieve the highest possible profit margin in the cash cow component of the consumer water filter sector.

Promotional expenditure in the sophisticated market had been negligible with the majority of effort being placed in public relations activity. It was thought that the sophisticated market was far less price sensitive than the standard, but there was insufficient market information to determine what the elasticity was. The launch plans for the Iceberg included £50,000 for promotion.

Some of the major outlets were also of the view that the competitive gap between Clearwater and the competition was widening and this would need to be reflected in the pricing of the product. When asked to rate quality of product, consumers had ranked Watatreat Clearwater at a higher level than in a previous survey. The research, with current findings and (previous findings in brackets) against an average of 100 are provided as follows: Diamond 112 (114), Crystal, 105 (105), Silent Spring 106 (104), Flowmaster, 103 (105), Clearwater 98, (92). Market surveys had also suggested that the new Iceberg had a substantial quality edge over the competition with a quality perception of 112 based on the market average of 100.

The distribution channels for water filters had changed over the years with multiple outlets gaining share against the independents. The trend over the past 3 years by percentage share, by store, was as follows: Bruckner 12, 12, 13; Copeland 13, 12, 12; Stockhausen 16, 15, 17; Nielsen 11, 11, 11; Corelli 9, 10, 11. The remainder of the market was supplied by independents. There was no price control operating in the market, though the majority of outlets tended to take their prices from the price leader, Stockhausen. Stockhausen had managed to increase its market share over the past 3 years by promoting heavily, an investment achieved by increases in retail prices accompanied by a steady widening of retail margins, up from the basic 33 per cent on gross - 50 per cent mark up on cost - that it had historically achieved on water filtration products. Though the average retail price had grown by 9.5 per cent, wholesale prices had only increased by 7.0 and this 2.5 per cent differential had been a feature of the market over the past 3 years. Watatreat appeared to be suffering particularly acutely from the discount activities of the major outlets, with a wholesale price to such outlets only increasing from 9.7 to 10.2 over the last year. The pattern for Iceberg was entirely different. As volumes in the specialist outlets went up, their margin demands had tended to decline from 60 to 55 per cent.

Given the importance of the multiple retailers, a steadily greater proportion of Clearwater's overall sales were achieved with the maximum volume discount - 10 per cent - with only 26 per cent of sales being achieved at a lower rate. It was likely that Iceberg would sell mostly with low rates of discount because of the distribution structure. It was anticipated that the average discount would only be 3 per cent across the current distribution system. Salesforce commission rates had however remained static over the past 5 years, averaging 2.5 per cent, and this would also be true of the likely Iceberg sales commission.

Physical distribution costs were based on the current use of third party road haulage companies, which quoted a flat rate of £0.80 delivery charge per unit. Company analysis suggested that the use of three delivery vehicles would cost around £100,000 for the next year, and both current and new products could be handled by the same delivery system. Warehousing policy would not need to change with the introduction of the new product range and total warehousing costs would be around £800,000 for the next year.

The marketing team was less sure however about inventory policy. They felt that the current levels of inventory were too high. Given that the economic order quantity for both products was 150, safety stock levels of 10,000 were too high. With internal financing costs at 20 per cent; overall finance costs were therefore substantial at those stock levels. In the current year, the company had not needed to invest in sales promotional activity, and this was likely to be the case in the next year, though contingency plans existed for a concentrated sales promotion campaign in late spring, should sales not come up to expectation. The budget set aside for this was £200,000. Salesforce structures would not change with the introduction of the new Iceberg range. The company would continue to employ five sales representatives, divided geographically. Costs for the current year were £300,000; historically salesforce costs had increased by inflation plus 3 per cent, and pricing would be based on this figure.

Order processing costs for the Clearwater lines were around £10,000. It was unlikely that these costs would increase with the introduction of the Iceberg range as new technology introduced during the last 3 years steadily decreased order processing costs. Variable production costs had shown the tendency to rise slowly over the last few years, though the overall rate had been slightly less than the underlying rate of national inflation. The 5 year raw material and component costs trends for Clearwater had been as follows: £1.6, 1.7, 1.9, 2.0, 2.0. Other variable costs had slightly declined as the company was able to manufacture products more cost effectively over time. It was anticipated that the variable costs for the Iceberg would be around £4.5. It was anticipated that once 100,000 units had been manufactured the cost would have declined to £4.0 with each additional 100,000 units lowering variable costs by £0.10.

The fixed cost environment for the entire consumer water treatment products manufactured by Watatreat had fallen over the last 3 years. The company had followed the policy of introducing flexible manufacturing systems which had reduced the overall space that the production line occupied. Fixed costs had declined over the last 2 years from £70,000 to £60,000.

Pricing objectives

Watatreat had for many years followed strategic objectives of margin maximisation. It also had a policy of attempting to achieve break even on new product developments within 3 years, based on a finance charge of 15 per cent on development costs.

Action

What pricing policy should you follow?