
Chapter 7

Pricing the offer

Chapter Objectives

After working through this chapter, you should be able to:

- Understand the significance of pricing in the pre-encounter mix
- Identify external and internal factors that influence pricing decisions
- Explain quality/pricing strategies in a hospitality context
- Understand pricing methods in hospitality organizations
- Describe the role of price promotions to increase revenue in low season periods
- Recognize the complexity of pricing in an international context.

Introduction

In this chapter, we will review the significance of pricing in the pre-encounter marketing mix and examine how companies set prices. We will then look at the external and internal factors that influence pricing decisions, and explain the pricing techniques that are especially relevant to hospitality organizations.

Pricing is the tool that matches supply and demand. Price influences the demand for a product, which in turn determines volume sales. Therefore, setting an appropriate price is one of the most critical factors in demand management and in generating revenue. Price is the only element of the marketing mix that is not a cost, because price generates revenue. Pricing decisions contribute to product and brand image, and product and pricing decisions are therefore inseparable.

Significance of pricing in the pre-encounter marketing mix

There is a clear link between the price a customer pays and the customer's quality expectations. The higher the price, the greater the expectations of a high quality hospitality experience. *Price is an indicator and a measure of quality, particularly in the absence of other cues.* If a high quality gourmet restaurant was routinely to offer cheap menus, or a five-star hotel was continually promoting budget holidays, customers would be confused and suspect that the product quality offered was not genuine. Price plays an important part in establishing customers' perceptions of a product and of a company's position in the marketplace. Over time, brands often become associated with particular value propositions, which become fixed in the consumers' perception of that brand. McDonald's brand values are firmly placed in the fast food, family, and lower spend position.

Although price is the easiest variable of the marketing mix to change, it is the most complex and least understood of the variables. In hospitality, short-term tactical price changes are often not consistent with strategic objectives, and can send out strong negative messages to consumers with damaging, long-term consequences. Price is:

the summation of all sacrifices made by a consumer in order to experience the benefits of a product.

This definition includes both financial and other sacrifices, such as time and effort. It is a broad definition, because monetary price is not the only consideration consumers have to think about when making purchase decisions. In many countries, some consumer groups are described as 'money rich and time poor'. These affluent consumers have busy lifestyles with limited time to enjoy discretionary purchases. 'Time is money' is an appropriate expression for these important target markets.

One of the first questions customers ask before booking a hotel or restaurant is 'how much is a room?' or 'how much is the price of a meal?' Although the reply will be given in money terms (and customers quite sensibly want to know if the room or meal is affordable), what they are really interested in is value, not price. Customer value is found in the relationship between costs incurred (cash, time, effort) and

benefits enjoyed (food, beverage, service, entertainment, atmosphere, experience). If costs rise without enhanced benefits for the customer, then value falls. If additional benefits can be included for the customer, without increasing price, then the customer enjoys better value.

An important distinction to recognize is that consumers' perception of the value/price of a product is strongly linked to their perception of the product concept. Product concepts are targeted at selected market segments with different needs and wants. Two very different product concepts are those that cater for special occasions and those that provide convenient solutions to consumers' everyday needs.

The price band for dinner at a luxury gourmet restaurant, a special occasion, is at the top end of most consumers' affordability, whilst the price band for a self-service meal, often a convenience purchase, is at a much lower price point. Consumers form expectations of what they will have to pay for a gourmet meal, and compare competing gourmet restaurant price/product offers. Equally, consumers choosing a self-service restaurant have price expectations of what to pay for a self-service meal, and compare competing self-service price/product offers.

Consumers tend not to compare the value/price offer between different product concepts; whereas they do compare the value/price offer within the same and adjacent product classes. In most cases, branded hotels are able to charge a higher price than independently owned, non-chain hotels. Consumers seem to be prepared to pay more to stay in a branded hotel, which guarantees a familiar product standard, rather than risk staying in an unknown, non-branded hotel.

Activity 7.1

- Contact hotels in the same competitor set in a city or town you know, and establish the prices for a room in each hotel for the same night.
- Evaluate the reasons why hotels in the same product class charge different prices. For example, normally the branded hotels will charge a higher rate than similar standard independents – but a prime location carries a price premium.

Stages in setting prices

Kotler (2000) proposed a generic pricing model that recommends eight stages in setting prices:

- 1 Select pricing objectives
- 2 Assess the target market's ability to afford the purchase price and consumers' perception of the price/product offer
- 3 Determine the potential demand, including the price elasticity of demand
- 4 Analyze the demand, cost, volume, price and profit relationships; businesses need to understand their fixed and variable costs
- 5 Research competitors' price/product offer
- 6 Select a pricing strategy

- 7 Select appropriate pricing methods
- 8 Set specific prices for rooms, food, beverages, conference and leisure products, and for special product-price bundles.

This approach requires a considerable amount of consumer, competitor and internal company research. Major companies are in a position to adopt this approach. One example is the large tour operators, who monitor their unsold capacity and competitors' prices on-line on a daily basis and alter their pricing schedule up or down accordingly.

The managers of smaller hospitality companies adopt a much simpler approach to setting prices, based upon a combination of historical factors and the current economic situation. The process of setting prices might be as follows:

- 1 Review last season/year's prices and business performance
- 2 Review current and potential cost increases.
- 3 Take into account current and forecast inflation
- 4 Take into account the general economic situation, and factors likely to influence customers' attitudes to prices
- 5 Check competitors' current prices
- 6 Set prices by adding a percentage (for example, 5 percent on the tariff of each room price) or a fixed amount (add £1 to each *à la carte* menu item) onto the current prices.

Marketing-orientated managers will try to find out what competitors are intending to charge next year, before setting their own prices. Although this process is flawed, managers of smaller businesses set prices using the historic price, plus or minus a sum, because it is simple and easy to adopt.

Factors influencing pricing decisions

Factors that influence price decisions can be sorted in to two major categories (Kotler, 2000):

- 1 External environmental factors, over which companies have little (if any) control
- 2 Internal factors, over which companies have a considerable amount of control.

External factors

The outer circle of Figure 7.1 illustrates five of the environmental variables that impact on pricing decisions – demand, inflation, industry structure, competition, and legal/regulatory factors.

Demand

We discussed the drivers of demand in detail in Chapter 3. In this section, we will review price elasticity, business and consumer confidence, exchange rates and the micro-environment within the context of pricing.

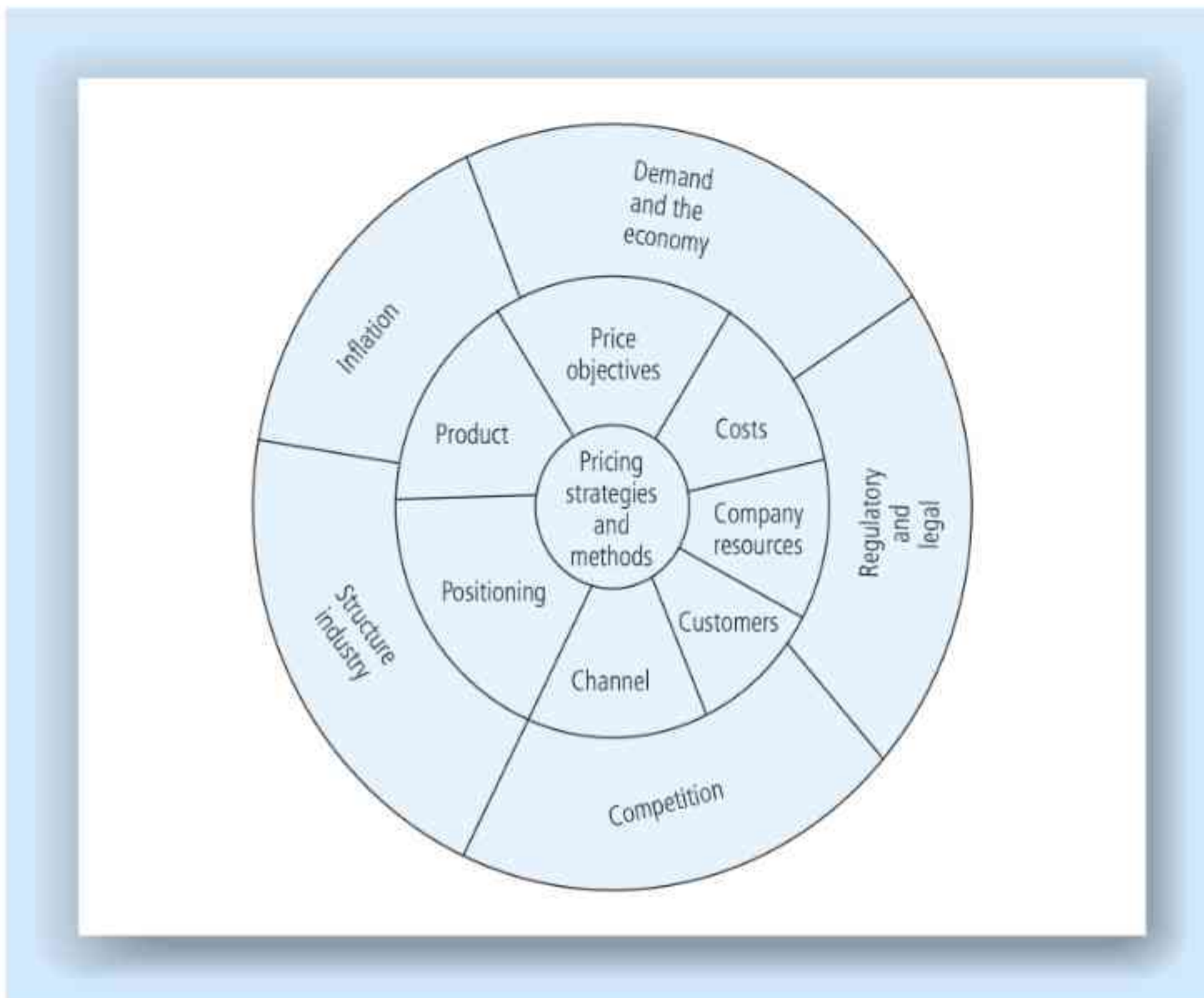


Figure 7.1 Factors that influence pricing decisions

Price elasticity of demand Understanding the price elasticity of demand is essential to making good pricing decisions. The sales volume of a product that has *inelastic* price demand does not vary significantly when price changes. In hospitality, the business market for accommodation is traditionally considered to be more price-inelastic in its demand schedule. Conversely, the sales volume of a product that has an *elastic* price demand varies significantly when prices change. Traditionally, leisure products are considered to be more price-elastic in their demand schedule because they are discretionary purchases. A simple way to understand the price elasticity of demand is to consider essential purchases as being price-inelastic, and non-essential purchases as being more price-elastic. The price elasticity for generic products can change over the long term, as products that were originally considered to be 'non-essential' become an 'essential' part of consumers' lifestyle. For example, many consumers now regard holidays abroad as an essential purchase.

Business and consumer confidence We have already discussed the business cycle and its impact on business and consumer confidence. During periods of economic growth, there is rising confidence and less price-sensitivity from business and consumers. This means there is less resistance to price increases. However, during a recession, the loss of business and consumer confidence significantly reduces demand. Both corporate and individual consumers become much more price-sensitive, and there is resistance to price increases – indeed, customers will expect price discounts.

Inflation Inflation is the rise in the average price of goods and services, measured over a period of time. Different countries have different rates of inflation; developing countries generally experience a higher rate of inflation than more developed countries. In countries with high inflation rates, like Argentina, international markets are quoted room prices in American dollars. A country's domestic inflation rate impacts on the entire national economy and affects businesses and consumers. Companies have to factor the rate of inflation into their pricing policies.

Exchange rates Exchange rate fluctuations present unique pricing difficulties for hospitality operators catering for international group markets, as contracts between hotels and tour operators can be negotiated eighteen months in advance of customers actually taking a package holiday. Factoring exchange rate movements into the pricing contract, with possible surcharges if the rate moves unfavorably against the hotel, is essential – but unpopular with customers.

Micro-environment Micro-demand is dependent upon the local characteristics of the area – the number, scale and buoyancy of local manufacturing and service industries; the image and appeal of local tourism amenities; and the density, wealth and purchasing characteristics of the local population. All of these factors will influence both group-owned and independent units within the area. Typically, most of the businesses in an area with buoyant demand will be prospering, whilst businesses in an area suffering from poor demand will generally all be suffering. Popular destinations can charge higher prices, and less popular destinations use pricing to attract price-sensitive markets.

Type and structure of industry

Structural factors that influence the pricing dynamics in hospitality sectors include the cost structure, number of players, and capacity of the industry.

Cost structure Different hospitality sectors have different cost structures, which impact on pricing policies. A five-star luxury hotel requires a high investment in the building, décor, facilities and staffing ratios compared to budget hotels constructed with pre-fabricated standardized bedrooms, in secondary locations, offering minimal staffing levels and no ancillary facilities. The pricing policies of the five-star hotel sector must reflect the higher investment and operating costs, whilst the pricing policies of the budget sector should reflect the lower investment and operating costs.

The sourcing of produce in remote destinations increases the cost structure – for example, hotels in the Seychelles have to fly in food produce that is not available locally, increasing food costs significantly.

Number of players If the sector is highly concentrated and dominated by a small number of very large players, the sector's overall profitability is dependent upon players *not* adopting price competition to gain market share. The impact of genuine price competition results in all players cutting their prices to prevent a loss of market share, thus leading to erosion of the sector's profitability. In this case, competition should be based on product differentiation rather than price. The rivalry between McDonald's and Burger King in the fast-food sector is primarily based on product differentiation, not price.

Where there are a large number of players, and no firms are dominant, the opportunity for players to adopt different pricing strategies is greater.

Capacity Given sufficient demand, limited capacity will enable firms to charge higher prices; while sectors with lower demand and 'over-capacity' will suffer from intense price competition. Because of the relatively low start-up costs, the restaurant market also suffers from excess capacity and remains intensely price competitive.

Competition

In Chapter 4, we discussed the 'five forces' model driving industry competition. If the competitive environment is benign and the intensity of rivalry gentlemanly, industry pricing policies should enhance profitability. However, if the competitive environment is fierce and the intensity of rivalry bitter; industry pricing policies can adversely affect profitability.

Legal/regulatory

National government taxation policies, like Value Added Tax (VAT), tourist taxes levied by a charge on letting bedrooms and excise duties imposed on alcoholic beverages, impact on the prices charged by the hospitality industry. Since each country sets its own taxation policies, companies operating in countries with lower taxation policies can gain a competitive advantage over companies operating in higher-taxed countries.

Governments can impose regulations on companies, which increase the costs of running a business. For example, the European Union directives on minimum wages, health and safety have forced hospitality companies to introduce new work practices and equipment/maintenance schedules, which has often led to companies having to increase prices to help pay for these regulations.

Internal factors

The inner circle in Figure 7.1 shows seven internal factors that affect the pricing decision: pricing objectives, costs, company resources, positioning, customers, product, and channel.

Pricing objectives

Price objectives are dependent upon marketing objectives, which in turn are dependent upon corporate objectives. Organizations often have long-term strategic price objectives, and short-term tactical price objectives; crucially, pricing objectives need to be consistent with the objectives of the other elements of the marketing mix. Pricing objectives should be SMART – Specific, Measurable, Achievable, Realistic, and within a set Timetable.

Pricing decisions are linked to the financial and marketing planning process of setting sales, cost and profit budgets. In some instances, the corporate objectives very clearly dictate pricing objectives – a corporate objective to maximize profits in the short term leads to a marketing objective of setting prices designed to maximize current cash flow, regardless of the type or suitability of the sales generated. Pricing objectives can be classified into the following categories: marketing-orientated, financial-orientated, and competitor-orientated.

Marketing-orientated pricing objectives Marketing-orientated organizations try to understand how price influences customers' perception of their product offer, and develop pricing objectives using a customer's perspective.

Market leaders in high quality hospitality markets, such as luxury hotels, gourmet restaurants, first-class travel providers and luxury cruise ships, adopt a 'prestige' or premium pricing objective (that is, to charge the highest prices for the highest quality service), and must ensure that the customer perception of their service matches the premium prices charged.

Hospitality operators adopting the 'best value for money' objective in a given product class monitor customers' perception of their product value, scanning competitors' price activity and ensuring that their offer delivers the best perceived value for money.

Another marketing-orientated pricing objective is to encourage trial or repeat purchases. When launching a new hospitality concept, marketers need to generate interest in the new venture, and one of the tools used is a free sample or discounted trial purchase. Repeat visits can be encouraged using price promotions.

Unfortunately, hospitality companies seldom commission in-depth psychological research regarding customers' perceptions of their product/price offer and are therefore rarely able to set optimum prices that are acceptable to customers whilst delivering the maximum contribution to the company.

Financial-orientated pricing objectives The majority of for-profit hospitality organizations focus on financial objectives rather than marketing-orientated objectives.

Profit-orientated pricing objectives focus on the company's profit requirements and include survival, target return on investment, skimming, optimal current profit and harvesting. Profit-orientated pricing objectives are effective for setting management performance targets, but typically fail to take in to account the external environment, competitor and customer factors. A typical profit-orientated pricing objective would be: 'to set prices to achieve a 15 percent return on investment, per annum, over a five-year period'.

Marketing insight

Profit-orientated Pricing Objectives (Source: Kotler, 2000)

- *Survival*. A company fighting for survival, e.g. during a recession, adopts short-term low prices, designed to attract value-sensitive customers. These prices are justified on the grounds that even a small contribution to fixed costs is better than none. Generating cash flow is critical to servicing high finance and labor costs. This pricing objective could have serious consequences for competitors, who not only lose market share but could also be forced in to financial difficulties as a result of the price competition.
- *Target Return on Investment (ROI)*. The selected ROI depends upon the type, scale and risk of the investment; the rate of inflation; and the company's internal minimum ROI policy. Prices are calculated to ensure that the ROI is achieved. If the initial investment needs to be repaid within a short time period, the pricing policy must also be set to achieve a rapid payback of the capital invested.
- *Skimming*. The objective of a skimming pricing policy is to charge the highest possible price at the launch of a new product, to maximize the contribution from price-insensitive customers. This objective is quite commonly employed for manufactured goods but is rarely used by hospitality companies, who tend to operate in markets with well-established price bands.

- *Optimal current profit.* In the mature stage of the market/product life cycle, companies generally seek to optimize their profit by setting prices that are consistent with maintaining market share. In mature markets it is difficult to charge higher prices, because customers have well-established price expectations.
 - *Harvesting.* In the late maturity or decline stage of the market/product life cycle corporations can 'milk' a product by using the profit generated as a source of cash for investment in an alternative product that has greater growth potential. This requires a pricing policy designed to protect market share whilst maximizing the cash contribution of the product.
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Sales-orientated pricing objectives focus on maximizing sales, market share and volume. A typical sales-orientated pricing objective would be: 'to set prices to achieve a 20 percent market share within two years'.

Sales-orientated Pricing Objectives (Source: Kotler, 2000)

Marketing insight

- *Maximizing sales revenues.* Firms with well-defined, highly differentiated market positions may be able to maximize sales revenue by managing prices upwards. For this to be possible, the business must have strong demand. Firms that are not market leaders and suffer from inconsistent demand flex prices with a view to increasing sales revenues.
 - *Market share.* Larger corporations measure their performance not simply in terms of capacity filled, but also in terms of market share. Hotels and resorts, and newly opened restaurants/bars, urgently need to develop sales. Unless the location and offer is unique, this is normally achieved by attracting competitors' customers. Pricing objectives to build market share quickly, a strategy known as penetration pricing, include a special offer encouraging potential customers to trial purchase.
 - *Volume.* Key intermediaries, such as major tour companies, booking agents and high-volume customers, are able to negotiate large discounts from larger hotel companies for a guaranteed sales volume. This negotiation can be one of the most crucial pricing decisions affecting the hotel's profitability for that period.
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Cost-orientated pricing objectives involve setting a target cost/profit margin, and calculating the cost and selling price of each item in order to provide the required margin. This pricing method is typically used in catering operations, where the management will agree the food/bar operating margins. Although cost-orientated objectives are widely used in hospitality operations, they fail to take in to account external competitor and customer factors. A typical cost-orientated pricing objective would be: 'to set restaurant prices to achieve a food operating cost of 30 percent during the financial period from April to September'.

Competitor-orientated pricing objectives It is easy for hospitality companies to find out competitors' published and quoted prices; and many do. Competitors' prices establish a benchmark and range for players in the same and in neighboring product classes. When competitors' prices change, market followers will simply move their prices up or down in line with them to maintain the same price differential as before. The problem with this 'me-too', follow-the-leader strategy is that the cost base of competitors might be very different, and the policy does not take in to account what customers might be prepared to pay.

Activity 7.2

Compare the menu prices of two fast-food restaurants and two fine-dining restaurants.

- Identify the similarities and differences in pricing between the two fast-food menus.
- Identify the similarities and differences in pricing between the two fine-dining menus.
- Can you find examples of product/price bundling, price-led promotions and prestige pricing?

Costs

A major input into the pricing decision is the cost of producing and marketing the product. Marketers need to understand the nature of the costs in hospitality products (Harris and James, 1999). *Fixed costs* do not vary with sales volume – examples include rent, property taxes, salaries of permanent staff, insurance, and depreciation. In some companies, bank interest and loan repayments are considered to be fixed costs. The key feature of fixed costs, given the seasonality of hospitality products, is that they do not vary and must be paid on a regular monthly or quarterly basis.

Variable costs vary in proportion to sales – examples include food and beverage purchases, and laundry usage. *Semi-fixed costs* vary in sympathy with, but not in proportion to, sales volume – examples include energy costs (light, heat, air-conditioning and cooking) and part-time wages.

In hospitality businesses, a high proportion of costs are fixed or semi-fixed. This is partly due to the high level of capital invested in buildings, equipment and refurbishment. Although the total capital investment is usually smaller in catering establishments, the predominance of fixed assets is similar.

There are several difficulties associated with the incorporation of cost considerations into pricing decisions. Cost-based pricing techniques are essentially retrospective – that is, prices tend to be based on costs that are known because they have already been incurred. Yet companies need to recover future costs, which may be quite different. Most companies do not try to apportion indirect costs, but assess departmental performance on a gross profit or contribution basis.

Whatever prices are set, they must recover the long-term total costs of being in business. In the short term, however, companies can use marginal costs to set prices. The *marginal cost* is the cost to the company of making the last sale – for example, letting the last room. If a room is unoccupied there is no margin earned; if the room is occupied at any rate above the marginal cost, there is a contribution to fixed costs.

Company resources

The size and financial assets of a company influence the pricing decision. International hospitality companies operating with strong brands in many countries have easy access to a variety of capital markets, and develop a strong resource base. They enjoy economies of scale and better purchasing, which reduces operating costs and improves profitability. Larger companies have more business experience, and can afford to experiment with different pricing policies in selected outlets. They can also tolerate short-term losses during the launch of a new product concept and, if the product concept fails, they can afford to write the investment off and learn from the experience.

Single-unit, privately owned operations do not have significant financial resources, and a single pricing error can seriously (perhaps even fatally) damage a smaller business.

Positioning

Prices must accurately reflect the property's desired position, be consistent across the range of products offered, and match the target market's expectation of quality and value. The relationship between the price and the product quality is symbiotic, in that the price charged has to cover costs, generate company profits and reflect the positioning strategy. In planning new hospitality concepts, the price the target markets are prepared to pay is a key determinant in the sales volume/cost/profit relationship, and helps to shape the product format.

Distribution channel

When setting prices, hospitality operators must understand their channels of distribution and factor in the costs of intermediaries. The minimum commission paid to travel agents is 8 percent and the norm is 10 percent, but on certain products (for example, weekend leisure breaks) the commission can rise up to 30 percent. The transaction charges of computerized reservation systems and credit card payments incur additional costs, which the business has to cover. Credit card commission can vary from less than 1 percent for major international companies to over 5 percent for smaller operators.

Customers

Customers' response to pricing, and changes in prices, is complex. Customers not only judge the total bill in determining whether they have enjoyed value for money, but may also focus upon its component parts. High individual drink prices can generate dissatisfaction, even when the overall bill is regarded favorably. As part of an effective positioning strategy, we should emphasize the dangers inherent in mixing incompatible market segments. In attempting to maximize sales, hospitality marketers' use of discounted prices can attract and encourage the 'wrong' type of customers.

Product

Characteristics of the hospitality product that influence pricing policy include the product class, the stage in the product life cycle, the production process, and the level of people-skills involved in producing the product. Different classes of hospitality products are sold within different price brackets, which determine the boundaries for setting prices.

Pricing strategies

Having established the price objectives, hospitality companies need to consider pricing strategies, which must be linked to the quality standards offered by the operation. In hotels, consumers often associate star ratings with quality standards. Alternative pricing strategies include the market leader and market follower options but there are also unsustainable pricing strategies, which are ultimately self-defeating.

Market leader strategies

Well-established hotel companies, with a loyal customer base and a strong brand image, can adopt *market leader strategies* where the prices are aligned with service quality. These strategies are suitable for:

- The most exclusive, luxurious, 5-star hotels in the world; they deliver the highest quality customer experience, and can justify charging premium and prestige prices
- Traditional 3 star, well maintained hotels, in good locations and with a high level of loyal customers and repeat business, offering appropriate value for money and competing effectively with a mid-market pricing strategy
- Budget hotels and motels charging relatively low prices for a product offering fewer facilities and delivering value for money.

Market follower strategies

New entrants and less established hotel brands, seeking to build market share by penetration pricing, adopt a *market follower strategy*. A market follower strategy offers similar quality but pitches prices lower than the market leader in order to be more competitive, attract customers and grow market share. These strategies are suitable for:

- High quality 4/5 star properties, seeking to grow market share by exceptional value pricing
- Mid-market hotels competing against more established properties; or aggressive chains, and individual properties, seeking to increase room occupancy and build market share by offering exceptional value pricing.

Unsustainable strategies

Unfortunately, some hotels implement *over-priced* strategies, which are unsustainable as a long-term proposition. These companies charge rates higher than the quality

can justify. Some of these hotels might have myopic management who unknowingly have become over-priced. As customers recognize the poor value for money, the reputation of the business will rightly suffer. Either the company will have to adopt a more appropriate balanced strategy, or be forced in to either selling or liquidating the business.

- Old-established, grand 3/4 star hotels, which are no longer as luxurious as they used to be, and whose facilities no longer match the price charged; these properties are trading on an historic image as they gradually decline; they will eventually either have to re-invest in their facilities or reduce their prices
- Once glorious, now shabby hotels, possibly in good locations, which only generate passing trade and charging high prices; this rip-off value will lead to a poor reputation, and limited – if any – repeat and recommended business
- Mid-market hotels with falling standards but still maintaining a medium pricing strategy, which does not represent value for money
- Budget operations, which have gradually increased prices to pay for ‘amenity creep’ items, and are no longer competitively priced.

Finally, some hotels can adopt an unsustainable price/quality strategy, where the price offered is too low to support the product/quality offer indefinitely.

- High-quality 4/5 star properties charging unsustainable prices either because of low season or due to a decline in the destination’s popularity
- Mid-market hotels operating in highly competitive environments and offering budget hotel prices without reducing quality standards.

Companies need to adopt a pricing strategy, which takes into account their relative quality compared to the competition. Table 7.1 provides several examples of hospitality products combined with price objectives, strategies and tactics.

Pricing methods

The next aspect of pricing is to review how prices are calculated in the hospitality industry. Pricing methods can be classified under similar headings to pricing objectives: cost-led, profit-led, competition-led and marketing-led. Here is a summary of the main features of each pricing method, which is then followed by a more detailed discussion.

- *Market-led* – the highest price that customers are willing to pay; considers the competition, demand and profitability, and sets the ceiling for prices
- *Competitor-led* – prices simply follow competitors; fails to take in to account customers’ willingness to pay, return on investment goals, and company costs
- *Profit-led* – return on investment target provides internal goals to motivate managers; fails to take in to account customers and competitors
- *Cost-led* – cost-based is the lowest pricing level that a company can charge to remain viable; fails to take in to account customers’ willingness to pay and return on investment goals; sets the floor for prices.

Table 7.1 Examples of Hospitality Price Objectives, Strategies and Tactics

<i>Price objective category</i>	<i>Hospitality product</i>	<i>Price objective</i>	<i>Price strategy</i>	<i>Price method and pricing tactics</i>
Customer – prestige	Five-star international luxury hotel	To charge the premium price for the highest product quality in order to maintain a prestige price positioning offer for the next five years	Monitor customers' perceptions of value for money Monitor local and international competitors' product/service/price offer Introduce innovations and improvements to maintain the product quality, whilst always charging premium prices	Carry out regular customer and consumer marketing research via focus groups to establish price image and value for money Scan international hospitality trade magazines to find out about competitor innovations Visit new-build and recently refurbished competitors; evaluate innovations and develop detailed plans to improve product/service constantly Check competitors' prices regularly
Customer – trial purchase	Health and leisure club	To set a special offer price that will encourage 100 trial purchases of club membership in March	Research existing and potential club members' attitudes to price-sensitivity towards health and leisure clubs to identify price points	Identify most cost-effective method of reaching consumers Draft questionnaire and run pilot study; adapt questionnaire and carry out main study Analyze results and set special price offer; test price offer and promotional material with focus groups Fix price of special offer and launch promotion Monitor results of promotion
Financial – volume	International 500-bedroom four-star gateway hotel	To win a 60-rooms-per-night contract for six months from April to September, from a major airline company, at a rate of \$125 per room per night	Research current and potential demand for aircrew room-nights Research existing and potential hotel supply to major airlines	Identify major airline operators and their number of flights requiring overnight stopovers for crew, number of crew per flight, length of stopover Visit competitor hotels to establish which competitors are catering for which airlines

Evaluate contract aircrew room rates
 Develop a good rapport with airline

Establish competitor rates and estimate discount offered to airline companies
 Prepare discount rate and confirm with general manager
 Contact airline purchasing departments and request opportunity to quote for business
 Negotiate competitive market-orientated rates

Scan environment for potential increases in inflation, consumer demand and hotel room supply during the next eighteen months
 Review historic and current trading performance
 Set price increases

Carry out detailed research into local and national economy to evaluate forecast industry and general inflation
 Identify potential market demand during period, including seasonal variations
 Research competitor prices and any additional accommodation supply
 Identify volume (number of bednights) and value (achieved room rate) of each market segment
 Set room rates to guarantee 5 percent increase across total room revenue

Utilize a computerized stock-control system to set and monitor bar and food costs and prices to ensure that the target is achieved

Carry out a monthly bar and food computerized stock check on all items' purchase and selling prices
 Monitor the sales mix and ensure that high-volume food and drinks are achieving their required target profit margin

Monitor competitor price movements and adjust room prices accordingly

Telephone competitor hotels on a monthly basis to check on current room rates
 Adapt own hotel's prices accordingly

Evaluate contract aircrew room rates
 Develop a good rapport with airline

Scan environment for potential increases in inflation, consumer demand and hotel room supply during the next eighteen months
 Review historic and current trading performance
 Set price increases

Utilize a computerized stock-control system to set and monitor bar and food costs and prices to ensure that the target is achieved

Monitor competitor price movements and adjust room prices accordingly

To increase room sales revenue by 5 percent above inflation, for the twelve-month period from October to September

60-bedroom provincial mid-market city hotel

Financial – sales target

To achieve a bar cost of 35 percent for the next financial year
 To achieve a food cost of 30 percent for the next financial year

Nightclub bar and restaurant

Financial – cost-led

To undercut the mid-market price leader by 10 percent on all bedroom rack rates during the high season

Three-star resort hotel

Competitor – price followership

Cost-led pricing methods

Break-even analysis

The purpose of break-even analysis is to enable management to calculate various cost, volume and profit scenarios to make appropriate pricing decisions. To work out the break-even point (the price at which sales revenues equal total costs and no profit or loss is made) the following information is required: fixed costs (FC) and variable costs (VC). Total costs (TC) are the sum of fixed costs plus total variable costs (variable costs per unit multiplied by the number of units produced). Therefore:

$$TC = FC + VC$$

Break-even analysis is useful in working out profit/loss projections for specific events, weddings, outside catering functions, and corporate hospitality at sporting occasions, when demand is established and fixed and variable costs can be easily calculated.

Cost-plus

Cost-plus pricing sets the selling price of a product based on the cost of production, plus a share of the company's overheads, plus a set percentage profit margin. Most food and beverage outlets utilize a form of cost-based pricing, which is called cost percentage pricing, factor pricing, or mark-up pricing.

The following equation explains cost-based pricing:

$$P = C + f(C)$$

where P = price, C = cost, f = percentage mark up.

For example, the cost of a bottle of wine is £2.00. If the company has a mark-up policy of 300 percent of the cost price, to provide a 25 percent cost margin and a 75 percent profit margin, then the selling price of £8.00 is calculated thus:

$$P = 2.00 + 300\%(2.00) = £8.00$$

Table 7.2 provides a range of possible selling prices for the bottle of wine, depending upon the company's target cost/profit margin. The advantages of using cost-plus pricing are as follows:

- The selling price is based on factual costings
- Management judgment is not required; the calculations are easily computed
- It is the most simple pricing method to implement
- Similar costs for outlets within the same product category should follow similar pricing policies, thus avoiding competition based on price alone

Table 7.2 Cost-plus Pricing

Cost (C) (Purchase price) (£)	Mark-up (f(C)) (%)	Selling price (P) (£)	Cost (% margin)	Profit (% margin)
2.00	50	3.00	66.6	33.4
2.00	100	4.00	50	50
2.00	150	5.00	40	60
2.00	200	6.00	33.4	66.6

- It helps management to forecast costs, and can be used as a control mechanism to monitor performance.

The disadvantages include the following:

- It ignores the price elasticity of demand
- It ignores consumer perceptions of quality and may produce prices that are inconsistent with market positioning and desired company image
- It fails to consider competitors' prices
- When purchase prices increase, selling prices may be increased without taking into account alternative options (changing the supplier or changing the recipe and ingredients), thereby alienating loyal customers.

Fixed mark-up

An unusual pricing feature of some restaurant wine lists is a standard (or fixed) mark-up, regardless of the cost of the wine. For example, a restaurant charges \$10 for a house wine that costs \$3. Instead of aiming for a 30 percent bar cost, the management aims for a \$7 profit per bottle of wine sold. Therefore, a wine costing \$10 will be sold for \$17 (giving a wine cost of 58 percent), and a wine costing \$20 will be sold for \$27 (giving a wine cost of 74 percent). The argument in favor of this pricing policy is to encourage repeat and recommended customers by providing exceptional value on more expensive wines. The problem with this pricing method is that it ignores the financial and storage costs of acquiring and keeping high quality wines.

Profit-led pricing method

Rate of return

Historically, American and European hoteliers used to adopt a \$- or £-per-thousand pricing method to ensure that the target return on investment was achieved. The target average achieved room rate was calculated on the basis of the total capital invested in the building project – if a 100-bedroom hotel cost \$10 million to build, then the total cost per room would be \$100,000 and the average achieved room rate required might be \$100. Today investors' calculations on the ROI are much more complex, but rate of return (ROR) pricing techniques are still important in helping to determine the feasibility of a project. The goal of ROR pricing is to find a price structure that provides the required return on investment. To apply the ROR method:

- Estimate the capital required for the project
- Set a target rate of return
- Calculate the volume of sales required to generate the profit target.

For example, a company invests \$20 million in a resort development. Given a target ROR of 20 percent, the profit required from the venture is \$4 million each year. The question now becomes: what volume of sales is needed to produce a net profit of \$4 million? If the company operates in a market where a net profit on sales of 10 percent is the norm, then it is evident that sales revenues of \$40 million are required ($\$4,000,000 \times 0.10$). Now, the task for marketing managers is to select a sales mix (total sales from room yield, meetings, food and beverage, leisure) and pricing policies that can generate the \$40 million sales revenue and \$4 million profit.

Management produces spreadsheet estimates, based on different sales mixes and sales volumes, taking into account the patterns of fixed and variable costs for each sales mix, and the pricing sensitivity of selected target markets. If a particular sales mix does not achieve the required ROR, there are several options available: adjust the sales mix to emphasize high margin products; seek savings in variable costs; seek savings in fixed costs; adjust the price mix across the product range; or even reduce the target ROR.

Competition-led pricing method

Price followership is the pricing strategy based on competition-orientated objectives so prices do not change until the competitor makes the first move. The manager then responds to maintain the price differential, which may be set in currency or percentage terms. The bed-and-breakfast houses located adjacent to each other on the Victorian terraced streets of English seaside towns like Blackpool watch each other's prices closely. If one reduces its price, the others will quickly reduce their prices to ensure they do not lose customers. The bed-and-breakfast house owners will also be reluctant to increase the prices, but if a market leader is able to raise its prices, the other owners will increase their prices too.

Marketing-led pricing methods

Yield management

Hospitality companies have learnt from the computerized reservation systems developed by the airline industry, and seek to maximize their potential revenue by using price as a demand management tool. Known as yield management, this is a complex form of price discrimination used in larger properties to help maximize REVPAR (revenue per available room). Because of the focus on sales, yield management is also known as revenue management. Room yield is the ratio, given as a percentage, between the actual room sales revenues and the total potential room sales revenues during a given period.

The formula to calculate yield is:

$$\frac{\text{Revenue raised}}{\text{Revenue potential}} \times 100$$

To calculate a property's yield ratio, the following information is required:

- Period of time (day, number of days, week, month, quarter, year)
- Number of rooms, room types and room rates
- Potential room revenue
- Rooms sold
- Achieved room rate.

The revenue realized is the number of rooms sold, multiplied by the achieved room rate. The potential room revenue is:

All room types \times number of rooms in each room type \times each room type's rack rate

Table 7.3 Simple Yield Management Calculation

Period	One day		
Rooms sold	200 rooms \times 95% occupancy = 190 rooms sold		
Revenue realized	Rooms sold \times achieved room rate = 190 \times £90 = £17,100		
<i>Room type</i>	<i>Number of rooms</i>	<i>Rate (£)</i>	<i>Potential room rate (£)</i>
Executive suites	20	200	4,000
Executive doubles	40	150	6,000
Standard doubles	40	120	4,800
Standard singles	100	100	10,000
Total potential revenue			24,800
Yield	(Revenue realized/revenue potential) \times 100 = (17,100/24,800) \times 100 = 68.95%		

The example in Table 7.3, using a 200-bedroom hotel operating at 95 percent occupancy with an achieved room rate of £90, for one day, will help to illustrate the method.

If the hotel illustrated in Table 7.3 decided to improve its yield by sacrificing 5 percent of its occupancy in order to increase the achieved room rate to £110, the yield calculations would be:

Period	One day		
Rooms sold	200 rooms \times 90% occupancy = 180 rooms sold		
Revenue realized	Rooms sold \times achieved room rate = 180 \times £110 = £19,800		
Yield	(Revenue realized/revenue potential) \times 100 = (19,800/24,800) \times 100 = 79.84%		

Yield management systems are normally found in hotels with at least 75 bedrooms and which have computerized reservation systems (CRS) and/or computerized property management systems (PMS). Sophisticated software programs have been developed to calculate the complex data, which compute the recommended prices quoted to customers. A minimum of three years' historic information needs to be inputted into the program to obtain an accurate projection. Table 7.4 demonstrates an example of the booking pattern in a hotel during the five months prior to 10 March. The historic room occupancy range, current state of reservations at the beginning of each month, and the yield management system's recommended rates are recorded. Table 7.5 provides details of the booking lead times and price-sensitivity of key hotel market segments.

Advantages of yield management Yield management is a marketing tool designed to tackle the problems caused by the special characteristics of service industries. Hoteliers have always recognized that it is better to sell a room at a low

Table 7.4 Example of a Yield Management System

<i>Time prior to booking date</i>	<i>Historic room occupancy range (%)</i>	<i>Current reservations (%)</i>	<i>Recommended rate (£)</i>
1 November	20–30	22	90
1 December	35	29	85
1 January	55	60	95
1 February	75	72	98
1 March	85	86	110
9 March	94	98	115
10 March	96	97	110

Table 7.5 Price Characteristics of Hotel Market Segments

<i>Market segment</i>	<i>Booking lead time</i>	<i>Price sensitivity</i>
International conference	5+ years	Low
National conference	2–3 years	Low
Major company conference	6 months–1 year	Low/medium
Leisure tour group	3–18 months	High
Individual leisure (FIT)	1 week–12 months	High
Small business meeting	1–12 weeks	Low/medium
Domestic business traveler	1–7 days	Low
International business traveler	1 day–12 weeks	Low

price tonight rather than have an empty room, because of the low marginal cost to service another room. Each room sold above marginal cost, even at lower prices, helps to contribute towards the fixed costs of operating a hotel property. A yield management system prevents reservation clerks from making critical decisions for themselves, since the computer will not accept a reservation with an incorrectly quoted price. Although there is an over-ride facility to allow some discretion by the reservations supervisor, any excessive use of the over-ride facility has to be justified to the management. In some chain-owned hotels, the management of properties that use the over-ride facility more than three times per month will be asked to explain why.

Disadvantages of yield management Like all data retrieval systems, the effectiveness of yield management is dependent upon the accuracy and completeness of the information originally entered into the computer. The number of customer, property, competitor and other environmental variables that need to be recorded and then processed is very large. Mistakes in the manual data entry process can easily be made, given the amount of historic data that has to be entered to make the system work.

Another difficulty concerns the nature of a typical hotel and its room stock. Many hotels have a wide range of room types, in different parts of the premises and often with their own idiosyncrasies. Some rooms are quieter while others are noisier;

some have been recently redecorated and others have tired décor; some have a sea-view and others overlook the air-conditioning units. This can present difficulties when reviewing the room inventory for yield management purposes.

However, the most critical aspect of yield management is the customers' awareness and perception of the variation in prices quoted to them. Whilst airlines have trained their customers to accept price fluctuations, hospitality customers may be more resistant. If prices to transient business travelers vary too much from a perceived rack rate, then vital customer loyalty may be eroded.

Price-sensitivity measurement

Lewis and Chambers (2000) suggest a pricing method that measures consumers' price sensitivity before a company sets its prices. This model uses consumer market research techniques to establish the range of prices acceptable to customers within a product category. Consumers are asked questions that will test the lower and upper acceptable price points, and the prices at which the service would not be purchased because it is considered either too cheap or too expensive.

Since price-sensitivity measurement (PSM) is based upon consumer perceptions of value, the model embraces the marketing concept; however, it could be argued that consumer perceptions are also shaped by competitors' product/price offers and that the range of prices solicited by PSM research could be determined by analyzing competitors' price brackets. Given the cost of consumer market research, hospitality companies are reluctant to commission PSM.

Price promotions

The impact of price promotions needs to be carefully evaluated in the planning stage to protect core revenue business and brand image. City hotels offering low season price promotions to leisure travelers ring-fence the promotion to prevent business travelers from taking advantage of it, by insisting on pre-booking conditions. Price-led promotions must also make a realistic contribution towards the overheads and justify the cost and effort that goes in to their development and promotion.

One tactic is to use loss leaders to attract customers. Bars typically have a special drinks offer – perhaps half-price on quiet evenings, or 'doubles' at a single price during a happy hour promotion. Joint marketing initiatives between hotel chains and newspapers make use of other promotions – one example is 'free accommodation' at selected hotels, which is offered exclusively to the readers of a newspaper providing the customer pays a minimum price for meals whilst staying in the hotel. 'Two for the price of one' or BOGOF (buy one, get one free) promotions are popular and effective in promoting hotel and restaurant products.

These price-led promotions help to boost sales in quiet periods, but they do have limitations and drawbacks. Theoretically the promotion should attract new customers who, having enjoyed the hospitality experience, are expected to return at other times and pay the normal prices. In practice, many (even most) of the customers who enjoy a promotional price do not book at the 'normal' price once the promotion has finished. There is also the danger of cannibalizing customers. This means that loyal customers may take advantage of the price promotion, changing their booking and purchasing habits, and consequently the hotel or restaurant loses prime rate business and suffers a reduction in sales and profits.

Product price bundles

All sectors of the industry bundle a package of benefits at an all-inclusive price. Examples include foreign package holidays, activity leisure breaks, 24-hour conference delegate packages, wedding receptions, and fast-food and drink combinations. The advantages of product price benefit bundles for the consumer include the perception of added value (indeed, really effective packages *do* provide customers with added value), and the ease of booking all the features of the bundle at one price in one transaction.

Price cuts

There is considerable research into the effects on company and industry profitability of price cuts and price wars. Although individual companies who initiate price cuts may gain market share, eventually competitors are forced to respond. If a price war ensues, customers begin to expect a lower price point, reacting unfavorably when companies attempt to increase prices later.

The evidence suggests that all companies in an industry involved in a price war lose profitability. Price cuts in hospitality are a natural reaction to excess capacity, but the consequences can be damaging if maintained for a long period. The dangers of price-cutting can be explained by Figure 7.2. This chart illustrates the additional occupancy a hotel needs to generate for a price reduction to maintain the same room revenue. If a hotel has a current occupancy of 60 percent and initiates a price cut of 10 percent, then an increase in occupancy of 7 percent will be required to keep accommodation revenue at the previous level. In the real world, to achieve a 7 percent increase in room occupancy is not a simple task. This increase in occupancy will also incur additional laundry, housekeeping, maintenance, energy and front desk costs,

Current occupancy	Occupancy required to maintain sales revenue, following rate cuts of:				
	5%	10%	15%	20%	25%
50	53	56	59	63	67
52	55	58	62	65	69
54	57	60	64	68	72
56	59	62	66	70	75
58	61	64	68	73	77
60	63	67	71	75	80
62	65	69	73	78	83
64	67	71	75	80	85
66	69	73	78	83	88
68	72	76	80	85	91
70	74	78	82	88	93
72	76	80	85	90	96
74	78	82	87	93	99
76	80	84	89	95	101
80	84	89	94	100	107
88	93	98	104	110	117
90	95	100	106	113	120

Figure 7.2 The cost of cutting prices (source: Buttle, F., 1986, *Hotel and Food Service Marketing*, Cassell, p. 266, reproduced by kind permission)

as well as possible marketing communication costs involved in the promotion of the new pricing policy. A similar situation occurs in restaurant operations. If a company is able to introduce an innovative process that significantly reduces its cost base – for example, eliminating an intermediary in the channel – and then passes some of that saving to the consumer, then its ‘price cut’ is a new pricing policy, which is sustainable.

International pricing

The difficulties in setting a pricing policy for companies operating in more than one country are compounded by:

- The different currency and cost structures between countries
- The different types of competitors – global, regional, national branded chains, and local independents
- The different stages of the market/product life cycle in each country
- Different inflation rates and fluctuations in the currencies
- The ability to repatriate profits, which again varies significantly from country to country.

For companies aiming to promote and protect their hospitality brands by standardizing the product offer, a uniform price position presents particular problems. The response in countries like Egypt and India is to charge a lower price for domestic customers and a higher price for international customers. The Paradise Sun Hotel (see Case study 7.1) illustrates the difficulties which hospitality businesses, dependent upon international markets, have to address when setting pricing policies.

Case study

7.1 Pricing at the Paradise Sun Hotel, Seychelles

The Paradise Sun Hotel, Praslin, Seychelles, is an 80-bedroom four-star resort hotel owned by Southern Sun Hotels. The hotel is dependent upon international leisure business from a mix of European countries, Southern Africa and the Middle East. The hotel segments its markets on a geographic country-by-country basis. Seven- and fourteen-day holiday packages are organized by tour operators in each target country for the hotel, and are generally booked through travel agents. The Paradise Sun management negotiates different prices with each of the different country tour operators, based on the historic prices from last season and the projected volume of guests that the operator is planning to book in to the Paradise Sun. Prices are agreed in the local Seychellois currency. The contract is negotiated up to eighteen months in advance of the booking, due to brochure publication deadlines.

Exchange rate fluctuations in the period between agreeing the contract and potential customers booking their holiday affect the relative price of the Seychelles compared to alternative island sun destinations. The volume of bookings from different countries changes according to the relative low/high exchange rate, which is governed by the prevailing economic conditions in each country.

Conclusion

In the final analysis, customers decide whether the company is charging the right price. However, given the hospitality industry's reluctance to carry out marketing research, and the dominance of financial concerns in budget planning, most pricing decisions will continue to be governed by cost and other financial objectives. Companies only find out if they are charging the wrong prices when customers desert their offer. Although pricing decisions are the easiest element of the marketing mix to change, they remain the most complex of decisions to pitch accurately.

In this chapter, we have explained:

- That pricing is the tool that matches supply and demand
- That price is the only element of marketing mix that is not a cost, because price generates revenue
- That price, in the absence of other cues, is an indicator of quality and sets customer expectations
- That price is the summation of all sacrifices made by a consumer in order to experience the benefits of the product
- Why companies have little control over the *external* factors that influence pricing decisions, but considerable control over the *internal* factors that influence pricing decisions
- Why the majority of for-profit hospitality organizations focus on financial objectives, rather than marketing objectives, when making pricing decisions
- Why pricing decisions should reflect quality strategies
- That larger hotels utilize computerized yield management systems to maximize occupancy and achieved room rate to improve profitability
- Price promotions, linked to product benefit bundles, which are extensively used to grow revenue in low season periods
- International pricing decisions, which are subject to local country environmental factors.

Review questions

Now check your understanding of this chapter by answering the following questions:

- 1 Why is pricing significant in the pre-encounter hospitality marketing mix?
- 2 Discuss the external and internal factors that influence pricing decisions. Provide examples from the hospitality industry to illustrate your answer.
- 3 Evaluate pricing and product quality strategies in three hotel markets.
- 4 Discuss the advantages and disadvantages of the following pricing methods:
 - cost-led
 - profit-led
 - competitor-led
 - market-led.
- 5 Evaluate the role of price promotions in the hospitality industry.
- 6 Discuss the pricing issues for a standardized international hotel brand.

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