

# 5

## Managing pricing strategies

### About this chapter

This chapter reviews the various pricing methodologies available to the hospitality and tourism industries for the pricing of accommodation, food, beverages and other activities. The review of accommodation pricing techniques considers formulistic approaches to pricing such as the rule of thumb method and the Hubbart formula which are based on cost plus calculations, as well as market demand approaches such as yield management. Food and beverage pricing is considered with specific reference to sales mix and approaches to menu analysis for maximising gross profit in percentage and cash terms. In theory, price setting appears to be a simple task, but in reality, the pricing process is complicated by market, economic and psychological influences and, as a result, the pricing decision requires input from financial, marketing and operational managers in order to ensure that the resulting pricing policy is based on the correct information.

### Learning objectives

On completion of this chapter, you should be able to:

- Describe how the optimum sales volume and selling price is determined using economic theory
- Understand the principles of cost-based approaches to pricing
- Apply cost-based pricing techniques to commodities such as accommodation, food and beverage and other tourism services
- Make pricing decisions based on market conditions.

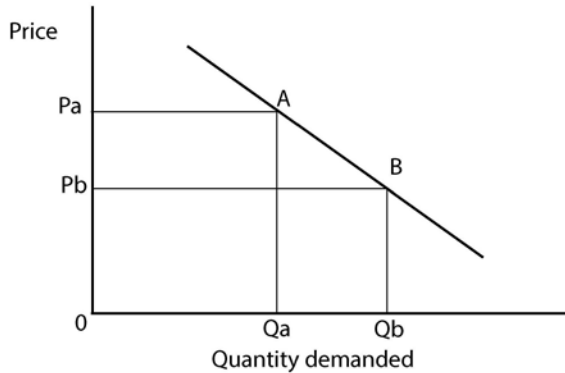
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## Introduction

The principle aim of any pricing policy should be to increase revenue without sacrificing the required level of volume, while increasing profitability and ensuring long-term business value. It should also aim to impact customer buying behaviour by responding to influences arising from the competitive environment. A good starting point is a knowledge of economic theory that provides a suitable basis for introducing the concepts required for pricing decisions.

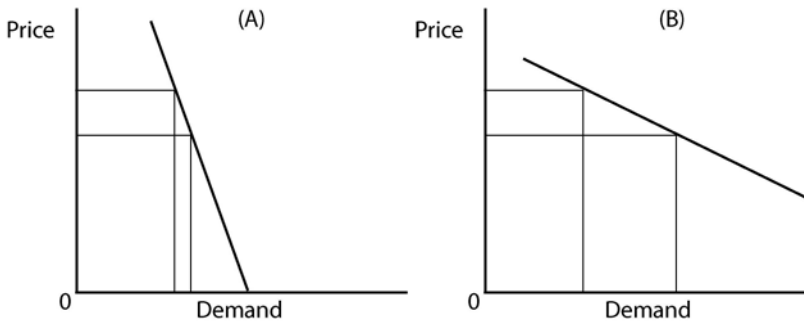
## Economic theory

Economic theory describes the relationship between changing prices and the impact on customer demand as the *price elasticity of demand*. Demand is described as being elastic when a change in price results in a change in the buying behaviour of customers. This relationship is illustrated in Figure 5.1.



**Figure 5.1:** The demand curve

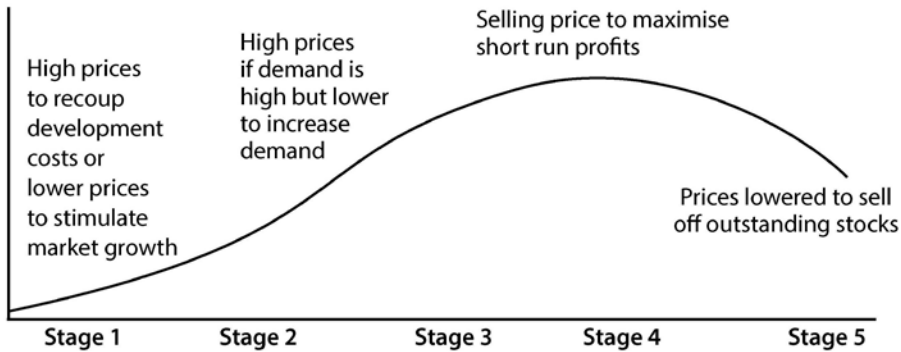
The points marked A and B represent two of the many possible price/quantity combinations. As the price falls the quantity demanded increases. Inelastic demand arises where the customer buying decision is unaffected by price changes. Figure 5.2 illustrates the price elasticity of demand where there is elastic demand and inelastic demand. When demand is inelastic an increase in price has only a minimal effect on quantity purchased, whereas with elastic demand a change in price results in a significant change in quantity demanded.



**Figure 5.2:** Price elasticity of demand: (a) inelastic demand; (b) elastic demand

## Price and the product life cycle

The concept of the product life cycle was introduced in Chapter 2. The development of pricing strategies should be considered in the light of the positioning of the product or service on the product life cycle. Figure 5.3 illustrates the relationship between product life cycle and price. At each stage on the product life cycle the pricing strategy needs to adapt, to respond the levels of demand.



**Figure 5.3:** Relationship between the product life cycle and pricing strategy

## Cost based approach to pricing

The overall aim of an effective pricing policy is to ensure that the profit per product is maximised while maintaining a perception of value for money in the eyes of the customer. Despite this aim, the traditional approach to pricing tends to be based on cost plus techniques where a mark-up is added to the cost of producing the product to arrive at the selling price. The cost of the product can range from simply calculating the food or material cost, in the case of menu pricing, through to attempting to calculate a total cost per product, including materials, wages, expenses and overhead. However, this level of detail is reliant on adequate information being available to enable fixed or indirect costs to be allocated to individual products in a satisfactory manner, particularly where there are several products or services available.

When the pricing policy is based solely on direct costs or on material costs, the difference between the selling price and those costs must be sufficient to cover all other costs and provide an adequate level of profit. The following example illustrates a mark up policy of 33.33% food cost of sales.

### Example:

A restaurant produces a dish which costs £3.00 in terms of the food portion cost. The aim is for the food to cost a third of the resulting net selling price. The restaurant has forecasted to sell 10,000 of these dishes over a set period with other variable cost expected to be 25% of net sales and fixed costs of £12,000.

$$\begin{aligned} \text{Net Selling price} &= \quad \quad \quad \text{£3.00} \times 3 \\ &= \quad \quad \quad \text{£9.00} \end{aligned}$$

Therefore

$$\begin{aligned} \text{Net Sales} &= \quad \quad \quad \text{£90,000} \\ \text{Food cost} &= \quad \quad \quad \text{£30,000} \\ \text{Gross profit} &= \quad \quad \quad \text{£60,000} \\ \text{Variable costs} &= \quad \quad \quad \text{£22,500} \\ \text{Fixed costs} &= \quad \quad \quad \text{£12,000} \\ \text{Net profit} &= \quad \quad \quad \text{£25,500} \end{aligned}$$