10 Pricing in hospitality and tourism

As we discussed at the beginning, the majority of products and services produced and sold in the hospitality industry are derived from the provision of rooms, food and beverages. Pricing these products and services requires a sound knowledge of the relevant financial factors that surround them and of the marketplace in which they are to be sold.

We need to be aware of customer perception and expectation of prices in the market and become familiar with what competitors are charging for similar items. We should also be aware of the costs incurred in providing our products and services, including the added profit element, which as far as consumers are concerned is just another a cost included in the selling price.

In this chapter we focus on the more practical approaches to pricing decisions and suggest how to develop an overall pricing policy for a business. First of all, however, we consider the basic methods of pricing product and services.

Essentially, there are three fundamental approaches to pricing products and services, with numerous variations of each method:

- Costplus
- Going rate
- Contribution margin

Note: Pricing is one of managers' most difficult and challenging tasks. With hindsight, and assuming reasonably competitive products and/or services, we can judge if prices were set at too high or too low a level, but we can never know the right price to optimise demand and profit.

Cost-plus pricing

With cost-plus pricing methods, selling prices are set at a level to recover all costs, comprising direct costs and indirect expenses (unallocated costs). The plus element is a predetermined mark-up, which normally incorporates profit element to provide a return on owners' capital (investment).

In its basic form, the cost-plus pricing approach can be expressed in terms of a simple formula, as presented below:

Cost + Mark-up (%) = Selling price

Mark-up takes the form of a percentage added to a cost base. As we shall see, in addition to including a margin for profit, the mark-up percentage can also be used to recover costs present in a business, but which are not able to be quantified for the item being priced.

As indicated in Figure 10.1, the proportions of cost and mark-up in a given selling price are determined by the level of costs known. The three main methods of cost-plus pricing are explained below, as follows:

- ♦ ***Full cost-plus pricing*** entails establishing the total cost of individual products or services (direct materials, labour, expenses and a share of indirect expenses) and adding a percentage mark-up to the total cost to provide a profit. This method is not widely used in the hospitality sector, though applicable to high volume/ limited choice establishments, such as fast-food restaurants.
- ♦ ***Direct cost-plus pricing*** entails establishing the *prime cost* (direct materials, labour and expenses) of the item to be priced and adding a percentage mark-up sufficient to recover indirect expenses and provide a profit margin. This method is widely applicable to the hospitality and tourism sectors, particularly related to hospitality event business, such as conferences and banqueting, meetings and exhibitions and group tour business.
- ♦ ***Gross margin pricing*** entails establishing the direct material cost of the item to be priced and adding a percentage mark-up sufficient to recover direct labour and expenses, indirect expenses and provide a profit margin. This method is used extensively where direct material is the only cost which can be accurately determined, such as the food and beverage costs (ingredients) of individual dishes and drinks. Widely applicable in various restaurants and bars, from cafés through to fine dining establishments.

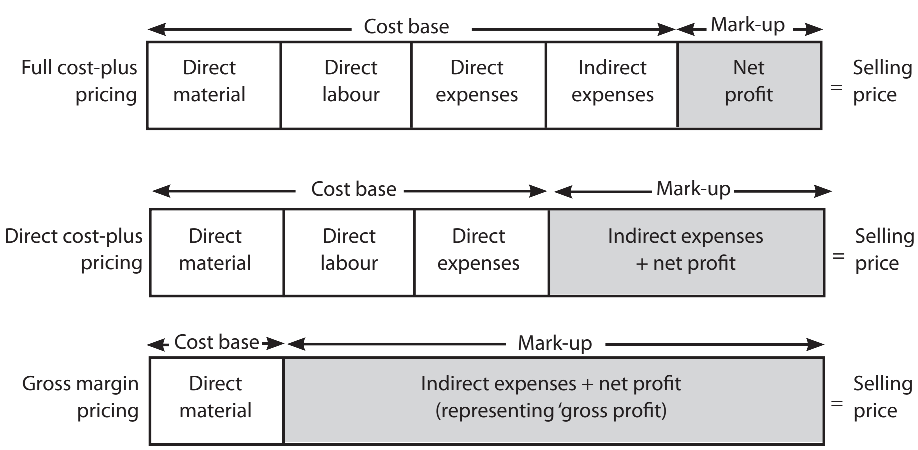

Figure 10.1: Cost-plus pricing variations

Note: Full cost-plus pricing is rarely applied in the hospitality sector in its traditional manufacturing form, by building up the total cost of individual products through detailed cost allocation and apportionment methods, but as we shall see, full cost-plus pricing is used for determining room and food and beverage average prices in the hospitality sector.

Note: Gross margin pricing arises where only the direct material cost of a product is known and, therefore, the direct material (cost of sales) deducted from the selling price represents gross profit (sometimes referred to as gross margin). Generally, gross profit refers to the money value, whereas gross margin refers to the percentage.

Note: As indicated by the shaded areas of each cost-plus pricing method in Figure 10.1, the size (proportion) of the mark-up is influenced by the extent of the costs identified for the item to be priced. Therefore, the more costs that are known (or estimated) the smaller the mark-up required.

A considerable amount of controversy surrounds the use of cost-plus pricing methods, some of which are summarised below.

Arguments for cost-plus pricing:

- ♦ It forms a logical basis on which to recover total operating costs and provide what is often described as a fair profit.
- ♦ It encourages price stability, whereas constant short-term tactical price changes may prejudice long-term objectives.

Arguments against cost-plus pricing:

- ♦ It makes an assumption suggesting the correct and, therefore, acceptable price to the consumer is the sum of the costs plus an assumed profit mark-up.
- ♦ The methods are product oriented, rather than market-related, disregarding consumer demand and ignoring competition.
- ♦ It involves circular reasoning, in that the level of unit cost depends on the volume, which in turn is influenced by price.

Note: Whilst the theoretical criticisms against cost-plus pricing may appear stronger than the arguments for using the methods, there are compelling practical reasons for using the approach as a reference point for setting prices, referred to later.