Lecture 3

Establishing Room Rates

- Market-based pricing
  - Market Condition Approach
  - Top-down pricing
  - Rate-cutting
  - Prestige product pricing

- Cost-based pricing
  - Rule-of-thumb approach
  - Bottom-up approach
  - Differential rates

Market-based pricing

Market Condition Approach

This approach can also be termed the "common sense" approach or "price followership". By adopting this approach a hotel considers what comparable hotels within the same geographic area are charging for similar rooms or products. The philosophy behind this approach is that a hotel can only charge prices which the market will accept, and therefore prices are dictated by the competition.

The market condition approach is really a marketing approach that allows the local market to determine the rate. This approach fails to take into account what a strong sales effort may accomplish.

Can hotels determine their rates after directly discussing their rates with each other?

Hoteliers cannot meet directly "in collusion" to determine prices. If they were to do so they would be in breach of our Competition Law.

> **5.** (1) [...] the following is prohibited, that is to say any agreement between undertakings, any decision by an association of undertakings and any concerted practice between undertakings having the object or effect of preventing, restricting or distorting competition within Malta or any part of Malta and in particular, but without prejudice to the generality of this subarticle, any agreement, decision or practice
> which:
> (a) directly or indirectly fixes the purchase or selling price or other trading conditions;
>
> Chapter 379, Competition Act, Laws of Malta

Top-down pricing

This approach is often used by companies entering a new market or trying to identify a gap which is unfilled. This method of pricing

will still require an element of cost-based pricing in order to ensure that the prices being charged are realistic and will result in an overall return on investment.

Rate-cutting

This approach assumes that demand will increase if prices are lowered – but we do know however that rate cutting can be risky and may also lead competitors to cut their rates – a situation which would result in everyone making losses.

Prestige product pricing

This approach takes that the view that raising the price of a room will make a hotel more exclusive and thus change the nature of the overall product. This method seems to defy the laws of economics, and will work only if the market is not price conscious. Prestige product pricing is more or less a psychological activity.

Cost-based pricing

Rule-of-thumb Approach

This approach sets the rate of a room at Lm 1 for each Lm 1,000 of construction and furnishings cost per room, assuming a 70% occupancy. As an example, let us assume a 200-bedroom hotel cost us Lm5,000,000 to construct and furnish. Each room therefore cost us Lm25,000 and using this approach the average room rate will be Lm25.00 per room. As Abbott & Lewry point out (page 190) this rule was devised quite some time ago when rates of interest, tax levels and expectations about appropriate rates of return were different.

However the main difficulty in adopting this approach is that it does not reflect the fundamental importance of fixed and variable costs in determining a hotel's profitability.

When can this approach be taken?

This approach was intended for newly constructed hotels to determine a starting average price. However it can be used for any hotel provided that the hotel operator revalues the property and calculates the rates accordingly. A hotel that was constructed in the seventies at a certain cost will have almost certainly appreciated in value.

Is this approach a valuable approach?

It is certainly indicative, even if not precise. If, for instance, a group of 4 hotels has a value of Lm 15,000,000 and a stock of 500 rooms, then one can assume with some confidence that the average room rate is closer to Lm 30 per night than Lm 20 or Lm 70.

The bottom-up approach

This approach was formerly known as the *Hubbart formula* and was introduced in the United States in the 1950s. It is known as the bottom-up approach because, contrary what we do in normal accounting practice, we first decide how much profit is required (return on investment) and then determine the expenses for the following period (usually one year).

The Hubbart formula can be summed up as:

$$\frac{\text{Operating Costs + required return – income ex other departments}}{\text{Expected number of room nights}} = \text{average room rate}$$

The steps are best described as follows:

1. Calculate the total amount invested in the hotel.
2. Decide on the required annual rate of return on the investment (this may be a percentage of the amount invested)
3. Estimate the overhead expenses.
4. Combine 2 and 3 to find the required gross operating income.
5. Estimate the probable profits from all other sources (i.e. restaurants, bars etc)
6. Deduct 5 from 4 to find out how much profit you need to make from room lettings.
7. Estimate accommodation department's expenses (include fixed and variable costs based on the occupancy forecasted)
8. Add 6 and 7 to find out how much you need to make from the rooms.
9. Estimate the number of room nights you are likely to achieve per annum (based on occupancy forecasted)
10. Divide 8 by 9 to find out the average room rate you should charge.

Example

A hotel company operates a 150-room hotel. The capital invested is Lm2,500,000 and the company is expecting a net profit of 10% after paying tax at the rate of 50%. We expect an average occupancy rate of 70%. Department expenses are expected to amount to Lm375,000 and profits from other departments are expected to be in the region of Lm 200,000. These are the overhead expenses:

Administrative and general	120,000
Advertising and promotion	75,000
Utilities	50,000
Repairs and maintenance	95,000

Depreciation	205,000
Insurance, licences and local taxes	80,000
Loan Interest	140,000

Step 1
Total Invested in Hotel = Lm 2,500,000

Step 2
10% of Lm 2,500,000 = Lm 250,000
Tax = Lm 250,000

Step 3
Overhead expenses = Lm 765,000

Step 4
The required gross operating income is Lm 500,000 and Lm 765,000 is Lm 1,265,000.

Step 5
Profits from other sources are expected to amount to Lm 200,000

Step 6
We need a total room revenue of Lm 1,065,000

Step 7
To this amount we need to add Lm 375,000 which is the departmental cost.

Step 8
In total we need to make Lm 1,440,00 from rooms.

Step 9
150 rooms x 365 days = 54,750 = 100% room occupancy
Therefore = 38,325 = 70% room occupancy

Step 10
Average room rate = Lm 1,440,000 ÷ 38,325 room nights
Lm 37.57

The Hubbart formula can be used for varying percentages of occupancy. To do so we would simply need to review Steps 7 to 9.

Differential room rates

One of the problems with both the rule-of-thumb and bottom-up approaches is that they only produce an *average* room rate. This would be a sound approach if a hotel had only one room type, but we know that this is not the case. Having determined an average room rate we now need to calculate differential rates.

Let us assume we have a 60-bedroom hotel, with an overall average of 65% occupancy and three room types -

	Type	Rms	Occ%
Single, single occupancy	S	20	68%
Double, single occupancy	D(s)	30	20%
Double, double occupancy	D(d)		60%
Luxe D, single occupancy	LD(s)	10	9%
Luxe D, double occupancy	LD(d)		48%
Total		60	
Average			65%

We must now determine appropriate weightings for the different rates. If, for instance, a Single room has a weight of 1, a double room will have a weight of 1.8, but if occupied by one person a weighting of 1.4. The weightings are purely a matter of judgement.

	Type	Rms	Occ%	Average Occupied Rooms	Weight
Single, single occupancy	S	20	68%	13.6	1
Double, single occupancy	D(s)	30	20%	6	1.4
Double, double occupancy	D(d)		60%	18	1.8
Luxe D, single occupancy	LD(s)	10	9%	0.9	1.8
Luxe D, double occupancy	LD(d)		48%	4.8	2.4
Total		60			

We now need to calculate the average revenue target per night which is Lm 1,365 (average rate Lm 35 x 60 rooms x 65% occupancy)

Type	Rms	Occ%	Average Occupied Rooms	Weight	AO x Weight	Revenue Expected	Room rate	Rounded	Total revenue
S	20	68%	13.6	1	13.6	274.86	20.21	20.00	272.00
D(s)	30	20%	6	1.4	8.4	169.77	28.29	28.00	168.00
D(d)		60%	18	1.8	32.4	654.81	36.38	36.00	648.00
LD(s)	10	9%	0.9	1.8	1.62	32.74	36.38	36.00	32.40
LD(d)		48%	4.8	2.4	11.52	232.82	48.50	48.00	230.40
	60				67.54	1365.00			1350.80

The other columns in the spreadsheet above are explained below:

AO x Weight
Average occupancies times weight. This produces a combined weighting which reflects both the 'value' of the room *and* the expected occupancies.

Revenue expected
This divides the nightly revenue expected (Lm 1365) into the proportions shown in the previous column. For the first row (Single) we calculate

$$1365 \times \frac{13.6}{67.5} = \text{Lm } 275$$

Room rate
The room rate is now calculated by dividing the Revenue expected for the particular room type by the number of average occupied rooms. The figure is then rounded up.

Seasonal rates

We may need to take differential rates a step further, because differential rates do not deal with the issue of seasonality. In this example we are considering two seasons: a high season with a weighting of 4 and a low season with a weighting of 3. The difference is now that the AO x Weight column now multiplies the Average Occupied Rooms by Room and Seasonal Weight.

Type	Rms	Occ%	Average Occupied Rooms	Room Weight	Seasonal Weight	AO x Weight	Revenue Expected	Room rate	Rounded	Total revenue
Low										
S	20	63%	12.6	1	3.0	37.8	106.41	16.89	17.00	214.20
D(s)	30	18%	5.4	1.4	3.0	22.68	63.85	23.65	24.00	129.60
D(d)		50%	15	1.8	3.0	81	228.03	30.40	31.00	465.00
LD(s)	10	6%	0.6	1.8	3.0	3.24	9.12	30.40	31.00	18.60
LD(d)		30%	3	2.4	3.0	21.6	60.81	40.54	41.00	123.00
High										
S	20	73%	14.6	1	4.0	58.4	164.40	22.52	23.00	335.80
D(s)	30	22%	6.6	1.4	4.0	36.96	104.05	31.53	32.00	211.20
D(d)		70%	21	1.8	4.0	151.2	425.65	40.54	41.00	861.00
LD(s)	10	12%	1.2	1.8	4.0	8.64	24.32	40.54	41.00	49.20
LD(d)		66%	6.6	2.4	4.0	63.36	178.37	54.05	55.00	363.00
	60	65%				484.88	1365.00			

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