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Pricing Tourism Products and Services

PRICING TOURISM PRODUCTS AND SERVICES

By Donald F. Holecek

INTRODUCTION

In general, tourism businesses appear to be in a highly competitive industry with limited flexibility to set prices. Either they sell at or below the established market price or see a rapid drop in sales. Establishing a firm's price under such circumstances is straightforward, although not always simple. All one needs to do is to identify what the competition is charging and price one's own product comparably.

Despite this apparent lack of flexibility, however, the uniqueness of tourism/recreation goods and services actually enables producers to establish prices. This uniqueness stems from a number of product attributes, including: business location, its natural environment, the types of facilities offered, the personal relationships that management and staff develop with customers, and real and perceived differences in the quality of the firm's products.

Because most tourism/recreation businesses have at least some flexibility to establish prices, this bulletin will address the key factors that should be considered in making pricing decisions. Keep in mind, however, that the same uniqueness which provides pricing flexibility also precludes development of a universally applicable formula for guiding pricing decisions. Furthermore, the goals of businesses in this industry vary widely and, because price is a major tool for achieving a business's goals, identical businesses under identical circumstances may logically establish different prices.

While it is not possible to prescribe a single formula for all price-setting decisions, it is possible to identify the primary components of a sound pricing strategy. These "ingredients" can be found in textbooks and by observing business pricing practices. Both sources are drawn upon here to provide you with the ingredients to make sound pricing decisions. Ultimately, you must fit them to your business goals and circumstances to arrive at the best prices for your products.

THE BASICS OF PRICING

Price theory is a keystone of economics. Because of this central role, no economics text would be complete without one or more chapters devoted to pricing. Many books have been written on this single topic. Successful business people, whether from books or practical experience, have learned to use basic pricing concepts for their products and services. These elements are introduced briefly below.

Economists begin their introduction to pricing by explaining the concept of demand. In simple terms, demand means that consumers will purchase more of a good or service at a low price than at a high price. Therefore, *demand is the economists' term to describe the relationship between the varying quantities of a product which can be sold over a range of prices.* Demand can be expressed in at least three ways: a) in tabular form; b) as a mathematical relationship; or c) as a graph. We will discuss demand as expressed in a graph, since that format is the easiest to visualize.

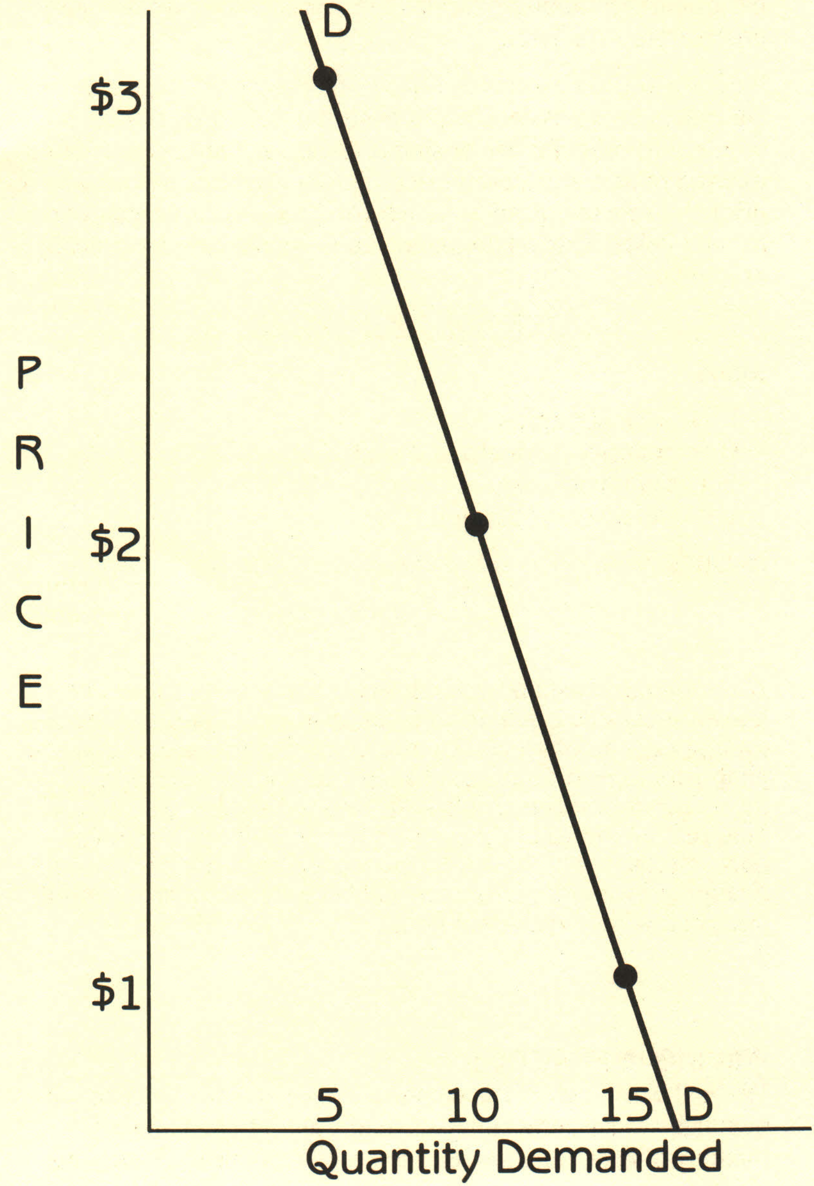
Note that as the price charged decreases from $3 to $2, the quantity which can be sold increases from five to ten units. Based only on this information, the operator of this particular business would maximize sales revenue by establishing a price of $2 for the product. At that price, gross revenue would equal $2 × 10 units = $20. At a price of $3 or $1 gross revenue would equal only $15.

If the unit cost of producing these 5, 10 or 15 units was identical—for example, $0.50 per unit, net revenue would also be maximized by setting the price at $2. Net revenue (gross revenue - production cost = net revenue) at a $2 price would equal $15. Note, however, that while gross revenue is $15 at both the $1 and $3 unit price, net revenue is not equal. At a $3 price, net revenue is $12.50 while at a $1 price net revenue is only $7.50. This illustrates the need to account for both demand and cost when setting prices.

In addition, unit costs contain both fixed and variable elements. Fixed costs include such items as rent, insurance and managerial costs which must be paid to be in a particular business. The per unit fixed cost burden declines as output increases. Doubling output, for example, would reduce fixed costs per unit by half. Variable costs, on the other hand, vary

Figure 1.

GRAPHICAL EXPRESSION OF THE CONCEPT OF DEMAND



directly with output. Examples of variable cost items include employee wages, laundry costs and supplies. Total variable costs increase as output increases but often will not be the same across all levels of output. Per unit variable costs typically are high at low levels of output and decline as output level expands because of economies of scale (e.g. volume discounts on large orders from suppliers).

With reasonably good projections of a business's fixed and variable costs, it is possible to establish the minimum price required in order for the business to earn a profit. This is often referred to as a break-even price. This is the price per unit for a given volume of output at which total revenue is exactly equal to total costs. This relationship can be expressed algebraically as follows:

$$P \times Q = F + (V \times Q)$$

where

P = price per unit sold
Q = quantity produced and sold
F = total fixed costs
V = variable cost per unit

Isolating price in the above expression yields the following:

$$P = \frac{F + (V \times Q)}{Q}$$

Even though fixed and variable costs and quantity may not be known precisely, calculation of an appropriate range of break-even prices can often be very revealing. Indeed, use of this simple business technique could keep you from inadvertently investing in products unlikely to be purchased at the price required for you to break-even on the quantity you could produce. Occasionally, however, there are circumstances in which a rational business person may deliberately establish a selling price below the break-even point.

PRICING IN PRACTICE

The real world which the commercial recreation/tourism business faces is far more complex than the highly simplified theoretical economic models which we have been discussing.

However, these models can help you to deal better with your real-world pricing problems and are a firm foundation upon which to build a more comprehensive tourism/recreation pricing strategy. When economists establish the price-quantity relationship which they refer to as demand, they mean it to apply to a single product which *consumers* perceive as being identical. Billions of dollars are spent each year on advertising with the single purpose of convincing consumers that apparently identical products in fact possess important differences. These advertising dollars aren't wasted. The boom in sales of certain designer jeans, headache remedies, soft drinks, and fast foods reflect consumer perceptions of differences among the products available to them, whether or not these differences actually exist.

Even without the influence of advertising, consumers' perceptions of products and services in the tourism and recreation industry do differ greatly. These differences in perceptions are extremely important to a business's pricing strategy. In essence, these perceptions define the competition. From a prospective consumer's perception, for example, the competition for a modern campground along a major highway, may be nearby budget motels, rather than less-developed campgrounds on the same route. In such a setting, the modern campground owner might be able to price a night of camping considerably higher—near the level of nearby budget motels—than would be feasible if the competition was exclusively other campgrounds. *Thus, a first step in developing a pricing strategy is to establish from the consumer's perspective what other products in your market compete most directly with your offering.* Be sure to include all significant attributes of your product such as: location, facilities and services you offer, and significant attractions in the vicinity of your business.

Many tourism/recreation businesses offer multiple products and/or services to the consumer. A marina, for example, may rent boat slips, sell boats, fuel, and equipment, offer maintenance and storage services, and even operate a grocery/beverage outlet. In establishing a pricing strategy, the marina must not only focus on demand, production costs, and its competitors' prices, but also must consider the impact of slip rental prices on the attractiveness of its other products and services. The objective is to maximize profit across its entire product line. This might be achieved by charging slip rental fees below the competition and even below the break-even price. Grocery stores commonly employ such a pricing strategy for turkeys at holiday seasons, since all but the most conscientious shoppers are likely to purchase the rest of the ingredients for the holiday meal wherever the best price on turkeys is offered. Restaurants with bars will often discount food prices in order to attract customers who will purchase drinks, which are a high profit product. *Impact across a firm's product line is an important consideration in establishing prices for an individual product offering.*

Demand for tourism/recreation varies with the season and the day of the week. In some cases, demand may also vary across product offerings. For example, rooms with a scenic view or campsites near the water are in greater demand than others which a business may have to offer. These differences can be exploited, since greater demand provides an opportunity to charge higher prices. Variations in demand also suggest that lowering prices during non-peak periods can yield added revenue. As long as the price discounts offered aren't excessive (i.e. the established price covers all variable costs), offering reduced rates can actually enhance a firm's profit. *To the extent that differences in demand can be identified, differential pricing should be an ingredient in a firm's overall pricing strategy.*

Pricing is often employed to attract new customers, to maintain good customer relations, to help a new business to become known, and to "wage war" on competition. The latter seldom makes sense for small businesses, especially those with limited capital or lines of credit. *Offering price discounts,* however, *can be effective* in the other instances noted and is often feasible even for small businesses. For example, offering a price discount on occasion may yield more business than allocating an equivalent sum for advertising. On the other hand, a business in the hospitality industry must *avoid the appearance of price gouging* or risk loss of customers over the long haul.

SUMMARY

This approach to making pricing decisions draws upon the concepts of demand and production costs. Break-even analysis reveals the minimum price to be charged in order for a firm to remain in business in the long run. In the "pricing in practice" section, we highlighted the importance of viewing your product from the consumer's perspective. Knowing the consumer's perspective helps identify your competitors. Assessing the impact of pricing decisions across your entire product line and using the concept of differential pricing were also noted as considerations in developing pricing strategies. Finally, the idea of discount pricing as a promotional strategy to attract new customers or to maintain good relations with old customers was noted as a possible use of pricing strategy.

One point remains to be made. Regardless of how much you read about pricing, both in theory and in practice, and how much research you undertake to support your decisions, *it is necessary to monitor the results of your pricing decisions.* Only through monitoring can you determine whether your pricing decisions are yielding the anticipated results. It is far better to adjust your strategy than it is to stick with a bad decision. Even good business people occasionally make bad decisions because of faulty information or incorrect analyses. The only way to determine what price to charge is to experiment. The ideas presented here should help you to narrow the focus of your experiments so that you can more quickly identify prices which are best for your business.

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Series Editor, Maureen H. McDonough, Associate Professor, Department of Park and Recreation Resources.

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