

# The Economy and Supply and Demand

## Section Objective:

- Understand the influence of the economic cycle in consumers purchase decisions.

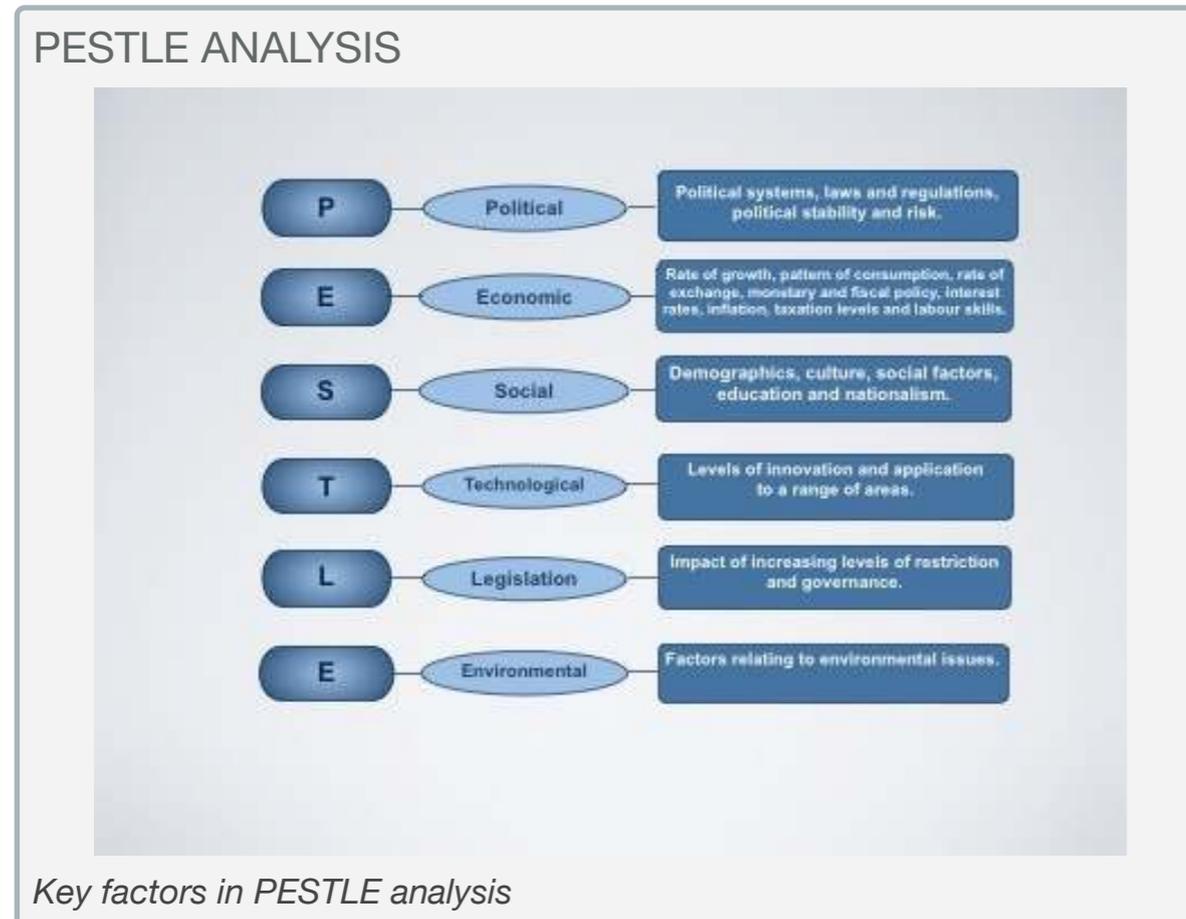
### THE ECONOMY

The state of the economy influences the confidence of consumers in making purchase decisions. In conditions of growth, confidence increases, which in turn increases the propensity to spend. In conditions of recession or stagnation confidence is reduced, savings increase, demand falls and spending is reduced. Under these conditions competition increases and for the consumer “perceived value” is fundamental to the purchase decision. It could be argued that revenue management is even more important when competition is increased and the economic conditions show little or no growth. The importance of maximising revenue under the circumstances of reduced demand is obvious, therefore the pricing policy implemented and the speed at which organisations respond to changes in demand determine their competitiveness.

### WIDER ECONOMIC CONDITIONS

Environmental scanning is the careful monitoring of an organisation's internal and external environments for detecting early signs of opportunities and threats that may influence its current and future plans. External environmental factors have a significant impact on a consumer's propensity to purchase. These are often

categorised using the acronym PESTLE which considers the following factors: Political, Economic, Social, Technology, Legal and Environmental.



## THE ROLE OF COST IN PRICING

In order to be profitable a seller must sell a product or service for more than the cost of providing the product or service.

Business costs can be classified in a range of ways with the following being the most important. The basic cost element approach represents a simple way of classifying costs using the resources required to produce the product or service. There are three cost elements:

- Materials which represent the cost of the components that make up the product such as the cost of ingredients for a restaurant meal.
- Labour which includes all costs associated with rewarding personnel for their efforts
- Expenses which includes all other arising costs

This approach forms the basis of the traditional profit and loss account.

A second approach is to divide costs into those which can be assigned to products, services, departments or particular activities, i.e. **direct costs** and those which cannot be assigned i.e. indirect or overhead costs. Examples of direct costs include:

- Materials: cost of sales e.g. ingredients
- Labour: restaurant managers salary
- Expenses: laundry of table linen

All these costs could be directly attributable to the restaurant.

Examples of **indirect costs** include all indirect materials, wages and expenses included in the operation such as:

- Site rental
- General manager's salary
- Energy costs

It is tempting to try to allocate indirect costs to products and services; however, this is often problematic, as it is usually difficult to arrive at a basis of apportionment which is truly representative of how the cost has been accumulated.

The third category illustrates how the cost behaves under differing conditions of volume or activity. The two extremes are variable costs and fixed costs but many costs contain an element of both.

**Fixed costs:** these are costs that remain unaffected by the level of activity.

Whether open or closed a business still has to bear fixed costs. Rent is payable regardless of how busy the business might be. Other examples of fixed costs could be loan interest and management salaries.

It cannot be said that fixed costs will never change. Fixed costs will change if there is a price increase i.e. rent charges may go up each year in line with inflation or indeed by a higher rate. The

main point to realise is that fixed costs are costs that do not alter as a result of changes in the activity of the business. Although fixed costs remain constant, in total the cost per unit of activity decreases as volume increases.

Finally, it is important to realise that fixed costs only remain constant for a certain range of business activity. This range of activity is called the relevant range.

**Variable costs:** these change in proportion to the level of activity of the business.

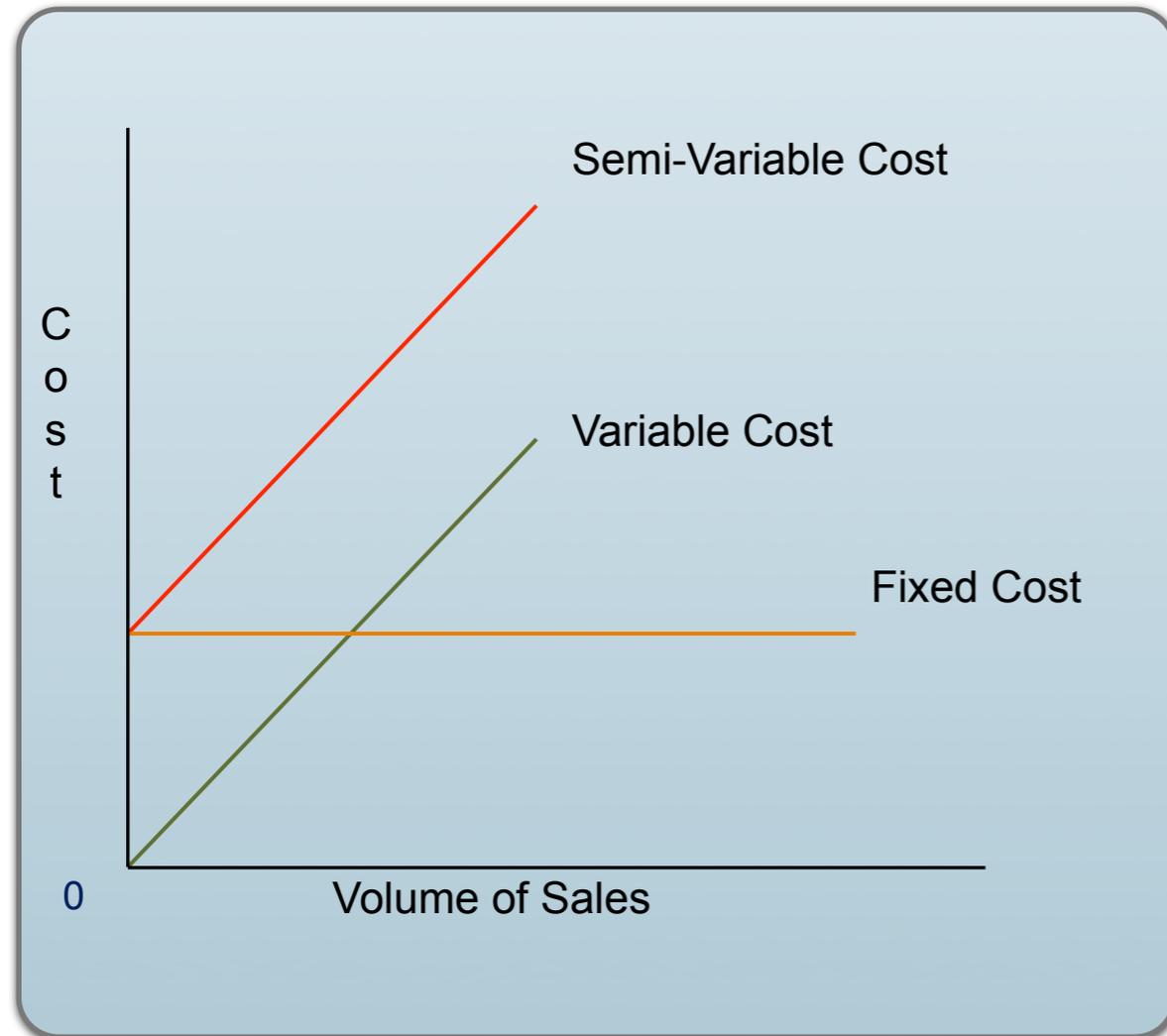
The most obvious example is food cost in the case of a restaurant. If the number of covers increases by 50% then food costs will increase in direct proportion. This means that we assume that the cost per portion remains constant and each additional cover served will create a linear increase in the cost of sales.

Of course, it is possible that the cost per portion may fall with increases in volume to take account of, for example, bulk-buying discounts, however generally we assume that the cost per unit is constant.

**Semi-variable costs** contain an element of both fixed and variable costs. Energy costs, for example are likely to contain a fixed rental charge whilst the remainder of the cost is dependent on consumption.

In order to be able to predict how costs will change with revenue or activity, it is essential to be able to determine which costs are fixed, variable and semi-variable and a linear relationship is

### Fixed and Variable Costs

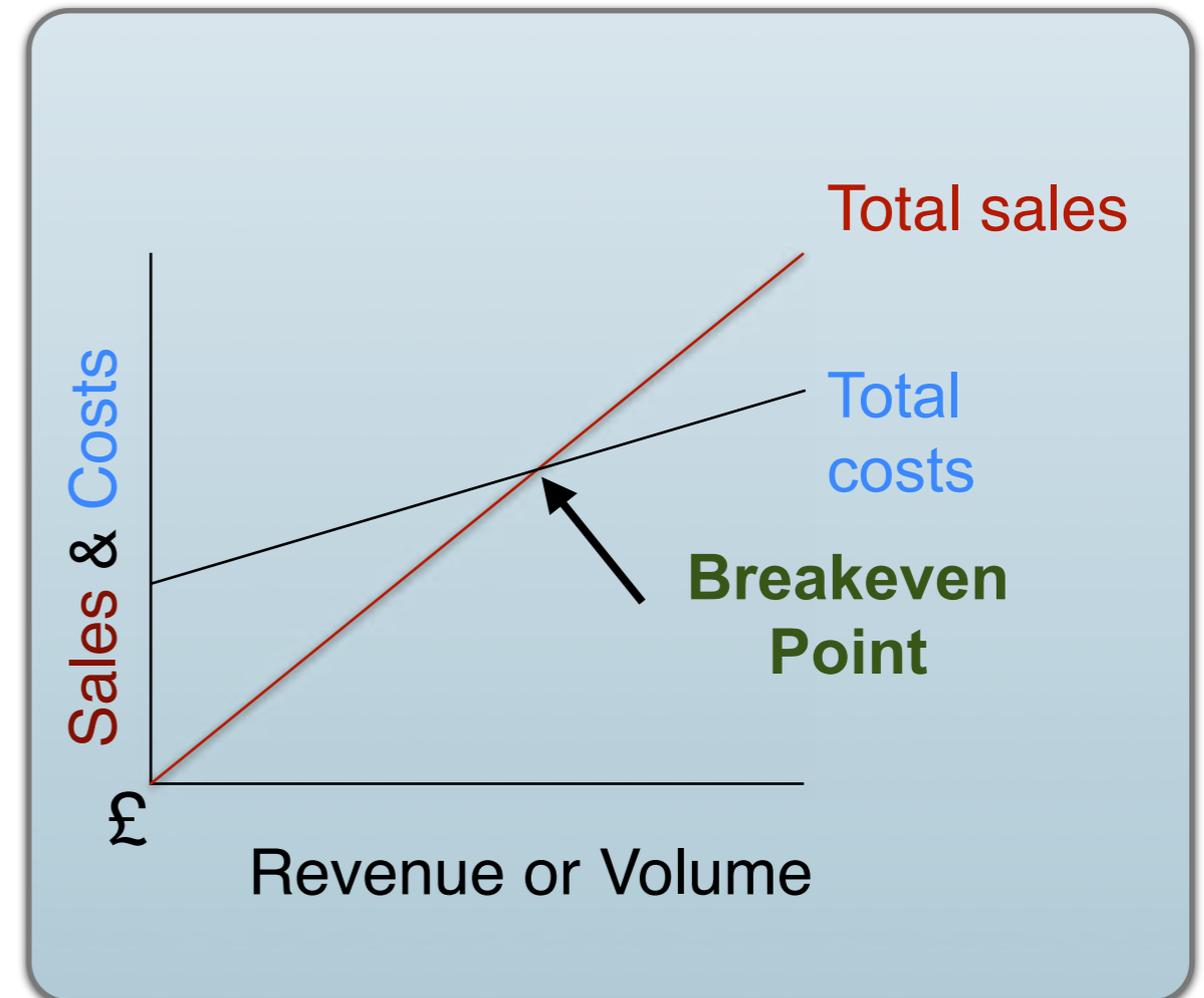


assumed. However, in practice it can be expected that variable costs per unit drop as volume increases due to increasing discounts for bulk purchase and economies of scale. Graphically the costs can be represented as shown.

The identification of the **breakeven point** is critical in understanding pricing as businesses need to ensure that the selling price exceeds the cost of providing the product or service.

The breakeven point is when the business revenue equals the

### Breakeven Point



total costs exactly and is illustrated by the graph shown.

Definitions of the differences between direct, indirect, fixed and variable costs are in the table below.

### Fixed and Variable Costs - Definitions

<b>Direct Cost</b>	Amount spent directly by a department for their operation
<b>Indirect Cost</b>	Amount spent by supporting departments to assist operations
<b>Fixed Cost</b>	A cost that does not change according to sales volumes, e.g. overheads such as rent or production costs
<b>Variable Cost</b>	A cost that varies in direct proportion to revenue or units sold
<b>Semi Variable Cost</b>	A cost which contains both a fixed-cost component and a variable cost component
<b>Contribution</b>	The difference between sales and variable costs is called contribution.

## SUPPLY AND DEMAND

The correlation between price and how much of a good or service is supplied to the market is known as the supply relationship.

**Supply** indicates how much the suppliers in the market place can offer.

**Demand** refers to how much (quantity) of a product or service is desired by buyers.

An accurate measurement of demand for products in the hospitality industry requires consideration of three key factors which affect buyer's behaviour:

- Desire to purchase
- Ability to pay
- Willingness to pay

**Equilibrium price** – The point at which the amount of a product supplied and the amount of demand for the product are in balance.

For a foodservice operator, the business has some ability to increase or decrease supply in order to adapt to demand. Supply in a sit-down restaurant is calculated by multiplying the number of seats in the restaurant by the hours of seat availability. For example a café with 20 seats which is open for 12 hours per day has a total available seat supply of 240 seat hours. The manager can increase or decrease the number of hours that the restaurant is open to satisfy demand, however it is important to note here, that just because the café adjusts its hours to try and cater for increased demand, there may not necessarily be the same demand at those times, for example late at night. Furthermore, revenues will not increase just by extending supply capacity, but only if customers spend money.

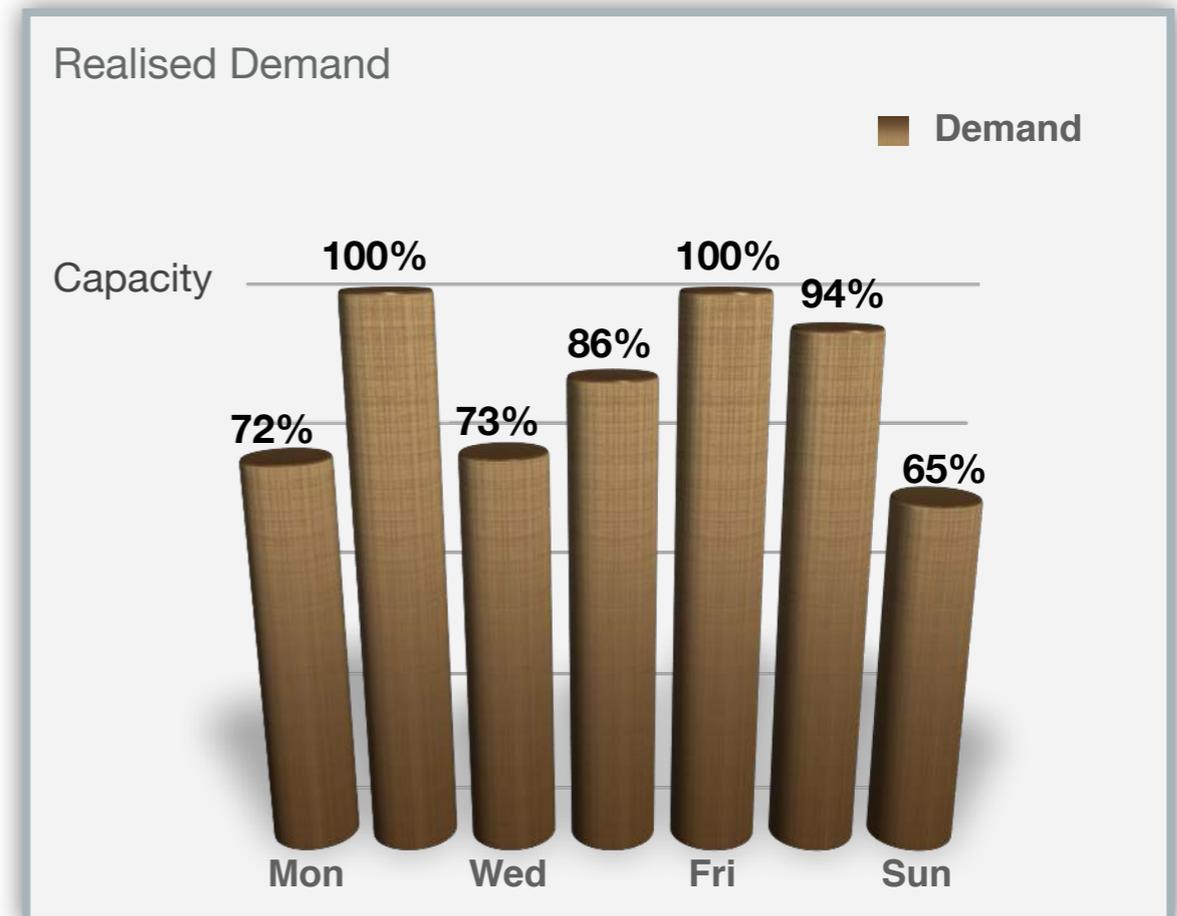
Unlike hoteliers who know that their guests will pay the agreed room rate, foodservice operators do not know how much a guest occupying one of their seats will spend until they order. However, foodservice operations have the advantage over hoteliers that often managers have opportunity to sell the same item offered on a given day, the next day, recovering some of the previous day's revenue-generating capacity.

Revenue management relies on the condition that the price that buyers are willing to pay for a product is subjective and constantly changing. The role of supply and demand in pricing is not to set the price but to act as a guide to setting price.

It is not always the case that increasing scarcity equals increasing value.

It is important to understand that there are two types of demand. The first is aptly called 'Realised' or 'Observed' demand, for it is the demand that is reflected in occupancy figures. On nights where a hotel fills, it is not unusual to hear comments such as "we had enough demand to fill last night". This is true, but the chances are that there was more demand than the hotel could (or wanted to) accommodate. This extra demand is known as unconstrained or frustrated demand.

The graph shows a hotel's **realised** demand by day of week.

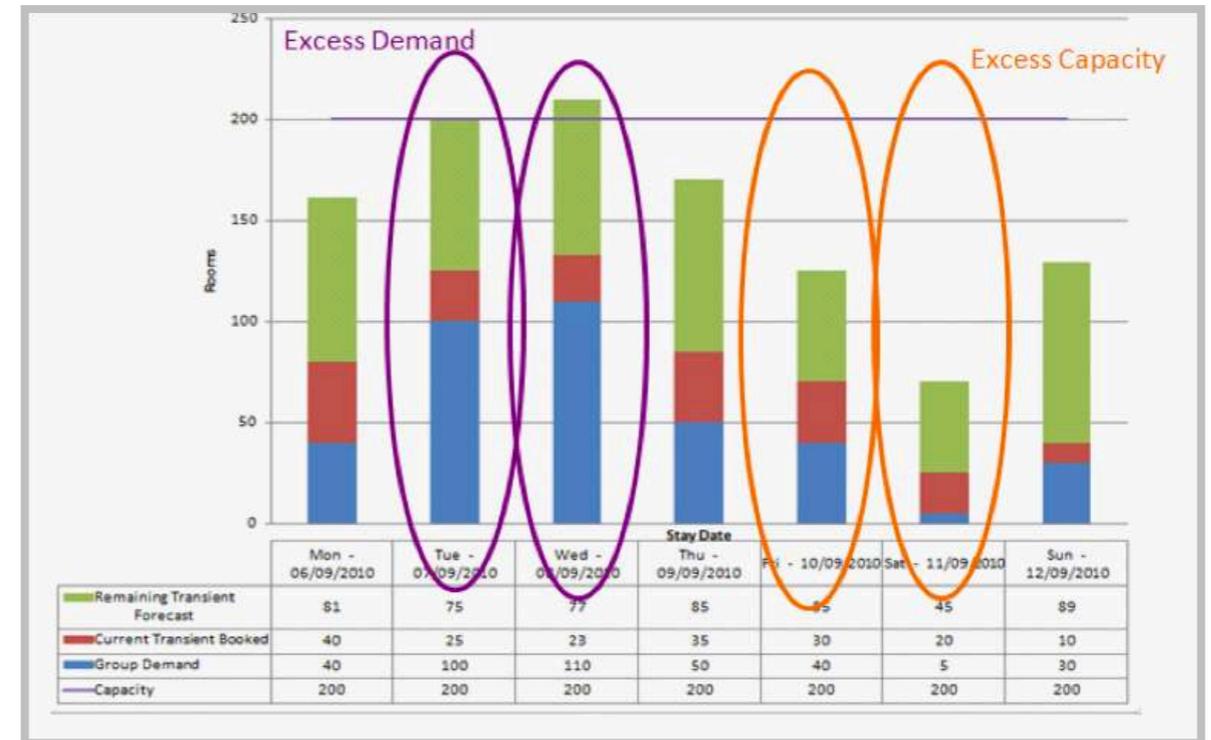


On the nights when the demand was realised to capacity this implies that the total demand was satisfied. However this does not show what element of demand was not satisfied and therefore was unsatisfied or 'frustrated' demand in that it exceeded capacity.

The following graph shows a hotel's realised and **frustrated** demand by day of week. Frustrated demand is defined as demand for products and services which cannot be met by the supply. Realised demand is defined as actual sales receipts.

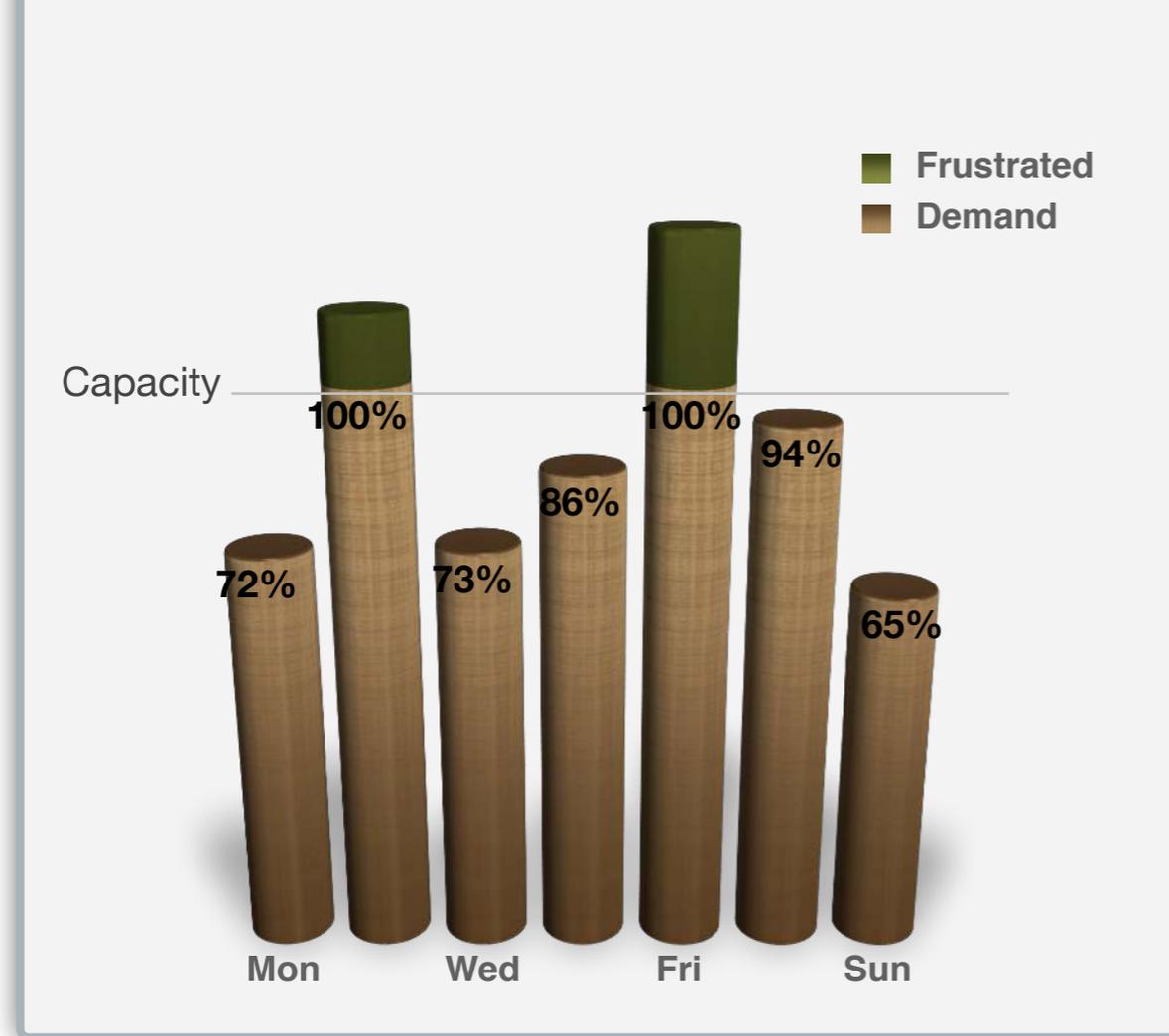
**What are the causes of constrained demand?**

Demand can be constrained by a variety of causes. The major causes would be no remaining capacity (either at room or house level), Length of Stay (LOS) restrictions or pricing that does not meet the customer’s requirements.



The chart above shows an example of excess demand and excess capacity by the two major segments of Transient and Group.

**Unsatisfied or Frustrated Demand**



**Why is it important to be aware of unconstrained demand by day of week?**

If the level of unconstrained demand is known, then this allows the business to set appropriate pricing and yield restrictions, optimising on the most profitable demand and rejecting the least profitable demand. A hotel can also ensure that it has sufficient capacity available for guests who wish to stay for multiple nights, without blocking out the peak nights.

## Review Questions: The Economy and Supply and Demand

Question 1 of 4

**How does a recession impact consumer confidence when making purchase decisions?**

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- A.** It has no significant impact
- B.** It increases consumer confidence
- C.** It decreases consumer confidence



Check Answer

