DIM ALL THE LIGHTS – U.S. Hoteliers Control Utility Costs

by Robert Mandelbaum and Aaron Walls

PKF Hospitality Research (PKF-HR) estimates that U.S. hotel revenues will increase an estimated 5.8 percent in 2007, and grow another 5.3 percent in 2008. Both projections exceed the long-term average annual growth rate of 4.5 percent. Further, revenue growth will be heavily weighted toward growth in room rates relative to occupancy.

Forecasts for revenue growth in excess of 5.0 percent should result in huge gains in profits especially when revenue growth largely comes from room rates. However, PKF-HR is concerned about the strong operating expense increases that typically occur at this point in the cycle and the negative impact they will have on profitability. Most troubling is the recent rise in costs over which management has limited direct control.

Historically, one of the operating expenses that management has struggled with has been utility costs. Hotel utility department expenses consist mainly of energy related expenditures (i.e., electricity, gas, steam), along with water and sewer charges.

PKF-HR analyzed the historical change in utility department expenses and found an extremely close correlation (i.e., 98 percent) between the annual change in property-level utility costs and the energy component of the consumer price index (CPI)[1]. This indicates that despite operating practices aimed at reducing energy consumption, the greatest influence on hotel utility bills has been the prices charged by the local utility company.

Based on a recent survey of managers in charge of hotel utility department costs, PKF-HR finds that hoteliers are starting to gain greater control over their energy costs. Despite a 5.5 percent rise in the CPI energy component, 22.2 percent of the survey respondents reported an actual decline in utility costs from 2006 to 2007.

To provide U.S. hotel operators with some guidance regarding movements in hotel utility costs, PKF-HR has conducted an analysis of data from its *Trends in the Hotel Industry* database of hotel financial statistics. In addition, we are pleased to share some of the energy cost saving practices reported by management in our recent survey.

Utility Components

In 2006, the cost of electricity comprised the greatest portion of hotel utility expenses (59.4 percent). Gas (20.4 percent) and water/sewer (17.6 percent) made up the majority of the balance of utility costs. Because some older properties in cities such as Chicago and New York still use steam for heating air and water, this source of energy accounted for 2.6 percent of the utility dollars spent by our *Trends* sample.

From 2000 to 2006, hotel utility department expenditures grew at a compound annual rate of 5.3 percent. This compares to an average annual growth rate of 2.3 percent for all hotel operating expenses. During the six-year historical period, growth rates for the individual cost components of the utility department varied. Money spent by hotels on steam increased the most (10.7 percent), followed by gas which rose an average of 8.9 percent per year. Electricity and water/sewer charges exhibited the smallest increases. Both expenses averaged 4.6 percent growth per year from 2000 to 2006.

Utility Forecast

Based on a poll of participants in our annual *Trends* survey, PKF-HR estimates an annual change in utility costs of 4.5 percent for year-end 2007. This 4.5 percent growth rate is the lowest single-year change recorded since 2000, except for the 5.5 percent cut in utility costs that occurred during the industry recession of 2002.

Energy conservation procedures implemented by management and the installation of more efficient mechanical and structural hardware, historically have been the main practices for controlling hotel utility costs. However, according to survey participants, advanced purchases of energy on a fixed price basis with local energy suppliers was the primary reason cited for utility cost reductions in 2007. Most respondents expected this practice to benefit them in the future.

A few managers mentioned that they use energy derivatives to hedge the risk of energy price movements. This practice involves buying securities that go up in value when energy prices rise so that this value increase offsets the decline in hotel profits caused by energy price increases.

For 2008, PKF-HR forecasts utility costs to rise 5.5 percent. Given our projections of lower occupancy, it might be assumed that both utility consumption and costs at the property level would follow suit and decline as well. However, our analysis of the historical relationship between occupancy and utility costs finds that changes in occupied rooms have far less impact on a hotel's utility bill compared to changes in energy prices.

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[1] U.S. Bureau of Labor Statistics – Urban consumer energy CPI.

News of near $100 per barrel prices for crude oil has fueled (pun intended) the fears of hotel owners and operators regarding the negative impact this could have on the utility bills for their properties. Fortunately, creative practices such as fixed-price advance contracts with energy suppliers, derivative instruments to hedge energy price movements, and the implementation of "green" operating procedures have helped to tame this largely uncontrollable cost.

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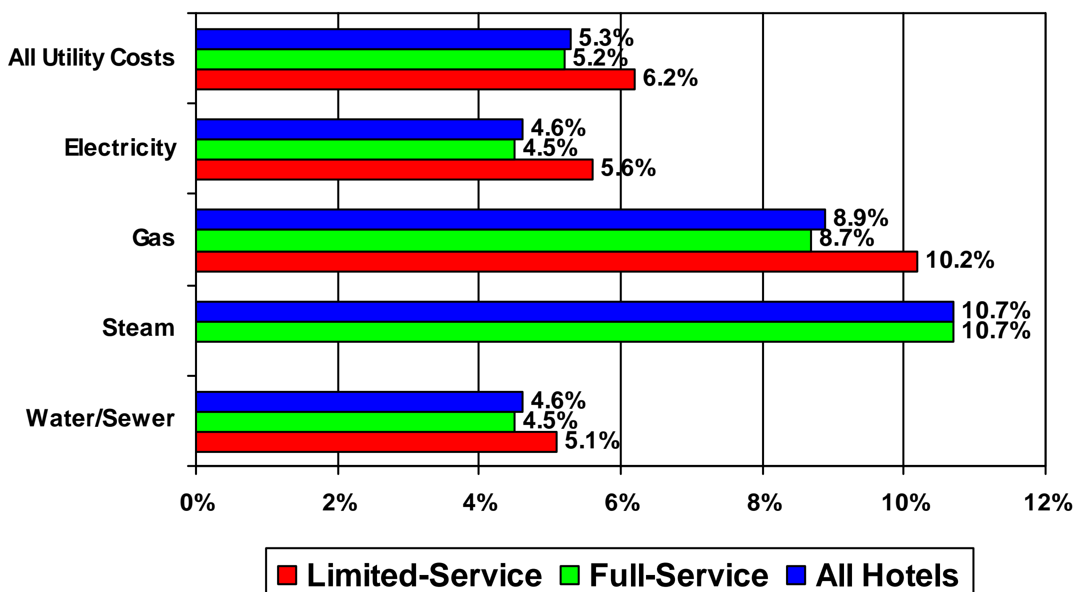
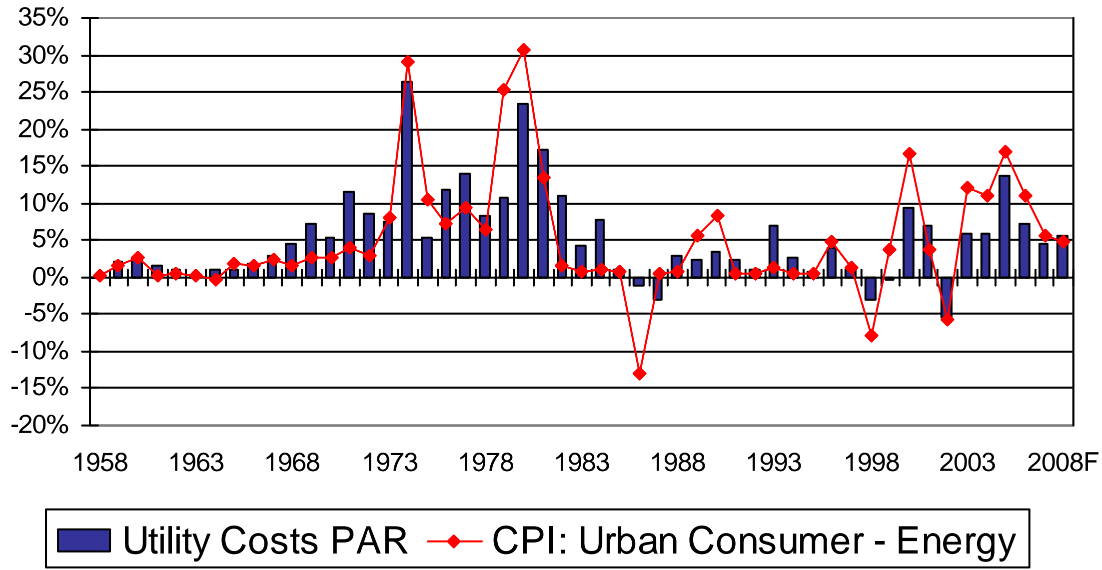
U.S. Lodging Industry – Compound Annual Growth – Utility Costs
2000 to 2006



Source: PKF Hospitality Research

U.S. Lodging Industry
Annual Change in Utility Expenses and Energy CPI



Source: PKF Hospitality Research, U.S. Bureau of Labor Statistics, Moody's economy.com