Brave New World: Online Hotel Distribution

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Brave New World: Online Hotel Distribution

Abstract
In a keynote address at the 2010 Cornell Hospitality Research Summit, STR co-founder Randell Smith highlighted the hotel industry’s distribution dilemma. On one hand, the online travel agents (OTAs) have provided a critical outlet for rooms that otherwise might go unsold, particularly in the recent recession. On the other hand, the OTAs are heavily focused on price transparency, raising a concern that the hotel industry would lose its pricing power. Smith’s comments came against the background of gradual recovery from the recession, but the hotel industry continues to feel the effects of economic malaise. At the depth of that recession, it seemed that almost any business was welcome at almost any price.

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Brave New World: Online Hotel Distribution

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Brave New World:
Online Hotel Distribution

by Glenn Withiam

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The relationship between the hotel industry and online travel agents (OTAs) continues to develop and deepen, as customers increasingly use electronic distribution channels to search out and purchase hotel rooms. While OTAs have substantial sales, it turns out that a major use of search engines, online travel agents, and other internet sites is to gather information regarding a room purchase. Quite frequently, that purchase is made on the hotel chain's own site. Consequently, hotels need to think strategically in terms of rate setting and market differentiation. The OTAs have numerous tools and policies that enable hotels to distribute rooms at various prices while also maintaining rate integrity and improving revenue. Perhaps most important is for hotels to use their relationship with an OTA as an ongoing business alliance, which helps sell rooms in both high times and low periods. Opaque sites in particular allow hotels to sell rooms at various prices without connecting the price directly to the brand. Understanding how the opaque sites operate allows hotels to set their rate and distribution strategy. Being listed on OTAs also creates a billboard effect, whereby sales at the supplier's website pick up when a hotel is listed on the OTA. Most critically, a hotel needs a strategic revenue management function that includes effective forecasting and an understanding of how various business segments respond to price promotions.
In a keynote address at the 2010 Cornell Hospitality Research Summit, STR co-founder Randell Smith highlighted the hotel industry’s distribution dilemma. On one hand, the online travel agents (OTAs) have provided a critical outlet for rooms that otherwise might go unsold, particularly in the recent recession. On the other hand, the OTAs are heavily focused on price transparency, raising a concern that the hotel industry would lose its pricing power. Smith’s comments came against the background of gradual recovery from the recession, but the hotel industry continues to feel the effects of economic malaise. At the depth of that recession, it seemed that almost any business was welcome at almost any price.
Smith urged the industry to focus on a balanced approach to value—not just price—and to maintain a dynamic revenue management strategy. Most critically, he suggested that the hotel industry and the online travel agents and other search engine providers work together for mutual benefit. This report synthesizes the major points of several CHRS presentations that focused on issues relating to OTAs and revenue management, with a goal of promoting the future virtual partnership of the hotel industry and its electronic distribution partners. Underlying all these sessions is the internet, and particularly customers’ expectations regarding how they will locate and book a room—electronically—and, moreover, that they can find a deal online.

Uneven recovery. A review of the U.S. industry’s average daily rate (ADR) data in a CHRS presentation by STR vice president Duane Vinson showed the results of the drop in rates that occurred in the last recession. Vinson pointed out that even as occupancy recovered, rate did not follow as quickly. Luxury hotels particularly experienced rate compression during the recession, with some ADRs approaching those of hotels in lower chain scales. Slow recovery in transient rates means group rates likewise will recover slowly.

Maintaining Price Integrity
Acknowledging that the intuitive response to a drop in demand is to cut prices in an attempt to build occupancy (and therefore revenue), Cornell Professor Cathy Enz presented the results of her extensive research that shows the downside of reducing ADR to boost occupancy. Her studies have found an outcome opposite to what the hotel might want, because lower rates (compared to competitors) mean lower revenue per available room (RevPAR). Faced with stiff competition or a drop in occupancy, hotel managers face an awkward choice. One path is to cut rates below those of competitors in an attempt to stimulate demand, on the classic economic assumption that demand is elastic and price reductions increase demand. Even if demand doesn’t actually increase overall in response to rate reductions, a hotel can at least steal market share from competitors by cutting rates below those of competitors. The other course is to resist discounting and maintain price integrity. In this approach, the manager is counting on the hotel’s value proposition which promotes targeted prices to targeted customers under the idea that revenue will hold up, even if occupancy doesn’t.

Based on data provided by STR for U.S. hotels, Enz found that, indeed, occupancies rise for hotels that price below their competitive set, and hotels that maintained ADR above the competitive set experienced lower relative occupancy. Those findings are in keeping with the expectations, but the effect on RevPAR runs counter to expectations. Lower ADRs mean lower RevPARs. The increase in occupancy from maintaining rates below competitors does not make up for the reduction in revenue. Enz concludes that in good times and bad times, a hotel makes more money by maintaining rate integrity and pricing above its competitive set.

Her research found a similar pattern in the United Kingdom, but not in Spain and Italy, possibly due to the nu-
merous small hotel operators in those countries. In her Asian study, she found that occupancy stayed a lot flatter when decreasing price compared to the competitive set. In short, discounting in Asia did not stimulate any kind of demand, since price is used as a signal of quality.

As a concluding point, Enz shared findings of a Cornell best practices study, which gave an indication of why discounting doesn’t work more effectively as a means to drive occupancy. Nearly nine of ten customers reported that they hadn’t noticed that prices had been reduced. Of the 13 percent that did notice, only 23 percent of those travelers said that the decreased room rate motivated them to stay in the hotel. Overall, only 3 percent of hotel travelers were influenced by a hotel price decrease. As a result, she suggested that hotels avoid focusing on price as a competitive point, and instead consider ways to differentiate a hotel in terms of the value it offers.

Despite Online Growth, Offline Sales Are Big Business

From his stance as chief commercial officer of Travelport GDS, Kurt Ekert has a broad view of global trends in leisure travel distribution through such systems as Worldspan, Galileo, and Orbitz Worldwide. He noted that the recession was far worse than anyone could have predicted. But by the end of 2010, recovery was in the air, particularly for mid-range and long-haul destinations. He foresees growth coming in Europe, Asia, and developing nations. China, for instance, ranks fourth in terms of leisure travel.

Based on data from over 12,700 leisure travelers, Ekert notes that the expense of air travel is barely one-fourth of the cost of the typical trip. Two other large categories are accommodations and food. Even though air fare remains the highest single category, it is treated almost as a commodity. Consumers tend to use searches to look at hotel options.

Despite the growth in online expenditures, the way people buy travel offline is still important, especially in Europe and the Middle East. Ekert outlined the four chief offline channels, as follows. Outside the U.S. are tour-operator-owned agencies which are increasing their reach and strength through acquisitions and technical development. The traditional, mass market retail agencies continue to work in all channels, particularly on complex travel requests and niche travel, despite being squeezed on all sides. Consolidators or wholesalers are gradually expanding away from their original business-to-business model into the business-to-consumer space. These operators also are being pressured by the internet. Finally, specialist agencies operate in niches where they have expertise on specific destinations or holiday types. Needless to say, in all cases, relatively simple transactions are migrating online.
Ekert pointed to a clear correlation between internet penetration and online travel booking. Thus, North America accounts for over 50 percent of online spending due to high levels of penetration, but that will change as emerging markets expand. Emerging markets are key to expansion, as the total number of internet users in Asia already exceeds the sum of users in the developed countries of North America, Europe, and Oceania and Australia. Out of the total of 1.7 billion internet users (according to Internet World Stats), 738 million are in Asia. Five online channels compete for business between the supplier and consumer. They are the OTAs; destination marketers (e.g., vegas.com); metasearch; supplier.com (the chain’s own websites); search sites; and metasearch sites.

Ekert concluded that this is an exciting time to be part of the travel industry, as the internet continues to transform search and distribution. Search is the most interesting dynamic, he suggested. Right now you can type in anything you’re thinking for a book, say, and Google or Amazon will fill it in. At the moment, however, for travel you must be precise in what you type. Moreover, complex processes cannot be handled online, often causing would-be customers to abandon the process. Enroute or self-service solutions are a growing factor, since an increasing number of people shop on the fly (e.g., using their mobile device).

Travel Demand and OTAs
The work of Cornell Professor Chris Anderson has shown that the addition of online sites as a distribution channel provides both opportunities and challenges to the hospitality industry. Anderson shared the results of three studies that he has conducted that analyzed the effects of online sales of hospitality products. He has found that, in addition to the well-known pressure on prices (due to price-sensitive shoppers), online sites also offer noticeable demand-related benefits.

Anderson’s first study looked at the effect of online distribution on rates at Continental Airlines over a ten-year period, culminating in 2006–07. He concluded that rates paid online were lower on balance than those for non-electronic purchases. However, one result of the migration to electronic distribution was that load factors increased during off-peak days. This means that consumers are using the information they find online to purchase during off-peak times, and the airline is smoothing demand by filling in the soft spots with price-sensitive travelers.

Anderson’s two other studies outline what he has called the “billboard effect” for hotels listed on OTAs. Looking at both a relatively small firm (JHM hotels) and a large, multi-chain company (InterContinental Hotels Group), Anderson found a similar increase in bookings through the hotels’ own websites when those properties were listed on the OTA (in this case, Expedia.com). This increased reservation volume does not include any reservations that came through Expedia. On the other hand, reservations fell off at “supplier.com” when the property was not listed on the OTA.

The billboard effect seems to be a function of consumers’ online behavior. Based on data compiled by ComScore, which monitors online behavior, 70 percent of consumers visit a travel-related site prior to booking at the supplier’s website, and 81.5 percent perform a travel-related search. Thus, even when customers book on a hotel’s own website, large numbers have used OTAs and search engines to research their purchase. Anderson suggests that hoteliers can consider the sales commissions paid to OTAs in part as a marketing expense.

OTA Best Practices
Several representatives of the online travel sites made presentations at CHRS, with a primary goal of increasing the understanding of how their systems work and how hotels can best use the sites. Making presentations were Brian Ferguson, VP Supply Strategy and Analysis Expedia; Tim Gordon, Senior Vice President, Hotels, at Priceline.com; and Jay Hubbs, director of revenue management, Hotwire.

Expedia’s Brian Ferguson pointed out that some 127,000 hotels sell rooms through Expedia and Hotels.com. With all those clients, the site sees 20 million daily rate updates. His first piece of advice to hoteliers is to make sure their prop-
Property is listed near the top of web searches, since 95 percent of transactions occur on Expedia's first page listing and 47 percent of Expedia transactions occur with hotels in the top five positions. In short, consumers don't scroll down when they look at search results pages. Instead, if they don't find what they are looking for right away, they move on.

In consideration of consumers' search activity, Expedia maintains strategies both for the point of sale and the point of supply. With regard to point of supply, it constantly adjusts its sort functionality, with the idea of benefiting both searchers and hotels. A hotel's placement on the OTA webpage is improved when the hotel provides room availability all year round (instead of just off-peak), and the chain should offer similar room availabilities on its own site and on the OTA. This consistency should provide an improved sort order and higher conversions. Ferguson suggested that hotels will also benefit from having diverse OTA partners.

Ferguson explained that numerous factors influence where a hotel appears on the results page. They include conversion rate, margin, strategy, and partnership with a brand. Conversion rates are influenced by price (which is a short-term factor that includes absolute price, promotional details, price relative to other hotels in the competitive set, price relative to that of the OTA, and price relative to historic purchase price); quality (a long-term factor that includes star rating, travelers' reviews and ratings, number of room types available, and historic production); and location (a fixed factor that includes distance from the user's search keyword and desirability of the neighborhood). Some strategic factors include a penalty for very low review scores, a short-term boost for new hotels, and strategic accounts.

Bracketing rates. One strategy for hotels is to offer a variety of stand-alone room rates, promotional rates, and packages via the OTAs. Ferguson said that this is a chance to exercise creativity in meeting customer needs while also supporting ADR. Rather than promoting just the lowest-rate room, which will just reduce ADR, hotels could assemble a suite-based package, for example, and thereby attract a different group of customers.

With regard to point of sale, the site also continually checks rates on other sites, acknowledging the transparency of rates on the internet. This also allows hotels to check rates across their competitive set. Ferguson notes that only in a few instances are there rate differences between Expedia and the brand website, and the OTA can quickly mirror price changes as need be. In that way, internet rate flexibility creates the opportunity to test rate changes and set rate fences.

Expedia also maintains a behavior database that allows it to analyze how consumers respond to what they see on the site. Although location matters greatly when people do their search, price is also important. People will, for example, search for hotels according to their proximity to a particular...
landmark (such as the Eiffel Tower or the Grand Canyon). One interesting development is that people also are searching more than one destination, perhaps seeking the best price or value in a set of possible destinations. Ferguson reiterated that people who shop online are price conscious and do not look for a specific brand.

The behavior database also found that travelers purchase air tickets approximately two weeks prior to booking lodging. This information is important because Expedia can promote accommodation packages in the interim. Tracking customer behavior also shows the remarkable power of electronic word of mouth. A study found that 87 percent of leisure travelers were influenced by reviews written by travelers whom they didn’t know as they determined their purchase. (For this reason, Expedia maintains TripAdvisor as a separate site.) Hotels have finally recognized the importance of online commentary. Initially, hotels ignored the reviews; then they refuted negative reviews; now they respond to positive reviews as a means to generate even more positive reviews. This process of managing reviews allows hotels to follow up with guests as needed.

Two Forms of Opaque Models (priceline.com and Hotwire)

Like Travelocity, Expedia has begun to sell rooms through an opaque channel (Hotwire), which operates in a slightly different fashion from the original opaque site, priceline.com. Both models are successful alternatives to the agent model found on many sites. The question posed in a session that featured Priceline’s Tim Gordon and Jay Hubbs of Hotwire is whether opaque sites create incremental demand or whether they reduce rates and dilute brands.

Gordon suggested that priceline.com’s name-your-own-price (NYOP) strategy is intended to create a situation where a would-be customer negotiates against the hotel directly on price. He adds that the purpose of the model is not to set hotels against each other or to drive down prices. The concept involves the classic economic idea of finding a price that would fill rooms that otherwise would go unsold. So, it may be that a hotel sells a $150-rack-rate room for $75, but the chance that the room would have sold at rack was only 10 percent. That income can be considered incremental. The key is to look at RevPAR, instead of just considering ADR.

Gordon then detailed how priceline.com’s NYOP concept operates. To start, the site must construct geographic zones that are sized correctly to balance the need to focus on a destination and thereby give the customer a degree of confidence regarding where they’re going to be, while being large enough to keep the hotel identities opaque. Once the customer has picked a geographic zone, specified a star rating, and offered a price, the site’s algorithms determine whether to accept the bid.

The choice is essentially random among the hotels that offer rates that fit the customers’ NYOP bid while allowing for an appropriate commission. If the bid is not accepted, that hotel is out of consideration for further steps in this process, and the algorithm moves to the next hotel that fits the criteria. Gordon pointed out that hotels can load multiple opaque rates to improve their chances of fitting the criteria. If there are multiple rates, however, the customer gets booked at the highest rate that fits the bid criteria. That approach allows the hotel to yield a higher ADR.

The issue for this site and all OTA-type sites is rate dilution—a problem the opaque model was intended to ameliorate. The opaque channel also screens out loyal retail customers who want a particular hotel or brand and eliminates rate-based competition, since the bid process does not allow rate comparisons.

There’s no real way to calculate dilution, since it’s hard to determine whether the customer would have booked a room without being offered the discounted rate. One cannot know what would have happened. The two key factors that influence dilution are the customer characteristics and price points. Customer characteristics include brand loyalty, hotel needs, price sensitivity, and trip purpose. With the opaque model, a hotel may not get a brand-loyal guest, but by the same token the guest cannot specify a particular set of amenities other than a particular level of hotel. Moreover, the guest must be committed to the hotel purchase, since NYOP
bookings cannot be changed. Critical in the transaction are the opaque model fences, which involve omitting identifying descriptions, the name, specific amenities, and guest scores and reviews. The major issue for price points is to ensure that the pool of hotels is sufficiently large to make the model operate correctly and give the guest full choice. By using a randomly chosen hotel each time, rather than the lowest price hotel, the NYOP model prevents the bid response from becoming predictable.

In closing, Gordon pointed to the continuous development of the priceline.com iPhone app, which is constantly being refined with the goal of increasing conversion rates. The advantage of mobile apps is that the phone will indicate where you are and will actually show you the hotels that are in the direction you’re pointing. Guests with mobile phones stand out in three ways: (1) Two-thirds of them book within one day of the arrival date; (2) Typical length of stay is one night; and (3) Mobile guests are looking for upscale hotels, three stars and above.

Incremental revenue. Hotwire’s Jay Hubbs explained that his site also uses a random function to recommend hotels, but the sort criteria are different from those used by priceline.com. Hotwire’s sort criteria are determined by purchase likelihood so that the display presents the best value overall. Another differentiation is that Hotwire offers a bed-type selection program. For an additional fee, guests can guarantee the type of bed that they will find in their room. Not only does this raise revenue, but it also alleviates an operational problem, in that some people booking on opaque sites are unhappy with the bed type they are assigned, particularly if the selection is left to the hotel.

Hubbs agreed with Gordon that opaque customers are in no way brand loyal, and, in fact many are not loyal to a particular website. One in five identify themselves as deal enthusiasts, in which price is the most important thing. These guests will check with several sites to get the deal, including Hotwire, priceline.com, Kayak, Expedia, Hotels.com, Orbitz, Travelocity, and Top Secret. Hubbs credits these guests with considerable intelligence, since they will use a multitude of reference price points to make their purchase decision.

However, other than their pursuit of the deal, opaque OTA customers are similar to other everyday travelers. On average, about one-third of opaque customers hold a master’s degree and have a median income over $70,000. Contrary to some perceptions, this is not the “cooler dragging” crowd. They simply have saving money as their top priority.

Hubbs points out that Hotwire’s differentiations offer value to travelers, by showing a posted price, product content, and the upselling opportunity of the bed choice guarantee, which increases ADR 5 to 10 percent. Hotwire’s mobile apps cover hotel and car reservations, but Hubbs related that some 38 percent of users spend 10 to 30 minutes with the app. In closing he emphasized the key aspect of opaque sites, which allows hotels to fill otherwise vacant rooms by offering a deal to customers, while at the same time maintaining rate integrity for brand-loyal guests.

Revenue Management Expands Strategically

In all of these presentations, it is clear that hotels need a strong and strategic approach to pricing in all channels. A presentation by Cornell Professor Sheryl Kimes tied revenue management to a larger strategy of hospitality industry distribution. The study was based on an international survey of 500 hotel managers and revenue managers and was supported by CHR and IdeaS (a SAS company). Although RM has largely been connected with room pricing and sales, Kimes explained that most hotel industry managers expect revenue management to be integrated into management’s pricing, forecasting, and budgeting processes. Rather than just focus on revenue per available room, revenue management will be judged in terms of broader measures, such as gross operating profit per available room or perhaps total revenue.

This expanded RM will take in not just rooms sales but also food and beverage and function space revenues. The revenue managers anticipate that revenue management will be technology driven. RM will face the following challenges: integrating RM with other systems (notably, the
property management system), web technology, the sheer volume of data, and a shortage of qualified RM practitioners. Eventually, organizational challenges will be overcome so that function space and other hotel revenue sources will be integrated in a revenue management model. The goal of RM will be to increase revenue throughout the entire hotel rather than only on the rooms side. In that regard, integrating the revenue management analysis for guests who want rooms and also want function space will be a challenge.

As a consequence, the key to future revenue management is that systems will become more sophisticated, to include analytical models for pricing. These models will have to take into account the ways to manage the many diverse distribution channels. Despite those many channels, hotels will continually focus on attracting customers to their websites, which the survey respondents believe will remain an important distribution channel.

Integrated Revenue Strategy
Picking up on Kimes’s research regarding the future of revenue management, David Roberts, senior vice president of global revenue management for Marriott International, said that above all, whatever form revenue management takes, it must operate seamlessly across many distribution channels, including social media and smart phone apps, and it must integrate with reservation systems. With those new distribution channels, revenue managers will have to reconsider their assumption that early bookers are price sensitive. It turns out that guests who book online will tend to book farther in advance of the arrival date than those who might call for a reservation. This means that revenue managers should revise their approach to “time windows,” which determine prices. Roberts said that setting artificial time windows might not be an effective strategy, since they do not account for differences among a chain’s properties or variations in the guests who book through social media.

Like Kimes, Roberts sees revenue managers becoming more central to hotel management, and even to hotel development, so that the hotel is designed efficiently. He also sees a need for revenue managers to adapt quickly to new technologies.

Roberts added that forecasting is perhaps the most critical aspect of revenue management (and pricing and distribution more generally). He explained that forecasting drives all pricing and inventory decisions. As distribution channels multiply and become more complex, forecasting becomes considerably more time consuming, even as it occupies an increasingly essential role. One fundamental issue regarding forecast accuracy is that a forecast does not have to be accurate forever; it just has to be correct in the time window when you need it to make a decision.

A more sophisticated approach to forecasting includes an analysis of the capacity required by various market segments, so that the revenue manager can assign capacity to various segments as needed. In this case, the segments are separated by price positioning: retail or premium (full price); negotiated corporate (discount price); government (discount price); packages (discount price); and e-channels (discount price). Complicating a segment-based approach to
forecasting is the fact that market segments are not entirely independent of each other. This calls into question the existing assumptions about segment incrementality, which are not necessarily well founded. Roberts suggested that more research is needed on the issue of segment incrementality. Roberts sees a role for OTAs because they can bring in incremental revenues, and opaque pricing sites also drive income for the hotel in certain instances.

**Incremental revenue.** One use of segment analysis is to offer discounts in a strategic fashion that adds revenue. The analysis of the discount program should include the volume of revenue that is incremental. Every customer represents either incremental business or a tradedown. The incremental customers would not have booked without some kind of rate incentive, but the trade-down customers are diluting rates because they would have booked anyway without a discount. So, the analysis of a promotional program involves a calculation of the number of incremental customers that would be required to make that promotion worthwhile. That calculation must take into account the number of guests who trade down from a higher room rate and the operating costs for the additional guests.

In creating promotions, hotels should not rely on pricing alone. Social media allow hotel operators to learn more about their customers, including what they wish to pay and what they seek in a hotel. As Roberts put it, you have to know your customer. Through customer relationship management, a hotel can set appropriate prices. Most hotel companies are delving into CRM, Roberts said, but unfortunately, at the moment, he doesn't see any hotel firm making full use of this kind of research. For instance, if we know that a guest likes to play golf, we can offer a golf package—but what we don't know is exactly how to price that package. Still, Roberts believes that it's just a matter of time before the hotel industry determines how to translate consumer data into revenue. Once you know about your customers, you then have the ability to sell and market directly to them. Most critically, you can determine which customers are content to pay existing rates and do not seek discounts.

One industry segment that is making considerable use of CRM data is casinos, which are making effective use of guest data through their loyalty programs and VIP treatment of high rollers. Harrah's, for instance, collects information on almost all aspects of its guests' gaming behavior through its Total Rewards program. For the guest, the program allows them to gain increasing loyalty rewards. For Harrah's, the program provides such information as frequency of play, favorite games, and F&B purchases. Harrah's can set room rates according to customers' gaming behavior, with the idea that a favorable rate encourages return visits. Roberts adds that non-casino hotels do not yet have this level of information.
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