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An Examination of Internet Intermediaries and Hotel Loyalty Programs: How Will Guests Get their Points?

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Abstract
Competitive forces have made loyalty programs a key point of contention between hotel chains and the online intermediaries that sell hotel rooms using a merchant model. Hotel companies would prefer not to award points for the discounted rooms that they sell through the internet agencies. The intermediaries, on the other hand, would like to strengthen their position by offering hotel loyalty-program points. Ironically, although loyalty programs are costly for chains to operate, the cost of giving points is low for hotels, and the points have little intrinsic value for guests. Moreover, loyalty points are being used increasingly as a commodity that can be exchanged for goods or services not related to the hotel companies that issued them. Beyond that, an analysis of the game theory relating to the hotels’ position suggests that hotels will eventually want to award points for internet-merchant sales, if only to minimize losses if a competitor does so. Finally, although one internet intermediary has experimented with setting up its own loyalty-point program, most seem to want to avoid taking on that expense.

Keywords
hotels, internet intermediaries, loyalty programs, merchant model, game theory

Disciplines
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by Bill Carroll, Ph.D., and Judy A. Siguaw, D.B.A.
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Loyalty programs have become commonplace in the travel industry, offered by all major airlines, hotel chains, and car-rental firms. Until the rise of internet-based travel intermediaries, the decisions regarding the structure of hotel chains’ loyalty programs were driven by the chains’ own market considerations. However, because the internet intermediaries use a merchant model, in which they purchase discounted inventory and sell it at a markup, the chains’ loyalty-program decisions are complicated.

Specifically, the following two key issues are emerging around loyalty programs. First, should a hotel chain award loyalty points for intermediary-merchant bookings? Because of the merchant model, these bookings have a high net cost to the hotel, with the hotel trading online display position or making inventory available for a reduction in its own margin. Second, on the other hand, should the intermediaries themselves launch their own loyalty programs that reward hotel bookings? These issues have come to the forefront of managerial concern for both parties primarily because of the penetration of online intermediaries into the business-travel market. The dilemma for the hotel chains is as follows. On one hand, do the hotel chains deny points for intermediary bookings in hopes of gaining direct bookings (and, presumably higher ADRs), or, on the other hand, should the hotels offer points for intermediary bookings, given the relationship-enhancing and customer-tracking values of those online bookings? Similarly, intermediaries face their own loyalty-point-program dilemma. Do they add to their overhead by incurring the considerable cost of creating their own loyalty programs, or do they find some way to cooperate with chains (and other suppliers) to provide a program?

To examine the loyalty-program issue currently facing major chains and online intermediaries, in 2004 and 2005 we conducted a series of interviews with senior executives of five of the ten largest hotel chains and the three largest online intermediaries. In conjunction with our interviews and analysis, we note a series of events that allow predictions to be made regarding the likely outcomes for these major competitors who are at the same time online channel partners.

In the following sections, we first provide insight into the divergent views regarding the disposition of loyalty points, and then we examine customer behavior regarding the use of these points. Next, we estimate the monetary value of a loyalty point and use game theory to examine the likely outcome of chains’ awarding loyalty points for merchant bookings. Finally, we discuss the pros and cons of intermediaries’ developing their own loyalty programs.

Exhibit 1
Costs and benefits of loyalty points for the hotel chain

<table>
<thead>
<tr>
<th>Costs</th>
<th>Benefits</th>
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<tbody>
<tr>
<td>Cost of redeeming points</td>
<td>Margin-saving benefit of a direct booking rather than an online intermediary-merchant booking</td>
</tr>
<tr>
<td>Program administrative costs</td>
<td>Net revenue benefit of a general share shift (or share maintenance) occasioned by loyal, point-motivated guests</td>
</tr>
<tr>
<td></td>
<td>Promotional value of direct marketing to a loyalty program member database</td>
</tr>
</tbody>
</table>

Awarding Points for Merchant Bookings: The Hotels’ View

Most major-hotel-chain executives see loyalty points as a resource that gives them a competitive advantage. Loyalty points have the following benefits for the chains: (1) Offering points encourages a direct, relatively low-cost booking; (2) Point programs assist in maintaining guests’ loyalty; (3) Point programs facilitate better service by giving providers more information on their guests; and (4) Guests’ participation builds a database the chains can use to track customers, offer promotions, and engage in customer relationship marketing. Likewise, online intermediaries perceive loyalty points as a maintenance factor in attracting business clients. That is, the absence of loyalty points will create dissatisfaction, but their presence, in and of themselves, will not create satisfaction.1

Hotel chains and online intermediaries are in various stages of negotiation over awarding points for business-travel transactions. At the core of these negotiations is the points’ ownership by and their value to the hotel chains. As illustrated in Exhibit 1, two expenses are associated with loyalty points: the cost of redeeming the points and the cost of administering the loyalty program. The majority of chain executives whom we interviewed felt strongly that their loyalty-program value is enhanced by the fact that points are not awarded for merchant bookings. These executives viewed loyalty programs as an investment in their customers for the purpose of obtaining a share of those customers’ travel budgets. Our check of the top hotel loyalty-program call centers (see Exhibit 2) found that they all restrict the means by which members may earn points and enhanced tier status to a direct purchase from the hotel chain or an indirect purchase through a traditional travel agent. The chain executives imply that stays booked using intermediaries’ merchant models are not considered valid in chains’ loyalty programs.

The Intermediaries’ View

For online intermediaries, the impetus to get the chains to award points for third-party transactions lies with the potential they see in gaining a greater slice of the business market. The three online intermediaries we studied, Expedia, Travelocity, and Orbitz, have specifically targeted this segment in two areas—lightly managed business travel and corporate business travel. These two segments are seen as moving online at a growing pace (see Exhibit 3).

The lightly managed travel segment comprises firms that annually spend between $500,000 and $2.0 million on air travel. These firms have an opportunity to gain cost advantages from managing travel through a formal corporate travel-management program (including staff, systems, and an agency).

We expect that lightly managed business travel will be a lucrative segment for online intermediaries, provided those intermediaries can extend their merchant programs to this business segment. Online intermediaries’ tactics for attracting the lightly managed segment include offering low-cost, per-use, self-managed travel through online applications that support travel-policy enforcement, expense reporting, and self-booking. These features are combined with call-center support and offering discount air, hotel, and rental-car inventory. The intermediaries maintain a differential fee structure according to whether travelers book themselves electronically or require human assistance. Exhibit 4 shows an example of the elements incorporated into the Expedia Corporate Travel program.

The intermediaries will have to modify their programs if they wish to advance their business-related transactions. Specifically, the intermediaries’ successful extension into the business market with regard to hotels depends on the intermediaries’ ability to provide customers with the following three items: (1) value in the form of satisfactory travel service at a price lower than other providers, (2) access to sufficient hotel inventory, and (3) some kind of premium for patronage, whether hotel chains’ loyalty points or the intermediaries’ own programs.

The online intermediaries’ success also depends on their ability to draw market share from enterprises that currently serve the business segment—including the hotel companies themselves, traditional travel agencies, and travel-management companies. These other players provide value, provide access to chains’ loyalty points, and offer hotel inventory, but the third-party sources (travel agents and travel-management companies) do not yet have merchant programs. Only time will tell if online intermediaries can match or beat the value provided by the chains.

Web-based intermediaries’ ability to continue acquiring merchant inventory from the hotel chains depends on the intermediaries’ ability to create a competitive threat or offer an opportunity for the chains. The chief concern for the chains is whether the internet intermediaries will have sufficient marketing clout to shift business away from the hotel chains (and their loyalty programs) toward:

• independent (non-chain) properties (with or without their own point programs);
• chains that offer points and are promoted (or more favorably displayed) by the intermediary as a “point-awarding” business-program participant; or
• chains that don’t award frequent-guest points, but have some other particular attraction for the intermediaries’ customers (e.g., a favorable price).

If the intermediaries can demonstrate the power to shift market share at will, then the point-awarding hotel chains will be forced to accede to the intermediaries’ demand to allow points for their transactions.
One side benefit of the internet is that communication costs are being lowered by direct e-mail programs, which are estimated to cost just 2 percent of generated revenue. One study suggests that the chains will continue to invest in loyalty programs. While chain executives generally tout the benefits of their programs, data and research findings concerning loyalty programs are equivocal. Several research studies indicate that loyalty programs are the key determinant in the purchase process for only 4 to 7 percent of guests. The research has shown that travelers select hotels first on the basis of location, price, and amenities. In contrast, loyalty points have only a limited influence on the purchase decision. Furthermore, studies of the short- and long-term effects of membership programs on loyalty across all consumer industries suggest negligible net returns. At worst, consumers simply continue to buy what they have previously bought, except that they earn points for a purchase they would arguably have made anyway. One study, for example, reported that the majority of loyalty program members do not believe that their program memberships add value or contribute to their commitment or loyalty. Other research found that loyalty programs create spurious loyalty, and any repeat purchases are not a proxy for customer satisfaction or psychological commitment. These latter works concluded that loyalty programs are not meeting their objectives. We received a tentative confirmation of the above findings from the chain executives who, even as they boasted of their program’s members also belong to competitors’ loyalty programs. The research on loyalty programs is not all negative. One study suggests the following benefits from loyalty programs: hotel loyalty program members are twice as likely to make a repeat purchase as non-members; and they spend more per room, have lower price sensitivity, and experience greater satisfaction. Similarly, results of another study show that loyalty programs which provide economic incentives promote both customer retention and customer-share development. However, the statistical effect of loyalty programs on these variables is small.

Regardless of the marketing effect, general agreement exists among chain executives and scholarly researchers that loyalty programs create databases rich in customer information, especially regarding frequency of stay, spending levels, preferences, and profitability. This information can improve customer relationship management (CRM) efforts. Some of that benefit is negated, however, because 15 to 30 percent of a hotel chain’s database typically is incomplete or inaccurate. The challenge for lodging organizations is to appropriately capitalize on the information through effectively targeted promotions to carefully defined sets of consumers. What complicates the effort is that anyone can join these programs without ever having stayed at the hotel (or, more likely, after logging in just one stay), a strategy contrary to the exclusive-membership approach suggested by marketing research. As a result, hotel chains have compiled huge databases that are costly to maintain and so large as to make data analysis difficult.

The chief reason we see for the growth in hospitality loyalty programs is competitive response. As each chain implemented and then expanded its program, others followed suit to remain at parity with competitors. Thus, even though one goal of loyalty programs was supposedly to cement a competitive advantage, they no longer constitute a key differentiator. Initial consumer excitement over program offerings has dwindled, especially as consumers have learned that rewards frequently are limited. Another putative reason for operating loyalty programs is facilitating customer satisfaction. This has gained support from research indicating that members of affiliation programs are more likely to express greater satisfaction than those who do not participate in such programs. However, despite the conclusions that we just stated, we repeat that the chain executives cited the availability of large and motivating databases as a major value of their loyalty programs.

Intermediaries believe that they need to be able to grant loyalty points to make their model more competitive. Hotel chains might be willing to award points for merchant book- ings to the extent that the chains see value in tracking guests’ purchases through all channels. The chains might want to be able to measure guest allegiance (as assessed by room-nights or spending) and to reward a loyal

Though their value as a purchase motivator is not certain, loyalty programs yield a rich database of guest information.

Motivator is not certain, loyalty programs yield a rich database of guest information.
This value is derived from the net contribution of incremental rooms sold versus the cost of granting. Free rooms (or points traded for other goods and services), plus the expense of program administration. Indeed, programs’ administrative costs may be considerably higher than the cost of the actual awards. Potential value also exists in acquiring customer information to facilitate promotions, direct marketing, and relationship building. Ultimately, that value, too, should come in the form of incremental or retained business.

For the traveler, point value equals the free or discounted hotel services or other items purchased with the loyalty points. Guests also reap the psychological value of being identified by the chain and its properties as a frequent guest, which accrues certain benefits, including special toll-free numbers, identification on web sites, special check-in areas, identification by and added attention from staff as frequent guests, and upgraded room assignments, room amenities, and services.

The value to the intermediary of being able to distribute chain loyalty points is the chance to gain or retain more customers. This may only require the awarding of loyal points to create the perception that the intermediary is a full-service provider.

Notwithstanding our discussion so far, the actual value of loyalty points is modest, when one considers what a consumer can receive in exchange for points. From web-based information, we developed an estimate of the typical value of points of no more than one-half cent per point, as shown in Exhibit 5. At that rate, the total exchange value earned for a two-day stay at a major chain hotel translates into a prospective benefit ranging from $8.50 to $13.50, given certain assumptions about the rate paid (say, $200 to $300 per two-night stay), brand category, and the following:

1. no promotional offers, (2) standard point rewards only, (3) typical brand for the chain, and (4) lowest loyalty membership level.

Most of the chain executives whom we interviewed suggested that guests place a far greater value on the prospects of earning free accommodations for personal and family vacations than the exchange value that we calculated for the points. Exhibit 6 provides illustrations of the point accumulations needed for a two-day, weekend stay at a typical property for major U.S. chains and the associated number of room-nights needed to accumulate those points. Note that this calculation is for illustrative purposes only and does not reflect price point values or the complexity of individual program awards and redemption values.

The real expected (marginal) cost of points that are redeemed for property stays cannot be determined. Not only is that information confidential, but it relates to both the variable or opportunity costs of making the rooms available and to the likelihood of points’ actually being redeemed. We can, however, estimate the “near-money” value of points from the minimum price a chain is willing to accept for a point that is explicitly exchanged for the goods and services that constitute program rewards. As suggested in Exhibit 5, such values range from two to five mills per point, or $4.77 to $11.25 per average two-day stay, assuming that the points are redeemed. That is not a fair assumption, though, because industry estimates suggest that fewer than 30 percent of program members ever redeem their points. Thus, the expected cost to the chain of guests’ point acquisitions may range from $1.43 and $3.38 per average two-day stay, assuming that point use is evenly distributed among those who redeem them. Stated another way, the chains appear to be willing to forgo between $1.43 and $3.38 for a typical two-day stay to gain the possible benefits from their loyalty program.

Returning to the issue of negotiations between chains and intermediaries over the awarding of chain loyalty points for merchant bookings, the calculation that we just presented indicates that allowing the internet agencies to grant points would not result in particularly large monetary expenses. Given the low actual expense of redeemed points, to the extent that awarding points for merchant bookings allows chains to better track guests’ behavior, establish deeper relationships through recognition, and direct market more effectively, chains may find value in granting points even for merchant bookings. Moreover, as we illustrate below, there may be an additional advantage for a chain to be the first to award points for merchant bookings.

One particular implication of our calculation is that if a chain estimates the value of its points as being too high for full awards on merchant-based transactions, it could appropriately reduce the number of points awarded for those merchant bookings, but it would still gain the tracking value of the transaction for guest-recognition purposes. Another way to gain guest information at modest cost would be to restrict point awards to a particular class of merchant rates, specifically, those intended for business customers who the hotel operators believe will offer higher future value, but not to leisure travelers. Some chains do something similar for travel agency bookings based on the rate of book.

Having just made that proposal, we must note research that suggests that frequent business travelers can be less profitable on a per-transaction basis than leisure guests. This is because frequent guests expect rewards, discounts, upgrades, and special amenities, while leisure or infrequent customers are more likely to accept a relatively high price category and have no expectations about special benefits.1

Beyond the chains’ explicit calculation of costs and benefits of awarding points for merchant-rate purchases is the implicit value of punishing a guest by giving no points for booking at a merchant site (even though the guest is not aware of the mechanics of the merchant transaction). For the guest, the choice of booking site and rate used stems from convenience or savings. Although the guest is not being malvolent in making such a choice, most major chains choose to punish their loyal guests by giving no points unless they book through the favored channels. If guests view that policy as punitive, the chain could lose market share and goodwill. We cannot explicitly measure this effect, but it certainly exists. Even worse, we have heard anecdotes to the effect that some hotels actually taunt guests who have booked through online intermediaries by placing cards in the guest room stating that the guest could have had a better room or amenities by booking directly with the hotel chain. If that report is true, we suggest that some properties are irrationally placing potentially lucrative guests in the middle of the battle with the online intermediaries.

Gaming the Chains’ Decision

To return to the heart of the decision of whether to give loyalty points with merchant bookings, chains must decide whether the value of direct booking revenues lost to intermediaries (which is an 18- to 25-percent markup for forgone bookings) is less than the incremental value of guest information and satisfaction gained from offering those points. As we discuss below, the chains must also consider the possibility that one or another chain will attempt to steal market share by making a loyalty-point arrangement with an internet intermediary. We developed a theoretical model of this decision, in which two rival chains individually but interdependently evaluate whether to award points for merchant-business bookings. In developing this model, we assume that an intermediary has sufficient market power to create gains for a chain that grants points and concomitant losses if the chain doesn’t grant points. Although this simple analysis involves just two chains, the analysis would be generally the same with any number of rivals; the calculation would simply be more complicated (and the mechanics of the resulting game theory is beyond this paper).

Using the classic payoff matrix from traditional game theory, as shown in Exhibit 7, suppose that chain A and chain B are individually strategizing about granting points for merchant-rate bookings made by an intermediary. In either case a decision can substantially increase the number of bookings for the chain’s properties or diminish that number, and the selected policy can either add to or reduce the value of tracked customer information for marketing promotion and guest recognition. This is not necessarily a zero-sum game, as it allows for potential gain or loss in share for other properties represented by the intermediary, but not associated with chains A or B. In this analysis, chain A and chain B each have just two possible strategies: (1) award points for merchant bookings, or (2) do not award them. The consequences or potential outcomes of these decisions shown in the Exhibit 7 reflect interdependent gains and losses plus gains from and losses to the intermediary and other chains. We assume that both chain A and B can quantify, or at least rank, net effects of their own and their rivals’ strategy options. Exhibit 8 shows the outcome.
If one of the chains awards points but the other does not. In this case, the point-awarding (cooperating) chain gains share and the non-point-awarding (non-cooperating) one loses share, according to the intermediary’s capability to shift incremental bookings.

The current situation among U.S. hotel chains is represented by the situation in which one chain chooses not to award points based on the premise that its rivals will also not award them. We see this strategy as being risky, because of the incentive for a rival to decide to cooperate with the intermediary (i.e., award points) and thus gain share. As we suggest below, there is precedent for this sort of action among U.S.-based hotel chains. In contrast, the game-theory logic of Exhibit 7 suggests that the rival chains are likely to elect an "award points" strategy (assuming the intermediaries can, in fact, shift sufficient demand to make this choice worthwhile). Thus, the worst outcome of the decision to award points would be for a chain to achieve a neutral position vis-a-vis its rivals, while the best outcome would be a temporary advantage, if a chain moves first. This will be the optimal, low-risk strategy.

The industry’s structure creates what we believe is a compelling argument for awarding points through merchant-based sales, as follows:

- A handful of major chains account for a large percentage of total bookings in the category of properties that compete with one another for business customers.
- All the major chains have made significant investments in their loyalty programs.
- All chain executives interviewed claimed significant value in the information-tracking and customer-relationship value of awarding points and point programs.
- Several major chains already participate in merchant programs for their leisure-travel customers.
- Some chains are already in negotiations with intermediaries over awarding points for merchant bookings for business customers. Some provide credit rates to third parties with less restrictive conditions than other chains require, such as no pre-payment.
- When the InterContinental Hotel Group (IHG) withdrew from Expedia in November 2004, several other chains elected not to follow, presumably gaining market share at IHG’s expense.
- Major chains frequently take actions contrary to their public statements. For example, Marriott “broke ranks” and signed an agreement with Expedia to offer merchant rates.
- Finally, notwithstanding the absence of an agreement at the chain level, loyalty-program members who book a chain hotel room with an online intermediary may display their membership cards at check-in and obtain points if the property agrees to grant them.

The growth of online travel intermediaries generates pressure on chains to award points. Three online intermediaries are working on entering the business market, namely, Expedia (Expedia, Expedia Corporate, Hotels.com, Hotwire, and e-Long), Cendant (including Orbitz), and Sabre’s Travelocity. According to PhoCusWright,14 these services account for:

- 88 percent of total online intermediary gross hospitality revenues,
- 46 percent of gross hospitality online revenues, and
- 9 percent of total hospitality revenue.

If current trends continue, the three intermediaries will account for 15 percent of total hospitality revenues. If current trends continue, the three intermediaries will account for 15 percent of total hospitality revenues by the end of 2006. Because of their broad market reach, the online intermediaries will be able to influence purchasers in choosing a hotel. They will also control increasingly greater quantities of information about a chain’s guests, who have become the intermediaries’ own customers. Furthermore, they will be in an even better position to support participating chains’ efforts to track, recognize, and promote to their loyal customers.

Fait accompli at check-in. To expand on our point above, the local properties may not support their chain’s decision not to award points for merchant bookings. Some chains have tried to systematically prohibit point awards through the local property management system (PMS) or effectively enforce such a policy at the property level. Others have tried to purge points granted on merchant rates. On the other hand, some chains may have the capability to prohibit point awards, but choose not to do so. Regardless of the chain’s position, it is still the front-line staff members who must disappoint the point-saving guest either by openly denying points or by surreptitiously purging awards. Faced with that choice, the employee most likely will simply give a guest his points despite the booking source or rate. Indeed, after stating their policy of no points for merchant bookings, two of the top-ten loyalty-program call centers admitted that the properties will likely award points if the guest presents the loyalty-program card at check-in. This last scenario, however, is the worst one for a chain that patronizes. Beyond consumers’ response, the intermediaries will benefit from knowledge about a much broader array of consumers’ travel habits—as will the companies that are willing to pay for that information. This knowledge will also allow an individual firm to truly understand the share of the travel wallet it is obtaining from its guests.

The intermediaries are not blind to this opportunity. Lodging.com has already launched a modest loyalty program, but that

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We expect that eventually all major chains will offer points for internet merchant-rate bookings.

Travelocity is testing an invitation-only “VIP Program,” which waives service fees and offers such perks as “a dedicated toll-free number for priority customer service, and meaningful, tangible, and easy-to-redeem benefits.” The VIPs also receive “surprise and delight offers.” We conclude that other intermediaries have not launched programs because they have judged them to be too costly to administer relative to benefits or they have determined that other ways to spend the same money will produce better returns. Furthermore, since airlines and car-rental agencies already give points for online intermediary bookings, the intermediary might just be waiting until the chains begin capitulating, as they surely will.

Conclusions

We expect that eventually all major chains will offer points for internet merchant-rate bookings. That said, we suggest that major online intermediaries give temporary advantage to the chain that is the first mover in granting points. We suggest that the initial deals should involve temporary exclusivity or a more lucrative deal than can be sustained. Almost inevitably, other chains will match the first mover’s initiative. At that point exclusivity and favorable deals will disappear.

Although the actual cash value of loyalty points is small, they carry substantial marketing value from the perception of point awards as being part of a “full service business travel intermediary.” In view of this perception, we suggest that chains initially give point awards that are less than those granted for direct chain bookings or for non-merchant (retail) bookings. Even if chains do try this tactic, however, they will eventually have to give full-value awards for all purchases, regardless of the sales channel involved.

Another way to soften the blow of awarding points for internet intermediaries’ transactions is to create a different award class, call it “business merchant rates.” This would be a new form of net rate with fewer restrictions, higher sell rates, and lesser margins than leisure rates. Since these rates are more likely to be used by a chain’s loyal guests, their benefits of tracking their points becomes a bargaining chip for the chain in its negotiations with intermediaries.

Finally, we do not foresee most online intermediaries developing a program of their own, at least until they can exhaust the option of a cooperative program with hotels or other travel services providers. In the near term, we suggest that the chains’ programs already fulfill this function. Already Expedia (with 74 percent of the hotel market share), has said that it does not plan to offer its own program. Travelocity’s program has not yet been shown to shift share as it is still in beta-testing. Instead, the intermediate intermediaries should do what they do best, which is to find a partner promoting that chain through display positioning.  
