

Implications of the Neutrality Rule:

APPLICATION TO OTHER SECTORS

Hotel Industry

July 2015

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1. Neutrality rule in hotel industry

Hotels sell lodging services directly to final customers or indirectly to intermediaries. Final customers are mainly tourists and business clients. The hotel industry is very heterogeneous, with significant differences according to each hotel's category, type of destination or location

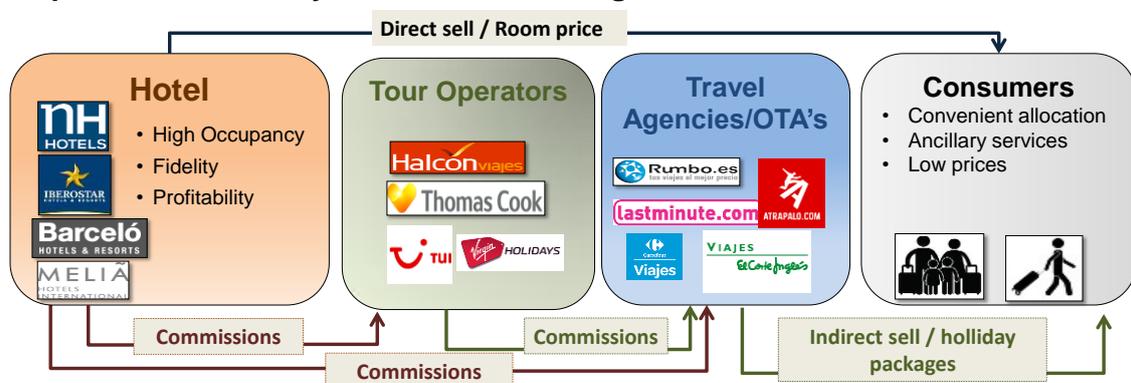
The hotel business model is mainly driven by occupancy needs. Fixed costs represent a great part of hotels' total cost structure. To cover them they are forced to guarantee minimum revenues from room selling.

Hotels use different strategies to sell rooms taking into account customers' profiles, needs and preferences. To cover occupancy risks most hotels book in advance a significant proportion of their rooms to intermediaries, among which we can find:

- **Tour operators:** They act as wholesalers creating holiday packages and selling them to travel agencies or final customers. Tour operators charge fees to hotel chains for announcing and selling hotel chains' rooms. Tour operators are usually large international companies. The sector is highly concentrated and occasionally also vertically integrated with other related activities, such as big hotel chains or low cost airlines. They obtain lower prices when booking large amounts of rooms as this gives them bargaining power.
- **Travel agencies:** They are retail companies that mainly sell tour operators' tourist products to final customers in exchange for a fee. Hotels have to pay travel agencies a percentage of the rooms' bill.
- **Online Travel Agencies (OTAs):** They mainly sell online bookings to final customers and charge fees to hotels.

According to these features, hotels can establish different relations with each intermediary as illustrated in next graph.

Graph 1: Hotel industry business model diagram



Hotel's commercial strategies

Hotel's strategies are based on attracting clients focusing on their needs and preferences. The most extended strategies for final customers are mainly focused on price differentiation, such as price discounts and extra services offers

- i. **Discounts for booking in advance:** Hotels can offer lower prices for earliest bookings with no cancellation options. This is a vital strategy to decrease occupancy risks.
- ii. **Last minute offers:** Discounts to increase the hotel's occupancy and last minute vacancies.
- iii. **Recommendation discounts:** Hotels can offer cheaper prices if their customers recommend the company to others. For example, 10€ discount in the next booking for each customer recommended. This is a loyalty scheme to increase sales.
- iv. **Discounts based on the number of guests or duration of the stay:** For example, cheaper prices for bigger groups or longer stays. This is a volume discount strategy to increase again sales and occupancy.

- v. **Discounts based on customers' profile:** Lower prices to the elderly, students or free of charge promotions for kids. This is a segmentation strategy to attract specific customer groups and increase sales.



- vi. **Special price promotions to certain groups of guests:** Programs to induce to booking from certain institutions, such as Imsero trips or for big company's events.

- vii. **Prices based on seasonal tourists' flows (peak and low seasons):** Hotels usually apply higher prices in most demanded periods.



- viii. **Loyalty cards:** Hotel chains offer advantageous conditions, price discounts and promotions to members.



- ix. **Optional services included in the price per room:**

Swimming pool, disco, conference room, gym, spa, organization of leisure events, might also be included in the price.

Hotels' strategies on intermediaries

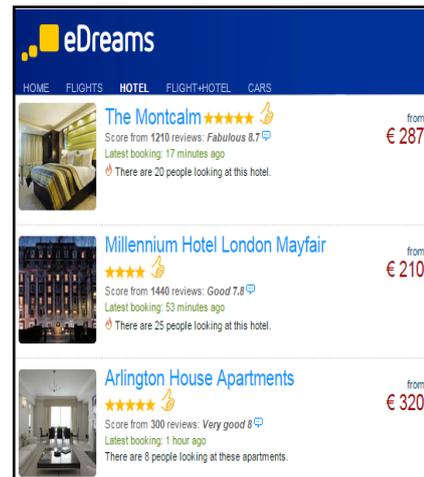
Hotels generally book several months in advance a high share of their rooms for intermediaries with the aim of ensuring a minimum occupancy. Terms agreed by hotels and intermediaries normally lead to different final prices for the rooms. Final conditions depend on the bargaining power of intermediaries and on the volume of rooms negotiated.

i. **Pricing segmentation strategies based on the type of intermediary / bargaining power:**

Generally, tour operators take advantage of their size and their position as distribution

capabilities to get lower prices and more convenient conditions from hotel chains. On the contrary, hotel chains normally reach better conditions when dealing with travel agencies and OTAs.

ii. **Volume discounts:** Hotels can charge lower prices for massive bookings made in advance by intermediaries. These normally benefit tour operators as well.



Neutrality rule on hotels strategies

The imposition of “neutrality rule” would restrict the majority of hotels’ commercial strategies, as “When neutrality occurs, all market participants should be treated equally in terms of prices, preferences, quality, quantity or priority”. “Neutrality rule” would imply that hotels are not allowed to distinguish among customer’s profiles and similar rooms should have the same price and conditions. A more strict interpretation could lead to equal prices whatever the sales channel is used for booking, either direct sale or indirect sale through intermediaries. It could also be interpreted that hotels have to apply the same conditions to different intermediaries, regardless of their retail power.

Equal room prices would imply that hotels cannot charge lower prices to tour operators for early massive bookings. Moreover, other hotels’ strategies to ensure occupancy would also disappear.

Tour operators as intermediaries would lose their main competitive advantage, as they would struggle to provide competitive tourist packages when they would no be able to obtain significant discounts in room sales. As a result, customers would also lose innovative tourist services and hotels would fail to cover uncertainty risks of occupancy.

As a result, hotels’ operational risks would increase, and hotels would require higher investment returns in order to compensate that risk. Hotels would necessarily raise their prices. Hence, customers will have less accessibility to hotel services, leading to a foreclosure of the market for some customers.

Neutrality imposition would significantly affect the hotels' business model, especially in relation with occupancy strategies. This would lead to higher prices, fewer investments in hotel lodging and less employment opportunities in the tourist sector.

a) Impacts of neutrality rule on hotels:

- Less tools to efficiently manage occupancy
- No marketing tools to sell rooms and use of ancillary services to appeal customers
- No segmentation strategies to increase revenues
- Loss of business profitability
- Less incentives to invest in the hotel industry
- Increase in hotels' operational risks

b) Impacts of neutrality rule on intermediaries:

- Less competition among intermediaries
- Distortions on business tools to efficiently manage occupancy.
- Less incentives to innovate and create new tourist packages
- Returns on e-commerce would be lower and less OTAs would participate in the market reducing the hotels' online visibility

c) Impacts of neutrality rule on customers:

- Higher prices for room bookings
- Less hotels available
- Less competitive holiday packages
- Less variety of tourist services
- Damages on e-commerce increase customers' transaction costs

Specific effects on each commercial strategy on customers are shown in table 1.

Table 1: Summary of retail commercial practices that would be forbidden in a “neutrality rule” scenario and impact on consumers of hotels

Commercial Strategy	Neutrality Rule restrictions	Impact on customers
Discounts according to customer’s profiles: <ul style="list-style-type: none"> · Loyalty cards · Discounts for families or big groups · Free of charge promotions for kids · Special price promotions for certain groups of guests 	<p>All customers should be charged equal prices for similar rooms:</p> <p><i>No discriminatory practices depending on customer profile can be applied</i></p> <p><i>No discounts among the same kind of rooms are allowed</i></p>	<ul style="list-style-type: none"> · No discounts for big groups or families · No incentives to recommend brands to friends · Less incentives to brands’ loyalty · No discounts for longer-stays · Higher room prices
Volume discounts: <ul style="list-style-type: none"> · Discounts applied to longer-stays 		
Recommendation promotions: <ul style="list-style-type: none"> · 10€ discount for new customer recommended 		
Optional services: <ul style="list-style-type: none"> · Provision of spa, gyms, conference rooms or organization of events 	<p>Enforces uniform conditions in services:</p> <p><i>Rooms’ prices must include equal services</i></p>	<ul style="list-style-type: none"> · Less hotels’ investments · Less lodging supply and worse quality of services
Discounts for booking in advance: <ul style="list-style-type: none"> · Lower prices for the early bookings · Lower prices for massive bookings made in advance 	<p>Enforces uniform conditions in services:</p> <p><i>No discounts for early booking and last minute bookings are allowed</i></p>	<ul style="list-style-type: none"> · Higher prices as hotels lose their tools to efficiently manage occupancy ratios
Last minute promotions		
Prices depending on the sales channel: <ul style="list-style-type: none"> · Tour operators, Travel agencies, OTAs, final customers 	<p>All market participants should be treated equally</p> <p><i>No differentiation in conditions among intermediaries and final customers</i></p>	<ul style="list-style-type: none"> · Less variety and higher prices of tourist packages · Harm on e-commerce and increase in customers’ transaction costs for searching and comparing among rooms and brands

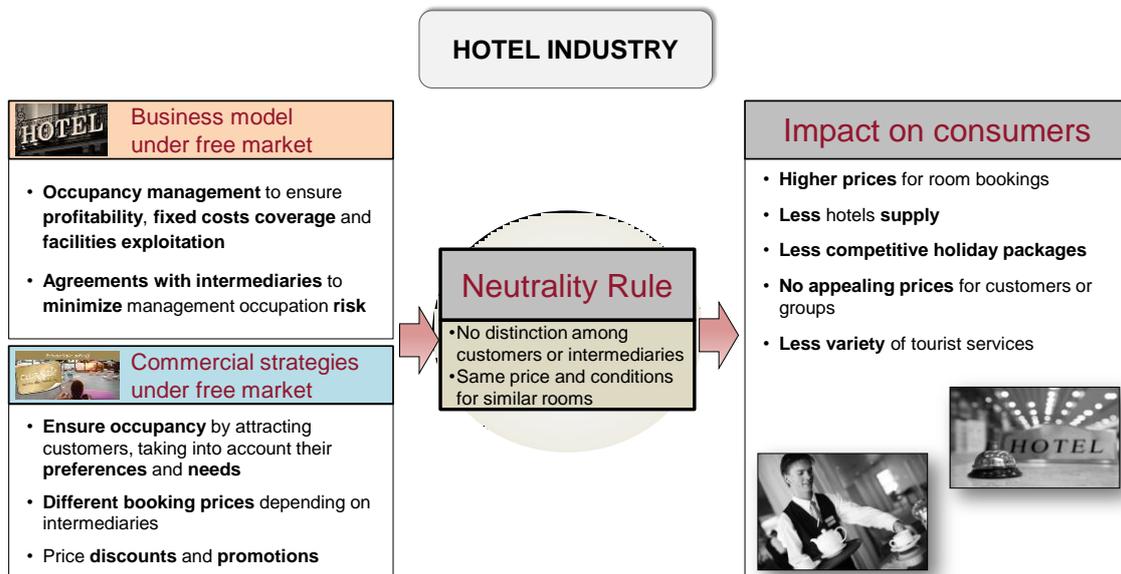
Main findings and conclusions

If a “neutrality rule” was imposed, hotels should charge the same room prices for intermediaries and customers. Hence, hotel chains would not be able to apply special offers, discounts or promotions on lodging prices; and tour operators would be less encouraged to offer appealing holiday packages or include additional services.

Hotels would have then fewer tools to efficiently manage occupancy, increasing their

operational risks. Consequently, hotels will require higher investment returns in order to compensate that risk. They would necessarily raise their prices. Thus, customers will have less accessibility to hotel services, leading to a foreclosure of the market for some customers.

Graph 2: Summary of “neutrality rule” application on hotel industry



2. Annex I: Description of the business model applied to hotel industry

Tourism is one of the most important sectors in the Spanish economy. It represents approximately 11% of Spanish GDP. Hotels have an important role within the touristic sector. In 2013, there were 285.9 million of overnights in hotel establishments represent a 53.1% of hotel occupancy. The number of hotel rooms was about 1.5 million, belonging to 9,100 hotels. The volume of investment in the hotel industry was up to 791 M€, its turnover (including hotels and hostels) was around 11,700 M€. The market share of the five most important companies reached the 19.2%.

Hotels need to use a wide variety of commercial strategies to optimize their capacity to guarantee fixed costs coverage. Some of these strategies are related to price discrimination. Other strategies involve agreements with intermediaries in order to ensure minimum room occupancy. These agreements can change depending on the type of intermediaries and their bargaining power.

i) Business model description, drawing out the relevant market, customers and suppliers profiles

Hotels are establishments that provide lodging services. They provide additional services that may range from a basic bed and breakfast to a variety of luxury features. Larger hotels might also offer additional facilities such as swimming pool, disco, gym, business centers or conference facilities.

According to some sectorial studies, the market could be divided depending on: the hotel's category (determined by hotel ratings), the type of destination and its location (holiday or urban hotels) and finally, the hotel's membership or non-membership to a bigger hotel chain.

The Spanish antitrust Agency establishes that the geographical market of the hotel sector has a national dimension. It also points out that in some cases, the geographical market might have a local dimension because clients may consider as substitutes the different hotels located in the same region or coastal area.

The most important Spanish hotel groups in 2013 were: RIU Hotels and Resorts, Meliá Hotels International, NH Hotels, Iberostar Hotels & Resorts, and Barceló Hotels & Resorts.

Hotel chains rent their rooms to final customers and to intermediaries. Final customers are mainly tourists and business clients. Hotels use different strategies to attract them taking into account their different types of profiles, needs and preferences. However, it is common for hotels to book a significant proportion of their rooms to intermediaries. In this industry it is important the role played by the following intermediaries:

- Tour operators: Act as wholesalers. Tour operators create holiday packages and sell them to travel agencies at a single price that usually includes accommodation and transportation from customers' origin to their destination.

Tour operators charge fees to hotels for renting their rooms. At the same time, travel agencies sell these packages created by tour operators to final customers in exchange for a fee. In some cases, tour operators sell their packages directly to final customers through their own offices or websites.

- Travel agencies: Retail companies that sell accommodation services to final costumers. Travel agencies can also create their own holiday packages. Other services and products provided by these companies are: flights plus hotels bookings, car rental services, travel insurances, etc. Travel agencies charge fees to both tour operators and to hotels.
- Online Travel Agencies (OTAs): OTAs have acquired an important role. OTAs charge fees to hotels for booking directly their rooms. They also sell through Internet some of the products created by tour operators in exchange for a fee. Moreover, tour operators, travel agencies and hotels can act as virtual agencies selling their products through Internet.

While the travel agencies' market is highly fragmented, the tour operators' market is more concentrated. There is a small number of large-scale international tour operators such as ClubMed, Tui AG or Thomas Cook that have a significant bargaining power with travel agencies and hotels because they are able to book high volumes of rooms and flights all over the world. Tour operators may sacrifice profit margins in order to maintain their market share and take advantages of economies of scale. Some tour operators are vertically integrated, participating at the same time in retail and wholesale markets. Some wholesalers even have hotels in property. On the other hand, the bargaining power of travel agencies is low because it is a fragmented market. According to these specificities, hotels can stablish very different relations with each sort of intermediary.

ii) Revenue cost function and profit maximization description

The main source of revenue of the hotel industry comes from the accommodation services tariffs and for managing hotels establishments and facilities belonging to third-parties.

Other revenues come from restaurants, cafeterias, hall for banquets or conferences that might be charged separately from the room prices. Some hotels have additional secondary services increasing their revenues.

Fixed costs are a high proportion on total costs. The costs related to the real state (depreciation and rents) and personnel expenses to keep the hotel open are the most important. Main variable costs come from fees paid to tour operators, travel agencies and OTAs for booking their rooms and increase their occupancy.

In economic terms, the hotels' profit maximization leads to the optimization of the room occupancy in order to overcome their fixed costs. Companies also try to reduce their costs by outsourcing some services and by centralized purchasing in the case of big hotel chains.

iii) Description of discrimination mechanisms and effects on quantity, quality, efficiency, equity and incentives of the industry

Hotels use different commercial strategies addressed to guarantee their occupancy to cover fixed costs and maximize their income in high seasons. We can distinguish among two groups of strategies: strategies addressed to customers and strategies addressed to intermediaries.

Strategies addressed to customers

These strategies are focused on attracting clients relying on their needs and preferences. The most extended strategies to final customers are focused on price discounts and price discrimination:

- Discounts for booking in advance
- Last minute offers:
- Recommendation discounts
- Discounts based on the number of guests or duration of the stay:
- Discounts based on customers' profile.
- Special price promotions to certain groups of guests
- Prices based on seasonal tourists' flows (peak and low seasons)
- Loyalty cards
- Optional services included in the price per room

Strategies addressed to intermediaries

Hotels negotiate with intermediaries in order to ensure a minimum occupation that covers their fixed costs. Hotels commonly accept the conditions established by tour operators because they use their high bargaining power. On the other hand, the bargaining power between hotels, travel agencies and OTAs is more balanced.

Tour operators

- Guaranteed agreements: tour operators book a certain number of rooms paying for them regardless if rooms are finally occupied or not. Hotels can charge lower prices because tour operators are assuming the occupancy risk.
- Occupation agreements: tour operators book a certain number of rooms paying only if they are finally occupied. Hotel charge higher prices because tour operators are not assuming the risk of a no occupation.
- Exclusivity agreements: hotels book their rooms only through one tour operator. Hotels charge higher prices because thanks to these agreements tour operators are able to offer a higher differentiated supply acquiring competitive advantages. The price charged by hotels would depend on some issues like their bargaining power, attractiveness and location. Some tour operators offer to

finance hotels' investments or reforms in exchange for exclusivity agreements.

Travel agencies

Hotels and travel agencies negotiate the sale of smaller volume of rooms in comparison to tour operators. The bargaining power between hotels and travel agencies is more balanced. As a consequence hotels are able to charge higher prices to travel agencies than to tour operators.

OTAs

Hotels pay fees to OTAs to include their rooms in the OTAs' websites. Thanks to that, the visibility of hotels increases and so do their sales.

In some cases, hotels use customers' price strategies through intermediaries. Moreover, hotels may use volume discounts or rappels to intermediaries depending on the volume of bookings through intermediaries.

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