

CHAPTER 7

Electronic distribution

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Introduction

Technology fulfils a number of roles in hospitality and tourism, acting as 'a creator, protector, enhancer, focal point and/or destroyer of the tourism experience' (Stipanuk 1993: 267). However, many believe that technology's greatest impact on this industry is on how the product is being sold. Electronic channels of distribution, particularly those enabled by the Internet, have forever changed the way in which tourism suppliers interact with the customer. This is clearly an operations management issue, as well as a marketing one.

The network of distribution channels (electronic and traditional) continues to rapidly evolve, and has been identified as one of the five most volatile factors affecting the hotel industry (Olsen et al. 1995). To gain an understanding of the importance and complexity of this arena, this chapter explores the development of hotel electronic channels of distribution. Research into how such channels should be managed is explored, and gaps in our current knowledge highlighted. The chapter is divided into three main sections. The first examines distribution, in general, to identify developments in the electronic arena. This is followed by an analysis of the growth of electronic channels, particularly those based on the Web, and the effect they have had on how tourism is being distributed. Lastly, current issues in the management of electronic distribution are explored, and the lack of quality and empirical research in the area highlighted.

Channels of distribution

The manner in which companies bring their products to the marketplace is a cornerstone of any competitive strategy. In their landmark paper, Porter and Millar (1985) specifically cite distribution as one of the primary – as opposed to support – activities of a firm, highlighting its importance for long-term success. Effective distribution is particularly important for hotels, where the product it is highly perishable (Vialle 1995). A hotel room left unsold cannot be stored and subsequently offered for sale at a later date. Revenue is effectively lost forever, making the sale of each room each night at an optimum price extremely important for profitability.¹

Channels of distribution form a key element in meeting this challenge. A channel of distribution has been defined as any organized and serviced system, created or utilized to provide

¹This is discussed further in Chapter 11.

convenient points of sale and/or access to consumers, away from the location of production and consumption, and paid for out-of-marketing budgets (Middleton 1994). In general, companies need help in distributing their products. With physical goods (e.g. a soft drink), arrangements must be made to get the product to where the customer can buy it. The distribution channel helps move the good from the producer to the consumer, overcoming the major time, place and possession gaps that separate it from those who would use it. Intermediaries, be they wholesalers or brokers, typically play a critical role in this process. Through their contacts, experience, specialization and scale of operation, intermediaries allow firms to gain better access to markets that they could working on their own (Kotler et al. 1996).

With physical products, the intermediary often takes possession of the product to be distributed, making concepts such as product flow, ownership flow and title transfer important. However, with less tangible products such as a hotel stay, it is information – about availability, prices, qualities and convenience – that is transferred (Poon 1993). While some might argue that the concept of a distribution channel, thus, does not apply, others feel that it is even more applicable (Duke and Persia 1993). Middleton (1994) points out that the inability to create physical stocks of products adds to, rather than reduces, the importance of distribution process. Creating and facilitating access for consumers is one of the principal ways to manage demand for highly perishable products.

One of the key functions of a distribution channel is to get the product from its producer to where the customer can buy it. However, with hotel rooms, the hotelier is usually both the producer and seller simultaneously (Lewis et al. 1995). The challenge, therefore, is not how to get the product to the retailer, but how to get the customer to the hotel. The literature suggests that this is best achieved by making it as convenient as possible for customers to find and book the hotel. In fact, Go and Pine (1995: 307) define a channel of distribution as one that provides ‘sufficient information to the right people at the right time and in the right place to allow a purchase decision to be made, and to provide a mechanism where the consumer can make a reservation and pay for the required product’.

Information has been described as the ‘lifeblood’ of tourism, as without it, a potential customer’s ability to book is severely limited (Wagner 1991). The intangibility, heterogeneity and diversity of the tourism product mean that consumers depend on accurate, timely, high-quality information to help them differentiate among competing properties (Poon 1994). Recent changes in society have heightened this need. Time is a scarce

commodity for most consumers, making leisure travel an important emotional investment that cannot be easily replaced if something goes wrong (Pollock 1995). This makes the annual holiday or even the weekend break risky, which has prompted consumers to seek out as much information as possible to both reduce risk and bridge the gap between expectations and experience (Zsomboky 1998). This heightened information search makes the fast, efficient exchange of data – between the hotel and the customer; the hotel and intermediaries; and intermediaries and the customer – increasingly important in the distribution process (O'Brien 1999).

Travellers have traditionally acquired information from a wide variety of sources, including directly from the hotel itself or through various travel intermediaries. *Travel agents* act as advisors to the customer, relieving them of much of the burden of searching for suitable products and using their prior knowledge and experience to help match customers with travel experiences. In many cases, they also act as a reservation service, completing the booking on behalf of the end consumer (Palmer and McCole 2000). *Tour operators*, on the other hand, act as consolidators, packaging various travel components (such as air, hotel, car hire, transfers and other destination services) together and marketing them as a single seamless product, which may subsequently be sold directly or through the travel agent network. Some national and regional *tourism organizations* also act as intermediaries, distributing information and processing bookings for suppliers in their region (Laws 1997). In each case, the intermediary's prime objectives are to facilitate the search and purchase processes. Information flow is critical, to the extent that Poon (1994) maintains that there is in effect a dual production system in tourism. While suppliers naturally have to produce products (in this case, hotel room nights), to survive, they must also distribute information about the price, availability, quality, convenience and conditions of purchase of their product. Poon claims that, in the case of travel products, this provision of appropriate information is as important for success as the quality of the actual products themselves.

Information has traditionally been provided to both end consumer and intermediary as printed media (such as brochures, guidebooks or flyers). However, developing such material is costly, time consuming and labour intensive. More importantly, its content is static by definition, while much of the data needed to make a reservation (e.g. availability and rates) is dynamic and changes frequently. Applying information technology to this function is a natural development of Porter's theory of competitive advantage. Porter and Millar (1985) point out that value

chain activities that represent a large proportion of overall costs need to be carefully scrutinized as it is here that opportunities exist for competitive advantage. This is particularly true where such activities 'have a significant information processing component or are critical to differentiation' (Porter and Millar 1985: 152). As we have seen, hotel distribution is both information intensive and critical for placement with both consumers and intermediaries. Within tourism, distribution also typically represents a significant proportion of overall costs, making the application of information technology to distribution very logical (O'Connor and Frew 1998). For this reason, information-technology-based systems, or electronic distribution systems, have become an almost universal feature of tourism (Bennett 1993).

In addition to disseminating information, distribution channels have a second but equally important function – providing a mechanism for customers to make a booking (Castleberry et al. 1998). The convenience with which consumers can purchase is critical, particularly when the sale is being facilitated through an intermediary, who by definition has an interest in handling the most easily sold products and could direct clients to competing suppliers if their product is more easily accessible (Bennett 1993). In the past, the booking process involved the customer (or their agent) contacting the hotel during the limited opening hours of the reservations department to confirm availability and rate; comparing them with proposals from other suppliers; and then re-contacting the hotel to make a reservation (Bennett 1996). Distribution took at least three steps – searching, contacting and finally booking – which were ineffective and inefficient for all concerned. Electronic systems allow travellers to make reservations in a fraction of the time, cost and inconvenience characteristic of manual methods by directly interacting with the hotel's reservation system (Connell and Reynolds 1999). Given such benefits, the use of electronic distribution within tourism would appear to be a foregone conclusion. However, diffusion has not affected all sections of the industry equally. The growth of electronic distribution channels in the hotel sector is examined next.

The development of hotel electronic distribution

In *Being Digital*, Negroponte described the convergence of IT, telecommunications and content as the single most important event shaping the business environment (Negroponte 1995). This digital convergence is part of a trend driving computers to ubiquity in everyday life – so much so that they are deemed

essential for survival in today's world – and giving rise to a digital economy where speed, agility, connectivity and the ability to amass and subsequently employ knowledge are key competitive ingredients (Tapscott 1996). In the hospitality industry, electronic distribution channels represent the quintessential example of the convergence of technology, communications and content.

According to Karcher (1995), electronic distribution systems in tourism began as inventory systems implemented by the airlines in early 1960s. Originally developed as internal control systems, their scope was expanded in the early 1970s by installing terminals in travel agencies and the travel departments of large firms, giving customers direct access to flight availability and pricing information, as well as the ability to make reservations directly on the system. Making such facilities available in this way greatly reduced administrative and labour costs, while at the same time greatly increasing the efficiency of the booking process (O'Connor 1999).

Deregulation of the U.S. airline industry in the 1970s accelerated system adoption. New airlines, coupled with more competition on each route, resulted in an exponential increase in the number of fare options available, making the use of a computerized system to a large extent essential to help untangle the complex range of options available (Hitchins 1991). Developing and operating such systems was expensive. As the investment could not be recouped based solely on the transaction fees generated from airline segments, most of these developing Global Distribution Systems (GDS) incorporated complementary travel products alongside their airline flights (Knowles and Garland 1994). As a result, today's GDS distribute a broad range of travel products, including scheduled and charter airline flights, hotels and other forms of accommodation, car rental, package holidays, ferry, rail and bus tickets, cruise packages, yachting, excursions, theatre tickets and even flowers and champagne. In effect, they provide a one-stop-shop for all the information and reservation needs of a travel agent (Emmer et al. 1993).

One of the first complementary products distributed through GDS was hotel accommodation. Although traditionally reluctant to embrace technology (Siguaw et al. 2000), with electronic distribution systems, hotels were able to benefit from the experience gained by the airline companies (Schulz 1994). At first, many tried to incorporate room inventory directly onto the airline systems. However, as the GDS were designed specifically to distribute airline seats, incorporating the data requirements of the more diverse hotel product was difficult (Emmer et al. 1993). Both the type and the amount of data that could be stored

was limited, leading to simplified, abbreviated or truncated descriptions, and only a limited number of room rates could be incorporated onto the system. Travel agents quickly found that they could obtain more favourable rates by contacting hotel properties directly and, as a result, quickly lost confidence in this initial solution (McGuffie 1994). Hotel chains subsequently began to develop their own computerized systems, with database architectures and methods of operation more adapted to the hotel product, linking them with the GDS through interfaces to give access to the travel agent market (Burns 1994). As each GDS served different geographical markets and hotels needed to be connected to multiple systems in order to effectively cover the marketplace, this still required the development of several complex and expensive interfaces. To overcome this, the major international hotel companies cooperated to develop a 'universal switch' – a bi-directional translator connecting each hotel Central Reservation System (CRS) to the numerous GDS platforms (Werthner and Klein 1999).

However, the capital cost and expertise required to develop and operate a CRS was still substantial, putting it to all intensive purposes outside the reach of smaller companies. Instead of operating their own systems, many chose to outsource electronic distribution to specialist third parties. Costs are typically on a per-reservation basis, allowing the hotel to profit from electronic distribution with little or no capital outlay. Such an approach is particularly attractive to smaller groups and independents, who in many cases also join marketing consortia primarily as a way of gaining cost-effective access to electronic distribution. Participation in Destination Management Systems (DMS) – which typically distribute a comprehensive range of tourism products from a given geographical region – could also be regarded as following a similar strategy (Frew and O'Connor 1999).

The arrival of Internet commerce

Until the mid 1990s, hotel electronic channels of distribution were essentially as described above – a linear status quo where systems cooperated with each other in a mutually beneficial relationship to facilitate distribution (see Figure 7.1). The system was in effect a closed user group, operating over proprietary networks and not available to non-members (Wade 1998). Use of such distribution channels was lucrative, but expensive and lacking in flexibility. This (together with a variety of developments in the external environment) convinced many hotels of

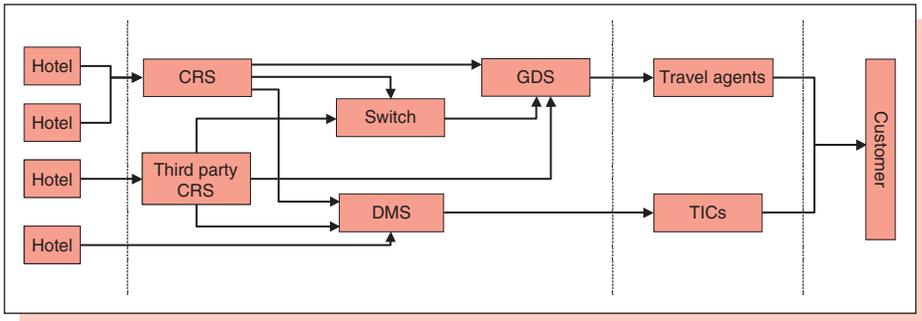


Figure 7.1

The proprietary electronic distribution channels.

the need to find an alternative way to distribute their product (Dombey 1998).

In 1994, the introduction of the Web as a mainstream communications medium provided such an opportunity (Smith and Jenner 1998). In addition to allowing suppliers to distribute directly to consumers, the Web provided a potentially more effective selling medium than the older text-based GDS, allowing images, multimedia and even video to be delivered on demand to supplement highly detailed – yet at the same time highly focused – description data (Murphy et al. 1996). Distribution cost could be greatly reduced by selling over the Web, as the transaction cost of processing voice calls was eliminated and selling directly to the consumer implied the reduction or even elimination of commissions (Helsel and Cullen 2005). The Web also facilitated access to customers with a high propensity to travel, presented little or no barriers to entry, and provided companies with enhanced opportunities to communicate directly with customers (Jeong and Lambert 1999). As a result, electronic commerce was quickly exploited by tourism suppliers and has had a profound effect on the way in which travel products are marketed, distributed, sold and delivered (Williams and Palmer 1999).

Dis-intermediation and re-intermediation

Perhaps the most significant effect of the Internet on tourism has been the way in which it shattered the pre-existing network of distribution channels. As electronic commerce grew, most actors in the tourism value chain started to compete with each other by creating their own consumer-focused websites, while at the same time continuing to cooperate with each other as they

had done in the past (Coyne 1995). The situation was well summarized by Dombey (1998) who described it as 'little short of a technological stampede. Up and down the traditional distribution chain, ... providers are working feverishly to re-engineer their travel systems ... to bypass both the GDS and the travel agent to create a direct link with the customer'. Paradoxically, in addition to there being more competition, there was also more cooperation. A key attraction of many online travel intermediaries is that they are 'full-service', providing consumers with the ability to research and purchase their entire trip on a single site (Ader et al. 1999). To achieve this, they need both detailed content and access to reservation facilities from multiple vendors, which they can only get by cooperating with other distribution providers (Wade and Raffour 2000). Thus multiple non-exclusive virtual alliances have been formed, with companies cooperating with each other to develop new synergistic relationships. The coexistence of competition and cooperation has given rise to a phenomenon which Werthner and Klein (1999) have dubbed 'copetition'!

As was discussed above, one of the key promises of Internet distribution was that the restrictive and expensive network of intermediaries that previously characterized tourism would be bypassed. For hotel companies, the advantages of setting up their own website are clear – few up-front capital costs, no periodic fees, lower transaction costs, a supplemental source of reservations and increased customer loyalty. This has made Web-based distribution very attractive, particularly for the many smaller establishments that could not afford to be included in the GDS channels (Wade 1998). Although initially slow to respond, by 1999, over 90% of hotel chains had a website, with nearly 80% of these providing some kind of reservation facilities (O'Connor and Horan 1999). In 2006, over one in four bookings in the United States originate online, up from one in twelve in 2002 (PhoCusWright 2006). While online booking levels currently lag in Europe, given the growth in e-commerce and the suitability of travel for sale on the Web, online travel sales in Europe should quickly follow U.S. trends and increase from their 2004 level of Euro 19 billion to approximately Euro 42 billion in 2006 (Carroll and O'Connor 2005).

However, the Internet has created just as many intermediaries as it has displaced (Connolly 1999). As early as 1995, companies from outside the industry identified the potential of travel as a product for sale online, and have attacked and positioned themselves strongly in the emerging distribution network (Nealon 1998). In general, such companies have positioned themselves as general-purpose travel retailers, providing

a comprehensive range of information and booking services, usually in cooperation with existing intermediaries and suppliers as was discussed above. Coming from outside the sector, they have no pre-existing relationships or historical emotional baggage, which permits them to question existing methods of operation and gain competitive advantage by doing things differently (Castleberry 1998).

In short, the Web prompted major change in the travel distribution arena. While prior electronic distribution channels were linear, closed and dedicated, the emerging model (see Figure 7. 2) is better described as multi-dimensional, with most participants able to distribute information to, and complete a transaction with, a customer using a variety of different routes (Anderson Consulting 1998). Channels continue to evolve and have become increasingly interconnected as intermediaries form strategic alliances and attempt to develop multiple routes to the customer. Both the number of channels and the complexity of their inter-network are increasing, and the distinction between channels has also become less distinct as systems become connected at multiple levels, as illustrated in Figure 7.2. While most would like to route bookings to direct channels, the domination of the marketplace by online travel intermediaries means that third-party distribution is likely to remain an integral part of the way in which travel gets sold for the foreseeable future (Ader et al. 1999). And since no single system has enough capability or reach to place a product in front of all potential buyers, hotels need to utilize multiple parallel channels (both online and offline) to effectively address the marketplace. Managing this portfolio of channels has become increasingly difficult, but at the same time essential to both profitability and long-term survival. Key questions include which channels to use; how to set prices across multiple channels, all communicating simultaneously with the marketplace; and how to encourage customers to use direct channels, both to minimize costs and to gather data for management of the customer relationship?

Managing hotel channels of distribution

As discussed above, the growth in the number and complexity of the hotel electronic distribution channels has resulted in a variety of interrelated challenges in terms of how to effectively manage this growing network. Channel choice has become increasingly complex as the number of options increases and as new and innovative business models are introduced. The relative cost of using each alternative may be a key factor, and one

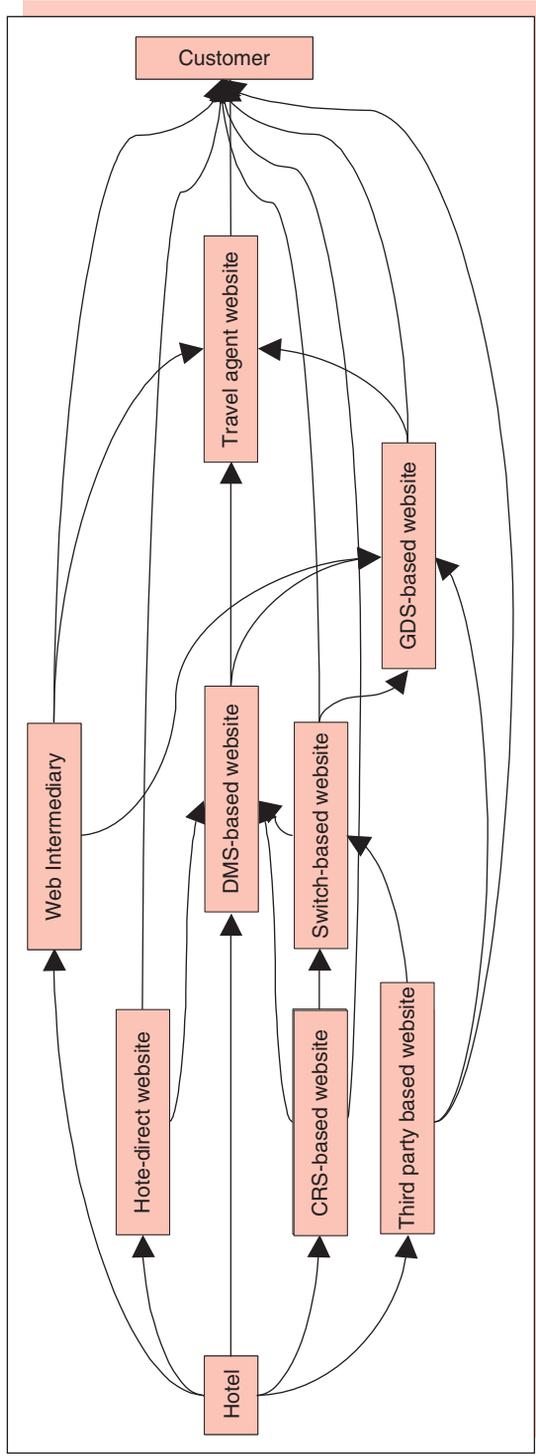


Figure 7.2 A new model of hotel electronic distribution channels.

which varies greatly as a result of the development of alternative forms of remuneration to the commission system traditionally associated with offline travel agents. However, as will be discussed, adopting purely a cost perspective towards channel assessment may be a mistake. Pricing over simultaneous channels is also problematic, while more strategic issues, such as ownership of customer data, also need to be actively managed.

The channel choice decision

Selecting 'an appropriate distribution channel is paramount to success and important if hotel firms are to grow top line revenues and control overhead, yet the number of choices facing hospitality executives is overwhelming' (Connolly et al. 2000: 12). Lewis et al. (1995) claim that such channel management is the backbone of distribution and that every organization must take the time to evaluate current systems and organize a cohesive plan for improvements. Kotler et al. (1996) argue that a well-managed distribution system makes the difference between being a market leader and struggling for survival. Perhaps the situation is best summarized by Andersen Consulting, who maintain that hotel companies urgently need to get better at managing their electronic channels, understanding the profitability of each and developing tactics to drive traffic through their preferred channels (Anderson Consulting 1998). Hence the question arises as to how to decide between alternative channels?

According to Avison and Horton (1988), the most common technique used to evaluate information systems projects is cost-benefit analysis – 'an analysis to determine whether the favourable results of an investment are sufficient to justify the cost of pursuing that alternative' (Shim and Siegel 1995: 97). However, performing such analysis with IT-related projects, particularly those related to electronic distribution, is problematic as costs and benefits are difficult to predict (Applegate et al. 1996). In particular, the benefits arising from adopting a distribution channel can be hard to quantify. Basing evaluations on bookings volume generated is problematic as it may not be possible to establish with certainty which bookings are influenced by which channel. For example, direct websites play an important role in convincing customers to make reservations, even if the actual booking itself is processed through another channel (Connolly et al. 1998). Using bookings volume as a metric would overlook such customers and thus underestimate the importance of the channel. Industry experts claim that online

travel sales are undervalued by as much as 25% because of this trend. Furthermore, bookings volume ignores the value of each booking. However, this in itself is also not a valid metric, as, in addition to suffering from the limitations discussed above (i.e. the difficulty in attributing revenue to a particular channel), it ignores cost of distribution. Each channel has different costs – both direct such as commissions and fees, and indirect costs associated with managing the channel (Lugli 1999). Given the interconnectivity of channels discussed earlier, it has become impossible to precisely quantify the cost of accepting a particular booking (Dev and Olsen 2000). Thus, given the number of unknowns, uncertainties and assumptions, cost-benefit analysis has clear limitations (Weill 1991).

Similar challenges exist with capital budgeting techniques. Coming from manufacturing, these evaluate investments based on ‘realized effectiveness and productivity gains, in terms of labour savings, increased output and lower unit costs’ (Connolly 1999: 69). As such, they tend to focus on cost displacement, to omit strategic implications, to be biased towards short-term returns and to set unjustly high hurdle rates in situations involving high perceived risk, such as with technology investments (Clemons and Weber 1990). While theoretically well grounded, such techniques place too little emphasis on drivers of value such as customer satisfaction, strategic positioning and access to markets. As a result, their utility for evaluating distribution-related projects is limited by the large variety of non-financial factors that need to be taken into account (Ballantine and Stray 1999).

The marketing literature proposes that distribution channels should be evaluated in terms of reach. However, simply choosing channels with the largest potential audience is not always the best solution, as a more focused approach may be more effective (Anderson Consulting 1998). Connolly et al. (1998: 44) cite ‘speed, reliability, accuracy, flexibility and functionality’ as important in channel evaluation in addition to the cost factors discussed above. Similarly, Kotler et al. (1996) acknowledge flexibility – how easy it is to change the terms and condition of sale – to be of key importance. Kotler also focuses on control – how much influence suppliers have over the manner in which the product is distributed. Can they dictate price, or are distributors free to discount or increase prices if they so wish? Both control and flexibility are often related to the length of the distribution chain (Lewis et al. 1995). Shorter distribution chains (with fewer intermediaries) mean less commission and less need for coordination. The fewer the middlemen, the more the profit and the less the potential for errors. Palmer and McCole

(2000) support this view by pointing out that shorter distribution channels are needed for perishable and complex products – both prime characteristics of a hotel room. Future potential is also a factor that needs to be taken into consideration (Horwath and Horwath 1992). Both technology and markets are rapidly evolving, and when evaluating distribution channels, their future as well as their current potential needs to be examined (Siguaw and Enz 1999).

Traditional models of competitive advantage are based on Porter's five forces model, with firms gaining an advantage by exploiting its strengths relative to those of its competitors (Ohmae 1992). Competitive advantage from technology results when the firm achieves economies of scale, reduce costs, create barriers to entry, build switching costs, change the basis of competition, add customer value, alter the balance of power with suppliers, provide first mover effects, or generates new products as a result of the use of that technology (Applegate et al. 1996). Thus, evaluating projects from a strategic perspective requires going beyond operations to assess their role and importance for company success (Olsen 1993). Taking a more strategic viewpoint balances short- and long-term benefits against capital expenditure, ongoing costs and other factors. However, with strategic issues, measurement difficulties are enhanced as it becomes even more difficult to quantify the tangible benefits.

Thus, choosing between alternative channels of distribution is not a simple process. Deficiencies exist in existing appraisal techniques, yet researchers have to date failed to provide a valid alternative. Collective wisdom now recommends a multi-dimensional approach taking a broad range of factors – not just the technical costs and monetary benefits – into account (O'Connor and Frew 2004). However, hotels have traditionally been poor at using formal methodologies for project evaluation. Whitaker (1987: 231) found that less than half of hotel computer system installations had been preceded by a formal systems analysis. In most cases, the decision process 'consisted of a series of ad hoc and uncoordinated decisions based on vague intentions'. Similarly, Murphy et al. (1996: 71) found that 'few businesses based their Internet investment on anything more than a back-of-the-envelope calculation – 18% had done no analysis at all, while only 12% had justified their investment under the scrutiny typically required within their organization'. Jung and Butler (1999) found that 40% of respondents did not measure the success of their website in any way.

Everyone seems to be using every channel, and no one is prepared to follow the airlines to take control of distribution (Stoltz 1998). Like hotels, airlines rank distribution costs as one of their

largest expenses (following fuel and payroll), but in contrast consider them highly controllable. Many have capped travel agent commissions to drive bookings towards more low-cost channels, a strategy which has been highly successful. However, to date, no hotel company has tested or implemented any similar strategy. Most treat distribution channels as analogous to shelf space in a grocery store. Under this type of thinking, more is better as it increases the chances of customer selection. However, additional channels cannot be added infinitum. In many cases, the cost of entering and maintaining these channels outweighs the benefits. Complex technology is needed to support the distribution of room inventory over multiple channels, and the costs of operating this infrastructure increase almost exponentially as additional channels are added. Complexity and the rapid pace of change make it difficult to choose the right mix of channels, yet increased competition, shortages of capital and rising costs make such management essential (Olsen 1997).

Costs and remuneration

Before the growth of the Web as a distribution medium, compensation of intermediaries was relatively straightforward. Travel agents received a standardized commission of 10% in return for selling rooms, while tour operators received highly discounted room rates on the understanding that they would only be sold as part of all-inclusive packages, thus disguising the fact that they had been discounted. Where the sale was facilitated by a technology-based system, such as the GDS or a Switch, a transaction fee for servicing the reservation was also paid by the hotel (O'Connor 1999).

At the beginning of the Internet boom, this model more or less remained the same, as online intermediaries initially positioned themselves as consumer travel agents operating in the online environment (O'Connor and Frew 1998). In most cases, they drew their hotel inventory from the GDS, and collected a normal commission just like an offline agent. However, this arrangement was less than ideal for two reasons. First, hotel inventory on the GDS was primarily business focused, being composed of properties from major hotel chains located in major cities and thus not a good match with the needs of the online intermediary's more leisure-orientated clients. Secondly, the compensation they earned selling such rooms was minimal. After investing in their technological infrastructure, investing heavily in building online brands and merchandizing to make the sale, their remuneration was still only the 10% commission

traditional paid to offline travel agents. As was discussed earlier, many of these intermediaries had their origins outside the travel sector and thus were more willing to challenge traditional ways of doing business. Under pressure from the stock market to continue their rapid growth and to become profitable, online intermediaries needed a more attractive and more profitable source of hotel rooms.

Their solution lay in what became known as the *merchant model* – an adaptation of how hotels had traditionally worked with tour operators. Hotels would contract a specified number of rooms each night (known as an allocation) to an online intermediary at a net rate (i.e. free of commission). Intermediaries could then offer these rooms for sale online at whatever price they wished. When they sold a room, they passed the reservation back to the hotel, paying the agreed net rate and pocketing the difference as their margin. If their allocation went unsold, they could release the rooms back to the hotel before their cut-off time without penalty. In an economic climate where hotels were scrambling to fill rooms at any cost, such an arrangement seemed like a win-win situation. Hotels got access to a powerful new channel of distribution to help fill rooms that would otherwise have remained empty, while online intermediaries got access to more hotel rooms and could potentially make higher margins as they, not the supplier, determined the retail price.

However, merchant contracts tended to be biased heavily in favour of intermediaries. Control over inventory and retail price quickly became problematic (O'Connor and Frew 2004). Online intermediaries had fixed allocations of rooms, substantial discounts and total control over retail price and could undercut hotels' direct prices by accepting lower margins, or earn super-normal profits by selling their allocation at a premium when the hotel itself was sold out. Many saw the relationship as unbalanced as the intermediary took no risk (Carroll and Siguaw 2003). If they sold their allocation, they collected their margin, but if they failed, they could return rooms at no penalty, leaving the latter with unsold inventory at the last minute. Hotel companies slowly began to realize that the merchant model meant that they no longer controlled how, and at what price, their product was being sold (O'Connor and Piccoli 2003). At the 2004 Berlin Hotel Industry Investment Conference, speakers cited this threat to profitability as the biggest single challenge facing the industry. Furthermore, as occupancy levels rose, hotels found themselves tied into restrictive contracts for allocations at highly discounted rates. The merchant model then had a negative effect as they were committed to selling rooms at rates lower what could be achieve by selling directly or through

other channels. Although intermediaries subsequently reduced their margins (particularly for larger hotel groups with superior negotiating power), industry estimates still place the typical cost of selling a room over the merchant model at over double that of commission-based sales (Carroll and O'Connor 2005).

Given the resistance that has developed to the merchant model, newer forms of intermediary have instead opted for a pay-per-performance compensation model. Meta-search sites in particular seek compensation based on the volume of business that they deliver to the hotel. This can be based on a cost-per-click model, with the intermediary receiving payment for each visitor they despatch to a website, or cost-per-purchase, with the intermediary only receiving payment if that customer subsequently buys. Unlike the merchant model, there are no allocations or discounts to be managed, just payment if and when a sale is made. Although still relatively uncommon, this model has the potential to become popular as it balances the cost minimization needs of the hotel against the revenue requirements of the intermediary, rewarding those who successfully deliver business to the hotel.

Pricing over multiple simultaneous channels

Pricing is a key element of distribution and one that has been made more difficult by the growth of the Web (Enz 2003). As was discussed above, most hotels now use multiple simultaneous channels of distribution to address the marketplace (Buhalis and Laws 2001). While giving hotels more reach, this is problematic as the resulting transparency means that consumers can easily comparing the product offered on each one in terms of price and features (Stone et al. 2002). Yesawich et al. (2000) claim that almost six out of ten leisure travellers now actively seek out the lowest possible price when booking travel services by shopping alternative distribution channels. Dedicated software tools and websites (known as Metasearch) that automate this comparison process (e.g. TravelAxe, Sidestep, cheapaccommodation.com and Kayak.com) are also available. These facilitate price comparison across dozens or potentially hundreds of online retailers, reporting back with the most appropriate or cheapest match (Varini et al. 2003).

Thus, by reducing search costs, the Internet has intensified price competition (Jiang 2002). Any variations or inconsistencies in price are potentially immediately apparent to the consumer, thus necessitating a logical, consistently implemented, pricing strategy. However, many researchers (see for example

O'Connor and Piccoli 2003; Varini et al. 2003) claim that hotels are haphazardly setting prices on electronic distribution channels without really understanding how their actions affect revenue and profitability. For example, a study by Thompson and Failmezger (2005) showed that cheaper rates can frequently be obtained through intermediary sites rather than on hotel brand direct sites. Not only finding the same product at different prices on different sites is confusing for the customer (Biswas 2004), but also having a cheaper price on a third-party site may result in the cannibalization. Existing customers, who might have booked direct, may now book through the intermediary as a result of the lower price. Such third-party bookings also result in a lower net contribution, as commissions, processing fees and other transaction costs usually have to be paid on intermediary bookings. Furthermore, inconsistent or illogical pricing lowers customer satisfaction levels (Murphy and Schegg 2004), can potentially alienate the customer (Kimes 2002) and ultimately result in lost sales (Sinha 2000).

To prevent this, many companies have developed more logical approaches to pricing across multiple channels. Some, for example Marriott International or Hyatt International, use a price consistency strategy – offering the same rate to customers irrespective of the channel – online or offline – being used to make the booking. Thus, customers booking on third-party websites, through travel agents, through the call centre, on the direct website or through the hotel property get offered the same rate irrespective of the point-of-sale. However, this approach ignores the cost of using a channel, and as a result the company will end up with a lower net contribution when the booking is processed through a third party. For this reason, some companies promise cheaper rates to customers booking directly through their brand website, in effect sharing the saving in cost in order to motivate direct bookings. An estimated 43% of hotel companies now promise such best rate guarantees to customers booking through their brand website (KPMG 2005).

Whatever strategy is used, it must be implemented consistently and communicated effectively (Hanks et al. 2002). Unfortunately 'pricing in the hotel industry appears to be unscientific, self-defeating, myopic and not customer-based' (Danziger et al. 2004: 6). O'Connor's (2003) study of international hotel chains found that 'no single channel consistently offered the lowest prices' and that the 'lowest prices were often offered on the channels with the highest transaction costs' (O'Connor 2003: 94). This lack of a comprehensive pricing strategy means that hotels have, to a large extent, lost control over the sale of their product in the online environment

(Murphy and Schegg 2004). While disengaging from merchant contracts can be difficult and painful, leadership has come from international hotel chains, such as Intercontinental Hotel Group (IHG). Taking a strategic decision as to how the company wanted to work with intermediaries, IHG withdrew its inventory from Expedia and Hotels.com, two of the most prominent online travel intermediaries, as the latter were not willing to cooperate with IHG's new business terms (Carroll and O'Connor 2005). Such decisive action is not typical. The KPMG (2005) worldwide industry survey indicates that the majority of hotels have not, to date, implemented a coherent pricing/distribution strategy.

The availability of multiple potential channels of distribution has also made yield management² more difficult (Choi and Kimes 2002). However, little empirical research has been published on how the process should be adapted to cope with this changing environment. Choi and Kimes (2002) use a simulation to demonstrate the applicability of yield management techniques to multi-channel problems. More practical advice comes from Noone and Griffin (1999) who propose combining Activity-Based Costing with yield management principles in what they call Customer Profitability Analysis. Noting that the cost of using channels can vary greatly, sophisticated yield management needs to focus not just on rate achieved but also on distribution cost to maximize net revenue (Choi and Kimes 2002). To achieve this, higher prices should be incorporated on channels with higher transaction costs (O'Connor and Piccoli 2003). Other things being equal, the higher rate would either compensate for the higher distribution cost or alternatively drive customers towards cheaper direct channels, thus delivering other branding and marketing benefits associated with having direct contact with customers (Helsel and Cullen 2005).

Having higher prices on intermediary channels may be difficult as hotels may not be able to set the actual retail price. With the merchant model, the hotel provides a net rate free of commission, which the intermediary then marks up by varying amounts (Carroll and O'Connor 2005). Thus, it is the intermediary, not the hotel, who sets the retail price and can undercut direct channels simply by accepting a low markup. Furthermore, the aforementioned transparency of the Internet makes it easy for customers to compare prices across multiple channels. If prices vary illogically, perceived unfairness can lead customers to defect, spread negative information and initiate other actions that damage the seller (Xia et al. 2004). Consistent

²See also Chapter 11.

pricing across all channels would address this issue, but suffers similar challenges to successful implementation.

Ownership of the customer

Hotels face an increasingly competitive market where the basis of competition is changing. While 'location, location, location' remains a key issue, a hotel's location is a given, at least in the short run. Attracting and retaining customers based on service, facilities or amenities is similarly problematic; as such attributes have, to a large extent, become relatively standardized. Competition based on price is unattractive as it can lead to a downward spiral resulting in uneconomical rates for all suppliers, driven in part by consumers' aforementioned ability to easily compare prices over the Internet (O'Connor 2002). And consumers are displaying less brand loyalty than in the past, eroding another one of the competitive methods on which hotels have traditionally relied (Gamble et al. 1999). For these reasons, many companies are turning towards attempting to build long-term relationships with the customer as a way of adding value and differentiating themselves from their competitors (Francesse and Renaghan 1990).

One of the great promises of Internet commerce is the ability to interact directly with customers – past and potential – to build meaningful long-term relationships. Developing such relationships is thought to increase customer loyalty, which is important because such customers stay longer, buy more and buy more often (Dowling 2002). Acquiring new customers is thought to be between five and seven times more expensive than keeping existing ones (Kotler 1997), while another oft-quoted statistic is that companies can improve profitability by between 25% and 85% by reducing customer defections by only 5% (Reichheld and Sasser 1990). Over time, a company can leverage its relationships to learn about individual customers' needs, wants and expectations and use this information to market more effectively and to provide more tailored customer service (Peppers and Rodgers 1994). This should result in higher profitability, from increased sales as a result of higher responsiveness to marketing efforts, from reduced customer acquisition costs, and from customers willing to pay a premium for 'better' service (Dowling 2002).

Success in building such relationships is thought to revolve around effectively capturing data about customers so that they can be profiled accurately to identify their individual needs and idiosyncratic expectations, and to generate actionable customer knowledge for both marketing and operations

uses (Gamble et al. 1999). Relationship building is also about consistency – specifically the ability to consistently treat different customers differently (Newell 2000). However, achieving this, particularly in large multi-unit, geographically dispersed hotel chains, can be problematic. Customer recognition is a key enabler of both success factors. However, this is severely threatened by the explosion in number and complexity of electronic distribution channels discussed earlier.

Online travel intermediaries operating under the merchant model in particular tend to pass minimal information about each reservation back to the hotel – typically just the guest name, date of arrival and length of stay – which severely limits the latter’s ability to provide customers with appropriate levels of recognition. Similarly, the absence of complete data makes marketing efforts difficult, and may lead to data duplication and data redundancy (Piccoli et al. 2003). From a strategic perspective, such customers are in any case being encouraged to develop relationships with the online intermediaries rather than with the hotel. In each case, the intermediary in question has provided them with a solution to their travel problem. Next time they have a need, their instinct will be to return to the intermediary, who not only provided them with a solution in the past but also offers a one-stop-shopping experience. As this relationship develops, they build up trust with the intermediary, which potentially allows them to be diverted to competing products. Online intermediary’s adoption of marketing and merchandising techniques borrowed from the retailing sector accelerates this trend. While much criticism of the merchant model has focused on profit margins and control over price, strategically this loss of ownership of the customer is much more worrying, and should be a prime motivator for driving customers directly. While no hotel company has as yet followed the airlines in actively discouraging indirect bookings by not awarding loyalty points or forbidding upgrades on seats booked through online intermediaries, such steps may be necessary in order to ensure that customers interact with the hotel directly during the distribution process.

Summary and conclusions

This chapter has given an overview of the origins and development of electronic distribution as it affects the hotel sector. The importance of information distribution for hotel product has been explored, and the role that technologies can play in making accurate, relevant and timely information available to consumers at the appropriate stage of their purchase decision-making

process has been explained. The importance of providing reservations facilities – to allow a consumer or an intermediary to book a room with minimum inconvenience – has also been highlighted, and the range of channels traditionally available to help in this process described. It has been shown how the arrival of the Web has acted as a catalyst in hotel distribution – breaking the pre-existing ‘status quo’ and encouraging both new developments and competition. This has in turn led to an explosion in the type, complexity and number of electronic distribution channels available.

Hoteliers now have a vast range of potential channels through which they can distribute their product. Channels vary greatly, from both operational and strategic perspectives, making management of the distribution space increasingly difficult. The arena is in a continual state of flux as a result of technological advancements, new and emerging distribution players and periodic shifts in the balance of power among suppliers, buyers and intermediaries (O'Connor 1999). An in-depth understanding of this highly complex and dynamic arena is essential for today's hospitality managers. Guidance from published research is sadly lacking (O'Connor and Murphy 2004). Most existing studies lack both rigour and relevance, and offer few concrete suggestions as to how to manage this increasingly complex subject area. The research potential is outstanding for those motivated to dig into this fascinating area.

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