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# When is a good deal bad for business? An exploratory study of room rates highlighting the practice and effects of discounting room rates

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**WHEN IS A GOOD DEAL BAD FOR BUSINESS?**  
**AN EXPLORATORY STUDY OF ROOM RATES HIGHLIGHTING THE**  
**PRACTICE AND EFFECTS OF DISCOUNTING ROOM RATES**

By

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**Master of Hospitality Administration**  
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**University of Nevada, Las Vegas**  
**May 2010**

**ABSTRACT****When is a good deal bad for business?****An exploratory study of room rates highlighting the practice and effects of  
discounting room rates**

By

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Through the analysis of available literature, this exploratory study highlights the practice and effects of discounting room rates within the hospitality industry. This study discusses methods used for setting room rates, rate integrity and brand integrity. At its conclusion, this exploratory study suggests who should and who should not discount room rates and it conveys methods that can be used for discounting room rates without loss of a target market and/or without financial loss.

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## PART ONE

### Introduction

The recession of 2008-2009, which has carried over into 2010, has generally wreaked havoc on the financial state of the hospitality industry. One example of this havoc is the fact that from the beginning to the end of 2009, hotel foreclosures in California increased by 313% and the number of hotels in California that defaulted on mortgages increased by 479% (Lansner, 2010).

Other areas in the United States such as Las Vegas, Orlando and New York City have been hit hard too. Many hotels and resorts in these popular tourist destinations as well as in other locations have adopted the practice of discounting, often deeply, their room rates for what seems like the long-term.

An example of this deep discounting is when Starwood's Resort at Singer Island in Palm Beach, Florida offered a 30% room rate discount that was marketed as their "Winter Sale" (Twelve Vacation Days Publishing, 2010). Starwood's Resort at Singer Island in Palm Beach and other hospitality industry businesses have gone to discounting in hopes of attracting more customers and thus continuing to make money, as a hospitality business must. The following decreases in ADR or RevPAR for 2009 for Las Vegas, Orlando and New York City were essentially due to hotels and resorts in these locations discounting room rates: (a) Las Vegas – 27% decrease in ADR (Lewis, 2009), (b) Orlando – 11% decrease in ADR (Orange County CVB, 2009), and (c) New York City – 26.3% decrease in RevPAR (Reed Business Information, 2010b). Is the practice of discounting working for or against hotels and resorts?



Rewind to the aftermath of September 11, 2001. The terrorist attacks on the Twin Towers in New York City paralyzed the air-traveling public and brought the hospitality/tourism industry to its knees for a relatively short time. Many hotels and resorts discounted room rates during that time too. Did discounting room rates work then? The Center for Hospitality Research at Cornell University published a very interesting and telling study done on the practice of discounting room rates revolving around the effects September 11, 2001 had on the hospitality/tourism industry (Enz, Camina and Lomanno, 2004).

One method for setting room rates sees them set based on a variety of factors including, but not limited to: (a) competitor's room rates, (b) cost of running business and (c) customer Comfort Level (Waller, 1997). By discounting the room rates that have been set based on the aforementioned factors in addition to any other factors that come into play, can the cost of doing business still be covered? Are the discounted room rates below what the competitors are getting for their rooms? Is the discounted room rate lower than what customers are willing to pay for a room? Those are just a few questions a savvy hotelier could ask about discounting.

Other questions that might arise out of the practice of discounting room rates include: (a) What about rate integrity?, (b) What are the financial effects of discounting?, (c) What are the effects, aside from financial ones, of discounting?, (d) What about brand integrity?, (e) Are there some hotels and resorts that should not give room rate discounts?, and (f) If hotels and resorts truly feel the need to discount - What would be a good formula that could be used to make sure too deep of discounts are not given?

Through a literature review on this paper's topics, the reader will discover the answers to the above listed questions. The reader will also gain insight into some methods for setting room rates as well as get a more in-depth look at the practice of discounting room rates for the long-term and the consequences that can occur because of it.

### *Purpose*

The purpose of this paper is two-fold: To suggest who should and who should not discount room rates and to convey methods that can be used for discounting room rates without loss of a target market and/or without financial loss. To arrive at this paper's purpose, this paper will explore and analyze: (a) methods used for setting room rates, (b) setting room rates for profit maximization, (c) rate and brand integrity, (d) methods used for discounting room rates, and (e) the positive and negative effects of discounting room rates.

### *Problem Statement*

Many hotels and resorts are discounting their room rates in an attempt to cope with the current financial crisis and economic recession. However, the practice of discounting room rates can easily lead to the loss of a target market and/or to financial loss in both the short-term and the long-term. Whether or not hotels and resorts should discount their room rates and if they discount how they should discount their room rates are issues that urgently need investigation.

### *Justification*

The economy's downward spiral that started at the end of 2008 has stuck around and has caused: (a) high unemployment rates (U.S. Bureau of Labor Statistics, n.d.); (b)

lower wages (Shedlock, 2009), (c) record hotel foreclosures (Lansner, 2010), (d) bank collapse of Washington Mutual – one of the largest banks in the U.S. (Russell, 2009); and (e) a sizeable drop in business and leisure travel (Office of Travel and Tourism Industries, n.d.). In the wake of this economic turmoil, owners of hotels and resorts are trying to maintain or even to increase their occupancy rates. To do so, many began to offer room rate discounts – some as much as 27% lower than their ADR (Lewis, 2009).

According to Smith Travel Research, the practice of discounting decreased the U.S. hotel industry's RevPAR by 16.7% for the year 2009 (Reed Business Information, 2010b). President of Smith Travel Research, Mark Lomanno, commented that 2009 would be remembered as the worst year in modern hotel industry (Reed Business Information, 2010b).

There are many factors that should be taken into consideration when setting, and especially when discounting, room rates. Discounting room rates is usually done when a hotel or resort feels the need to realize a higher occupancy rate. The discounts that are being offered may indeed not be in the best interest of the hotel or resort that is giving the discount (Feiertag, 1993).

It is important for the owner and for the managers of a hotel or resort to understand the ramifications of discounting room rates (Feiertag, 1993). In turn, it would be helpful for the owner and the managers to have a formula to go to when calculating room rate discounts if they really feel the need to use the practice of discounting (Smith, 2009).

### *Constraints*

One of the limitations of this paper is the fact that it does not speak specifically to a certain hotel or resort but rather generally to all. This is because hotels and resorts are unwilling to publish or to share their discounting data as it is regarded as confidential corporate information.

A second limitation of this paper is that its presentation of methods used for setting and/or discounting room rates is not exhaustive. The methods presented are what were available through research of this paper's topics.

A third limitation of this paper is that some of the methods presented for setting room rates and for discounting room rates, though they represent what has been used or what is being used in the industry, may not work for every hotel or resort. In the end, it is up to the individual property's ownership and management to decide which method will work best for their property.

### *Glossary*

Following are definitions for some of the core terms and concepts used throughout this paper. These core terms and concepts are explained in more detail in the body of the paper.

ADR – Average Daily Rate

Hotel – Provides lodging with limited amenities and limited or no personal services.

Resort - Provides lodging, a wide array of amenities and a wide array of personal services.

Revenue Management – Method used to set room rates that maximizes revenue and manages demand by using pricing and duration controls. The “new” Yield Management.

RevPAR – Revenue Per Available Room

Yield Management – Method used for setting room rates to maximize room revenue and profits.

## PART TWO – LITERATURE REVIEW

### Introduction

The current economic recession that began in 2008 has, once again, brought about the practice of discounting room rates – often deeply (Lewis, 2009). Historically, another time of economic slow down for the hospitality industry also brought about the same practice. This time began with the recession of 2001 that was magnified after September 11, 2001 (Lewis, 2009).

Enz et al. (2004) released a report that they wrote based on a study performed about the years 2001-2003. The study revolved around the practice of room rate discounting that occurred during that time period's economic downturn for the hospitality industry. The study was based on hotels and resorts in a competitive market. To reaffirm the study's findings, Canina and Enz (2006) released a follow up report based on a study done in 2004 when the economy stabilized. This study reported the same findings as the 2001-2003 study did.

With the assistance of the aforementioned literature as well as other topical literature, the Literature Review section of this paper will explore the nuances of setting room rates, address rate as well as brand integrity and end with a discussion on the practice of discounting room rates including the positive and negative effects that come from this practice.

#### *Methods used for setting room rates*

The methods for setting room rates that will be presented in this paper are broken down into the three following categories: (a) based on cost, (b) based on market, and (c) based on combination of cost and market.

### *Methods Based on Cost*

Per Schmidgall (2006), the two most common methods for setting room rates that are based on cost are the \$1 for every \$1,000 method and the Hubbart Formula. The \$1 for every \$1,000 method makes each room cost \$1 for every \$1,000 of construction cost. For example, a 300-room hotel is built for a price of \$40 million or a per room cost of \$133,333.33 per room. Therefore, the room rate for a room would be set at \$133.33 per night if using the \$1 for every \$1,000 method to set room rates. As Schmidgall (2006) noted, this method does not take the current value of the building into consideration. This method also does not take the other services the hotel may offer such as a restaurant, spa and bar into consideration. In addition, it ignores current operating costs.

The Hubbart Formula is a procedure that sets the average room rate through the use of eight steps (Steed and Gu, 2005). Schmidgall (2006) commented that the Hubbart Formula starts with the property's preferred profit. The eight steps to the Hubbart Formula as laid out by Schmidgall (2006) are:

1. Step One – Compute the property's preferred profit by multiplying the wanted return on investment by the investment of the owner.
2. Step Two – Compute before tax profits by dividing the number arrived at in Step One (property's preferred profit) by the tax rate subtracted from 1.
3. Step Three – Compute fixed costs and any management fees.
4. Step Four – Compute undistributed operating costs.
5. Step Five – Compute departmental operating costs leaving out the Rooms department.

6. Step Six – Compute Rooms department income by adding Steps 2,3,4 and 5 together.

7. Step Seven – Compute the revenue for the Rooms department by adding all Rooms department costs to Step 6.

8. Step Eight – Compute the average room rate divided by the number of rooms expected to be sold.

As noted by Steed and Gu (2005), the \$1 for every \$1000 method and the Hubbard Formula have been discarded by today's hotels and resorts because these methods for setting room rates that are based on cost do not take other aspects that should affect a property's ADR into consideration. Waller (1997) suggested that in addition to operating costs, a property's competitor's room prices as well as how much a property's customers are willing to pay for a property's rooms should be taken into consideration when setting the ADR.

#### *Methods Based on Market*

The methods based on market for determining room rates that will be discussed here are: (a) competitor-based pricing, (b) behavioral-based pricing, and (c) yield management.

*Competitor-based pricing.* One method for setting room rates based on market can be called competitor-based pricing - it is also known as "going-rate pricing" (Kotler et al., 2010). Going-rate pricing is when pricing is set according to a property's competitor's prices. In a market whose elasticity is hard to determine, going-rate pricing is a good method to use for setting room rates (Kotler et al., 2010). It is a good method



because it feeds off of the group intellect of a property's competitors and may, also, avoid "price wars" (Kotler et al., p. 306, 2010).

Before pricing off competitors, a property must first research who its competitors are by performing a competitive analysis (Kotler et al, 2010). As recorded by Kotler et al. (2010), a successful competitive analysis will take more factors than just the physical ones into consideration. These other factors include service standards and general property & room cleanliness.

When a property has found its true competitors, that property's room rates can be set off of the room rates of those competitors. Enz et al. (2004) reported that to attain and/or to maintain a respectable RevPAR against a competitor's a property should set their room rates using + or - 2% as a guide. In other words, a property that is setting their room rates off of their competitor's room rates should not go lower or higher than 2% from their competitor's room rates.

In the study that was performed by Enz et al. (2004), properties that set their room rates greater than 2% below that of their competitors may have realized more occupancy than their competitors however their overall revenue was lower in comparison. On the other end of the scale, a property that set their room rates 2% or more higher than that of their competitors realized higher revenue in comparison (Enz et al., 2004) even when their occupancy rate was not as high.

*Behavioral-based pricing.* Another method for setting room rates that is based on market can be called behavioral pricing - it is also known as "value-based pricing" (Kotler et al., p. 305, 2010). This method takes Waller's (1997) suggestion of a property knowing its "Customer Comfort Zone" to heart. In order to use this method, a hotel or

resort will need to perform some market research. This research can be done in a variety of ways however needs to ensure that all market segments are surveyed properly (Kotler et al., 2010). A simple strategy for polling market segments' value perceptions would be to attach the survey to a property's guest satisfaction survey with a question similar to "At what price would this room be too expensive?" (Waller, 1997).

Once a hotel or resort has gathered and assessed all of the value perceptions from its market segments, the property can set room rates with this information in mind. The business segment may have higher room rates than the leisure segment or vice versa (Kotler et al., 2010). Steed et al. (2005) commented that the value-based pricing method works very well with the group market segment. Economy hotels are another good outlet for the use of this method of setting room rates as economy hotel guests are quite price sensitive (Enz, Canina and Lomanno, 2009).

*Yield management.* To set room rates based on a property's market, Waller (1997) advised to track market demand of a property as well as market demand of its competitors while anticipating any supply changes. Waller (1997), also, commented that a property should look at their room pricing strategy as it relates to their market share instead of how it relates to their occupancy percentages. In other words, if a property enjoys a year-round occupancy percentage that hovers between 85% and 95% that property should look more to the seasonality of the market as opposed to their occupancy percentages to set room rates more accurately. Yield management takes market trends including seasonality into account (Relihan, 1989).

In essence, yield management endeavors to set room rates in line with market trends (Relihan, 1989). Therefore, yield management is another method that is used to

set room rates that is based on market. To use yield management for setting room rates, a hotel or resort must comprehend their guests' buying behaviors and draw comparisons between current and future room demands (Relihan, 1989). Using yield management to set room rates can help a hotel or resort realize equilibrium for supply and demand. This is because it will allow a hotel or resort to make small room rate adjustments in anticipation of seasonality and other market trends. According to Withiam (p. 4, 2001), "...yield management uses the basic strategy of providing the right service at the right time to the right customer at the right price."

The room rate fluctuations that can be seen from a hotel or resort practicing yield management should not be confused with room rate fluctuations that can be seen from a hotel or resort that is simply discounting their room rates. In its function as a method for setting room rates, yield management sets rate fences for discounted prices (Withiam, 2001). Rate fences are limits on discounts that can be given on room rates.

To put yield management into practice for setting room rates, Withiam (p.4, 2001) suggested remembering the "4-c's: calendar, clock, capacity and cost". Calendar refers to managing the date of the guests' reservation. Clock refers to the timing of the guests' stay. Capacity refers to finding equilibrium between supply and demand. Cost refers to the room rate that is set in relation to calendar, clock and capacity.

The basis for a good hotel or resort yield management program is the ability to project room demand (Withiam, 2001). To project demand accurately, the demand for each market segment or rate class must be known. The seasonality (timing of demand) must also be known. To further project and manage demand a hotel or resort must track the length of guest stays. This will assist the hotel or resort in controlling capacity. Once

demand, inclusive of seasonality, is accurately projected and capacity is controlled, a hotel or resort can go about setting room rates. Setting room rates is the most difficult task of practicing yield management for a hotel or resort (Withiam, 2001).

When setting the different price categories, a hotel or resort should utilize strong rate fences. Strong rate fences will keep guests from getting too large of a discount (Withiam, 2001). Rate fences can be physical like the location of a room, the size of a room or the in-room amenities. Rate fences can also be related to guests' group memberships such as AAA or AARP. Other rate fences include days of the week.

The largest possible downfall of yield management happens when a guest is upset by feeling that a hotel's or a resort's pricing practices are unfair because that guest did not qualify for a lower room rate due to the rate fences a hotel or resort has set (Withiam, 2001). This downfall can be circumvented by a hotel or resort by ensuring that guests have knowledge of that hotel's or of that resort's pricing practices (Taylor and Kimes, 2010). As laid out by Taylor et al. (2010), to ensure that guests have knowledge of a hotel or resort's pricing practices that hotel or resort can: (a) make information available on the property's website, third-party websites and through the reservations department regarding the different room rates and the reasons for the differences; (b) advertise any restrictions along with special room rates or packages; and (c) make sure reservation and front desk employees have knowledge of the different rates and the rate fences that go along with each rate so they can explain them accurately to guests. When guests feel that they are being treated fairly, the likelihood of a return stay rises exponentially (Taylor et al., 2010). Using yield management for profit maximization will be covered in more detail later in this paper.

*Methods based on a combination of cost and market*

Kotler, Bowen and Makens (2010) conceded that costs set the lower price limits for setting room rates but that it is the market and demand that set the upper price limits for setting room rates. Per Pan (p. 750, 2007), seasonality definitely affects room rates in both “low and high” seasons. “Low” season occurs when a hospitality property is experiencing a low rate of visitation. “High” season occurs when a hospitality property is experiencing a high rate of visitation.

Daily variable costs per room sold and room capacity also have effects on room rates. However, as recorded by Pan (2007), the daily variable costs per room sold only affect room rates set during the low season. Because room capacity has the greatest impact on room rates set during the high season, it is a negative impact.

To account for the daily variable costs, Pan (p. 750, 2007) proposed the following two models for setting room rates, which are based on a combination of cost and market and take into consideration not only the daily variable costs but also seasonality (market demand) and room capacity:

$$\text{Low season average room rate } (P^{L*}) = (A^L + r)/2$$

$$\text{High season average room rate } (P^{H*}) = A^H - Q$$

Where  $P^{L*}$  is the average room rate set for low season,  $A^L$  is the room demand in low season when rooms are free,  $r$  is the variable cost per room sold,  $P^{H*}$  is the average room rate set for high season,  $A^H$  is the room demand in high season when rooms are free, and  $Q$  is the total number of rooms.

Pan (2007) based his models on the hypotheses that (a) higher high season demand will increase the high season room rate without affecting the low season room

rate; (b) higher low season demand will increase the low season room rate without affecting the high season room rate; (c) if the highest demand in the high season, the highest demand in the low season and the daily variable costs per each room sold remain the same then an addition to a property's room capacity will cause a decrease in the equation  $P^{H*} - P^{L*}$ ; and (d) if the daily variable costs per room sold go up when the greatest demand in the high season, the greatest demand in the low season, and the room capacity stay the same then there will be a decrease in the equation  $P^{H*} - P^{L*}$ .

When Pan (2007) developed a regression model to test these hypotheses using data from hotels and resorts in Taipei, Taiwan, he found that his equations provided the best means of setting room rates for the high and low seasons.

The basis for Pan's (2007) model was Gu's (1997) model for setting room rates based on a combination of cost and market which is expressed in the following formula:

$$r^* = (a + \beta v) / 2\beta$$

where  $r^*$  is the optimal room rate,  $a$  is the possible room demand when rooms are free,  $\beta$  is the measure for demand that is price sensitive, and  $v$  is the variable costs per rented room.

Because this model accounts for the demand for rooms, as well as the variable costs per rented room, it is another method for setting room rates that is based on the combination of cost and market factors. This model requires that demand characteristics and variable costs per rented room need are recalculated often to ensure that the model is continuously adjusted to the factors that influence it.

In the *multi-stage synthetic hotel room pricing model*, a third method that can be used of setting room rates based on cost and market factors, Kim, Han and Hyun (2004) combined the methods for setting room rates based on cost with the methods for setting room rates based on market according to the following seven steps:

1. Identify target markets, market position and competitors for the same markets. Identify competitor's average price (room rate).
2. Calculate "Cost-Based Price (CBP):  $CBP = (VC+FC+PG)$ " (Kim et al., p. 172, 2004).
3. Determine the property's "Differentiation Premium (DP)" (Kim et al., p. 172, 2004). Compute "Market Premium Price (MPP):  $MPP = (1+DP) \times \text{Average competitor's price}$ " (Kim et al., p. 172, 2004).
4. Contrast MPP with CBP. If " $MPP > CBP$ " (Kim et al., p.172, 2004) then use MPP as price and go to next step, if  $MPP < CBP$  then DP needs to be improved.
5. Ensure price set (MPP) is within limits between the pricing ceiling and pricing floor.
6. Apply rate fences to price.
7. Apply seasonality to price.

#### *Setting room rates for Profit Maximization*

According to Butscher, Vidal and Dimier (2009), the ability to set room rates is the best tool that hotels and resorts have to optimize their revenues, even during economic downturns. As a goal of a good yield management program is to maximize profits (Relihan, 1989), this section discusses the use of yield management as a way for hotels and resorts to maximize profits through setting the appropriate room rates.

### *Yield Management*

When practicing yield management for profit maximization, hotels and resorts must control room rates to avoid large differences among different rates that could upset guests (Relihan, 1989). Gu and Caneen (1998) presented the following two quadratic models to help maximize profits through setting the appropriate room rates. These models do not help hotels and resorts determine room rates but rather calculate how to optimize revenue from setting the appropriate room rates.

*Ym quadratic formula I.* According to Gu and Caneen's (1998) first quadratic formula for maximizing revenue from room rates,

$$r^* = a/2\beta$$

where  $r^*$  is the optimal room rate,  $a$  is the room demand when the ADR is zero and  $\beta$  measures price sensitivity of demand

Gu and Caneen (1998) explained that, "If the actual ADR is higher than the model-calculated  $r^*$ , reducing ADR may increase room revenue. If the actual ADR is lower than  $r^*$ , raising room rates could lead to higher room revenue" (Gu et al., p. 249, 1998). Thus, hotels and resorts can use this equation as a means of determining when to make an adjustment to room rates.

*Ym quadratic formula II.* According to Gu and Caneen's (1998) second quadratic formula, which incorporates cost considerations,

$$r^* = (a + \beta v)/2\beta$$

where  $r^*$  is the optimal room rate,  $a$  is the room demand when the ADR is zero,  $\beta$  measures price sensitivity of demand and  $v$  is the variable cost per rented room.



### *Revenue Management*

Revenue management is the hospitality industry's new yield management. Although the terms are often used interchangeably, there has been a definite transition from yield management to revenue management in the hospitality industry (Cross, Higbie and Cross, 2009). While yield management was more concentrated on inventory, revenue management has become more concentrated on the guests. Instead of just managing demand, the modern practice of revenue management has an important role in the creation of demand, making it imperative for a revenue management department to work closely with its sales and marketing departments. When the departments all work together on pricing, revenue management can truly have a positive effect on all aspects of a hotel's or resort's business.

Cross et al. (2009) contended that there are four main areas of concentration that have emerged from the transition from a focus on inventory to a focus on guests: (a) to maximize price, not just inventory; (b) to find solid pricing strategies that will enable multiple rates each day of the year; (c) to have a comprehension of guests' price comfort level; and (d) to control positioning in the marketplace. The process of setting room rates using revenue management, which is almost identical to setting room rates using yield management, includes: (a) segmenting customers by market, (b) ensuring rates for each market segment do not contradict one another, (c) projecting seasonality, and (d) limiting practice of overbooking (Vinod, 2004). To truly maximize profits from room rates, today's revenue management can take advantage of sophisticated software (Cross et al., 2009). The appropriate information is input into the program which then calculates room rates that will optimize revenue.

Although RevPAR is a strong indicator of the effect of revenue management on the entire business of a hotel or resort, an even better indicator is the Revenue Per Available Customer (Cross et al., 2009). By consistently measuring the Revenue Per Available Customer, a hotel or resort can better track spending by market segment, allowing it to maximize pricing even more throughout its property.

Revenueyourhotel.com and the HSMAI Revenue Management Advisory Board (n.d.), laid out the following action items for all revenue managers for 2010:

1. Ensure everyone involved in owning and operating the hotel or resort has knowledge of the goals of revenue management.
2. Recover rates as quickly as possible.
3. Gain a better comprehension of market segments so solid forecasts can be made.
4. Collect the necessary data needed for strong pricing decisions.
5. Make revenue management a part of managing the guest relationship with the hotel or resort.
6. Become more strategy oriented instead of just being analytical.
7. Gain more insight into marketing on the internet.
8. Utilize software and other available revenue management tools to enable better forecasting.
9. Concentrate on increasing Revenue Per Available Customer.
10. Communicate focus on customer value instead of on price.

### *Rate and Brand Integrity*

Rate Integrity in the hospitality industry can be defined as maintaining "...general prices based on the value of the product..." (Martinez, p. 19, 2009). Rate Integrity is gauged by comparing a property's different room rates (Wolfe and Boger, 2001). Low rate integrity occurs when there are large differences among rates. Rate Integrity is important for hotels and resorts because it keeps prices consistent with the guests' perceived value of the property, thereby decreasing their likelihood of being sued over pricing practices considered unfair.

Brand Integrity in the hospitality industry can be defined as "...a desirable outcome for companies seeking to maintain a consistent, unambiguous position in the mind of their audience" (Wikipedia, 2010), with the audience in the case of hotels and resorts being the guests. Much of a hotel or resort's brand integrity rests not only on physical accommodations but also on the number and quality of services provided by its employees (Mangan and Collins, 2002). As rate integrity and brand integrity together determine guests' loyalty to a hotel or resort, any fluctuation in either factor can lead guests to question their loyalty (Mangan et al., 2002).

### *Methods used for discounting room rates*

An effect of the current recession is that many people have become more price-sensitive (Duff, 2009). By offering room rate discounts, hotels and resorts in the hospitality industry are hoping to appeal to people's price-sensitivity.

### *Housekeeping discounts*

One method for discounting room rates used by Starwood Hotels & Resorts Worldwide, Inc. is to extend hotel credit or points in its guest loyalty program to guests

who choose not to have housekeeping services for their rooms (Nassauer, 2010). For each night that a guest does not require housekeeping, Starwood gives a \$5 hotel credit or 500 points towards the guest loyalty program. Other hotels that use this method for discounting include Marmara Manhattan, which gives guests a \$20 discount for every night they do not require housekeeping (Nassauer, 2010), and Marriott's Grand Chateau in Las Vegas (M. Colvin, personal communication, February 12, 2010). This method of discounting rooms has not cost for the hotel – in fact, it saves the hotel the costs associated with cleaning a room - and gives the guest the option of taking the discount by not requiring housekeeping services on a daily basis (Nassauer, 2010).

#### *Competitor-Based discounts*

Another method used for discounting room rates in a hotel is similar to the competitor-based method for setting room rates. If a hotel's competitors are giving room rate discounts, a hotel may feel pressured to do the same by either matching their competitor's discounts or by giving an even deeper discount (Enz et al., 2004).

#### *Discount packages*

A third method resorts use for discounting room rates is a method referred to as packaging or bundling (Kotler et al., 2010). One example of this is Chula Vista Resort's All-Inclusive package which includes the room itself, all food and drinks, and unlimited waterpark access for \$199 for two nights, not including weekends (other restrictions apply; Chula Vista Resort, 2010). The room rate outside of the inclusive package was \$99 per night.

#### *Discount based on historical data*

A fourth method used for discounting room rates is to determine the

discount based on historical data (R. Roger, personal communication, March 2, 2010). If a certain room rate filled rooms in the past, it is used to fill rooms again, even if doing so requires a 50% discount off the current ADR.

#### *Discount based on promotions*

One more method often used for discounting is to run promotions. One popular promotion is offering a free night after a stay of a certain number of nights. Examples of this type of discounting have been used at Starwood's Resort at Singer Island in Palm Beach, FL (Twelve Vacation Days Publishing, 2009), the Grand Hotel Marriott Resort, Golf Club & Spa in Point Clear, AL (Marriott International, Inc., 2010) and the Four Seasons Hotel in Las Vegas (Four Seasons Hotel, 2010).

#### *Positive Effects of Discounting Room Rates*

##### *Higher occupancy levels*

Higher occupancy levels are a possible positive effect of discounting room rates. According to the study performed by Enz et al. (2004), hotels and resorts in a competitive market did indeed experience slightly higher occupancy levels when they discounted their room rates.

##### *Gaining market share*

Gaining market share has been another possible positive effect of discounting room rates. Hotels and resorts in a competitive market may be able to grab some market share from a competitor by discounting their room rates before their competitors match the discount (Lomanno, 2008).

## *Negative Effects of Discounting Room Rates*

### *Decreased Rate Integrity*

According to research done by Kimes (2009), it is difficult for revenue managers facing an economic downturn to maintain rate integrity because it is difficult to convince their owners to hold rates without discounting to protect rate integrity. Lomanno (2008) found that by offering discounts, hotels and resorts are conditioning their guests to expect the discounted prices even after the recession lifts, requiring years to pass before owners can return rates back to their original pre-discount period levels. For example, six years passed after September 11, 2001 before hotels and resorts in New York City could return rates to their pre-9/11 prices (Lomanno, 2008).

### *Decreased Brand Integrity*

Kimes (2009) also found that revenue managers are concerned that discounting can damage brand integrity. In many cases, the larger the discount given, the greater the potential for damage was to a property's brand integrity. Lomanno (2008) supported revenue managers' concern by contending that by discounting room rates, hotels and resorts teach their guests that a different value has been set for that property.

### *Price Wars*

Kimes (2009) reported that surveyed revenue managers were also concerned about the price wars that discounting has produced. In the face of price wars, revenue managers felt great pressure to discount rates in order to maintain and compete for market share. Unfortunately, these price wars were over who could charge the lowest price for a room.

### *Lower RevPAR*

In a competitive market, hotels and resorts whose rates were discounted more than 2% below that of their competitors had a lower RevPAR than their competitors (Canina and Enz, 2006). Canina et al. (2006) found a 4.44% lower RevPAR as compared to competitors when rates were 12% to 15% lower than competitor's rates and a 2.51% lower RevPAR as compared to competitors when rates were 6% to 8% lower than competitor's rates.

### *Decreased service quality*

Revenue for many hotels and resorts has dropped due, in part, to the discounts many hotels and resorts have been giving (Reed Business Information, 2010a). To make up for the lost revenue, many hotels and resorts have laid off employees and, having fewer employees to service their guests, have experienced a decrease in service quality that, as reported by Reed Business Information (2010a), has not gone unnoticed by guests.

### *Loss of target market*

Discounted room rates tend to attract a market segment that is different from a hotel's or resort's typical segment. For Chula Vista Resort in Wisconsin Dells, Wisconsin, this market is more price-sensitive, more spendthrift and less respectful of physical property than its usual target market, which has led to an increase in guest complaints and property damage (P. Finnegan, personal communication, February 20, 2010).

## Conclusion

As discussed in the literature review, many practices used for setting room rates and optimizing profit from those room rates are widely available to hotels and resorts. However, once hotels and resorts start discounting room rates, all practices used for setting room rates and for maximizing revenue from those room rates are set aside.

The advantages of discounting room rates are limited to achieving slightly higher occupancy levels and temporarily gaining market share. The disadvantages to discounting room rates are many – erosion of rate and brand integrity, creation of price wars, decreasing a property's RevPAR, decreasing a property's service quality and losing an original target market.

Whether or not hotels and resorts should discount their room rates and if they discount how they should discount their room rates are issues that need answers. The answers to these issues will help mitigate the negative effects of discounting.



## PART THREE

### Introduction

As previously discussed, the practice of discounting room rates has more possible negative effects than positive effects on the properties offering such discounts. The answer to the question of whether or not hotels and resorts should discount their room rates is in this section of this paper. In addition, the answer to the question of if hotels and resorts are going to offer room rate discounts – how they should discount their room rates is presented in this section of this paper.

This section goes on to remind the reader of the limitations of this paper. Additionally, this section covers financial and management implications and recommendations regarding discounting room rates.

### Analysis and Results

#### *Does discounting room rates work?*

Any hotelier may be interested to know that discounting room rates is not as beneficial to a hotel or resort as it would seem. As was found by the Enz et al. (2004) study and the Canina et al. (2006) study, discounting does not work in favor of the hotel or resort that is giving room rate discounts. This was found to be especially true in a competitive market due to the availability of making comparisons. As mentioned earlier, though discounting may benefit a hotel or resort with a slightly higher occupancy level and a temporary gain in market share when compared to a non-discounting competitor it does not increase overall revenue. Discounting also erodes brand and rate integrity. The creation of price wars, a decrease in service quality and loss of an original target market are additional products of discounting room rates. Overall, discounting room rates does

not always work in favor of the property doing the discounting as one would think it would.

*Who should discount room rates?*

Higley (2003) commented that as long as discounting is done as a part of a successful revenue management program it is an acceptable practice for that property. As previously discussed, revenue management takes many different factors into consideration when setting room rates including but not limited to customer segmentation, competitor's prices and seasonality. In agreement with Higley (2003), if a property is practicing a successful revenue management program, discounting room rates may not be harmful, as a successful revenue management program would use strong rate fences to ensure that room rates would not be too deeply discounted against the ADR or against the room rates of competitors.

An example of a successful revenue management program can be found in the Hilton Hotel Corporation. In preparation for becoming Directors of Revenue Management, Hilton sends its revenue managers to the Hilton Revenue Management University. The two-week long training program includes classes in forecasting, assessing competition, pricing strategies and other processes for making decisions (McCann, 2000). The success of Hilton's revenue management program became clear after Hilton's purchase of Doubletree Hotels. Hilton's revenue management program enabled RevPAR at Doubletree Hotels to grow from 94.1% to 99% (Center for Effective Performance, 2004).

*Who should not discount room rates?*

In contrast, hotels and resorts that do not have successful revenue management programs should not discount their room rates. This is because that while revenue management is very enabling of revenue maximization during good economic times, the practices that make up revenue management are even more important in a sluggish economy (Lloyd-Jones, 2009). In a sluggish economy, each guest and each dollar count more than they do in a prosperous economy. A property that does not have a successful revenue management program in place exposes itself to more negative effects from an economic downturn than a property that is practicing a successful revenue management program does (Lloyd-Jones, 2009). Examples of unsuccessful revenue management programs can be found among the many hotels that foreclosed in California in 2009 (Lansner, 2010).

As was reported by the Enz et al. (2004) and Canina et al. (2006), hotels and resorts that are part of a competitive market should not discount room rates. In a competitive market, hotels and resorts that price room rates below those of their competitors realize a lower RevPAR than that of their competitors.

Hotels and resorts that are respected brands in their marketplace and seek long-term increases in room rates should also think twice before discounting room rates. As previously discussed, discounting room rates teaches guests a different value for the property, conditioning them to expect lower rates even after a recession lifts (Lomanno, 2008). For example, a guest who becomes accustomed to paying \$99 for a room will balk at paying \$129 for that same room under similar circumstances at a later date.

If, despite the disadvantages of doing so, a hotel or resort decides to discount room rates, it should follow the recommendations presented in the following section to continue to operate without a loss while offering the discount.

*Calculating room rate discounts that do not incur losses*

The following methods may be used to discount room rates without incurring loss:

1. Method 1: Calculate the breakeven point for each room type by dividing fixed costs by selling price minus variable costs (Kotler et al., 2010). The breakeven point for each room type should be the price floor. Therefore, discounts that bring room rates lower than the price floor or room rates that are below the breakeven point for each room type should not be offered.

2. Method 2: First, categorize the room types of competitors that are similar to the room types of the hotel or resort, then calculate the average room rates for market competitors per the room type categories. Next, multiply each average room rate by at least 2%, then add this figure to the average room rates per room category. By charging at least 2% more than competitors, the RevPAR of a hotel or resort should remain respectable for that market.

3. Method 3: Use both Method 1 and Method 2.

4. Method 4: Do not discount room rates and use value-added items to add more value for guests (Nevistas and Raff, 2009). An example of a value-added item is the inclusion of a hotel or resort gift card as part of the room rate.

5. Method 5: Offer a housekeeping discount program whereby a hotel or resort

extends hotel credits or points toward its guest loyalty program for guests who choose not to have housekeeping service for their room. This method for discounting rooms has not costs – it actually saves the hotel or resort the costs associated with cleaning a room - and gives the guest the option of taking the discount by not requiring housekeeping services on a daily basis (Nassauer, 2010).

### Paper Limitations

The limitations of this paper are:

1. Because hotels and resorts are unwilling to publish or to share data regarding their discounting practices, this paper could only discuss the practices in general, and was unable to provide information regarding specific practices.

2. The methods presented by this paper for setting and discounting room rates are not inclusive of every method that may exist. The methods included are what were available through the research of literature on the topics of setting and discounting room rates.

3. The methods presented by this paper for setting and discounting room rates are not inclusive of every method that may exist. The methods discussed are those presented in the literature pertaining to the topics of setting and discounting room rates at the time of the research.

### Financial and Managerial Implications and Recommendations

Surviving a global economic recession is not an easy task especially in an industry that relies upon leisure and business travelers. Vacations and travel for business are often the first items to get cut short or to get cut completely from personal and business budgets.

Although discounting room rates may maintain occupancy rates during an economic recession. Though discounting room rates may keep occupancy up, it does not necessarily maintain revenue. Table 1\* shown below exemplifies how much more occupancy is needed to maintain the revenue level of pre-discounted pricing. For example, if present occupancy is 76% and a 5% discount in room rates is given – the property will need to achieve an occupancy of 81.4% to realize the same revenue as it did prior to giving a 5% discount in room rates.

Table 1

## Increase in Occupancy Required to Compensate for Discount

<b>The price of rate-cutting</b>						
<b>Reduction in present rate</b>						
	5%	10%	15%	20%	25%	
<b>Present Occupancy</b>	<b>Occupancy required to make up for reduction</b>					
76%	81.4%	87.7%	95.0%	103.60%	114.0%	
74	79.3	85.4	92.5	100.9	111.0	
72	77.1	83.1	90.0	98.2	108.0	
70	75.0	80.8	87.5	95.5	105.0	
68	72.9	78.5	85.0	92.7	102.0	
66	70.7	76.2	82.5	90.0	99.0	
64	68.6	73.8	80.0	87.3	96.0	
62	66.4	71.5	77.5	84.5	93.0	
60	64.3	69.2	75.0	81.8	90.0	
58	62.1	66.9	72.5	79.1	87.0	
56	60.0	64.6	70.0	76.4	84.0	
54	57.9	62.3	67.5	73.6	81.0	
52	55.7	60.0	65.0	70.9	78.0	
50	53.6	57.7	62.5	68.2	75.0	

(Based on cost of operating additional occupied rooms equal to 25% of present rate.)  
 \* Source: The Horwath Accountant 47, no.7 (1967): 8.

Hotels and resorts exist for people to remain comfortable away from home, whether they are away due to leisure or business travel. During these trying economic times, it is imperative for hotels and resorts to maintain their value to guests. One way to maintain value is to maintain a level of service quality that is commensurate with the property. Another way is to keep room rates consistent with small yearly upward increments (Lomanno, 2008). Too much of a room rate discount can devalue a property from a guests' perspective.

Studies have shown that one financial implication of discounting room rates is a lower RevPAR than a competitors' RevPAR when room rates are 2% or more below that of market competitors (Canina et al., 2004). The erosion of rate integrity is another financial implication as are price wars.

Regarding the managerial implications of discounting, management must remain aware of all the possible financial impacts that discounting room rates can have on a property. In addition, management needs to remain cognitive of guests' perceptions of service quality especially during times of discounting. Management must also consider that a loss of an original target market can be a very real effect of discounting room rates. In other words, prior to instituting the practice of discounting room rates management must equally consider all effects of discounting room rates.

Based on the research presented in the literature review, this paper recommends that hotels and resorts only discount room rates if they have a successful revenue management program in place. The practice of discounting room rates simply has too many possible disadvantages to make it a viable solution in a sluggish economy. Instead

of simply discounting room rates, alternatives, such as value-added items, can be found that will create demand and help guests place value on a property.

### Conclusion

This paper explored the methods that hotels and resorts can use for setting and discounting room rates while maintaining rate integrity and brand integrity. Based on this exploration, it discussed the possible positive and negative effects of discounting room rates and provided suggestions regarding which methods to use if a property decides to practice discounting. Finally, this paper recommended against the practice of discounting room rates unless a hotel or resort already has a successful revenue management program in place.

Further research is needed to discover how the hospitality industry can recover from the practice of discounting room rates more quickly than history dictates. In support, Smith (2009) recommended that an industry-wide analysis of pricing be performed at the end of the current recession. This would provide the hospitality industry a more comprehensive view of pricing during an economic downturn, allowing it to better prepare for the next economic downturn.

The current recession is beginning to lift as reported by STR, who, estimates 2010 rates dropping only 3.4% (Smith, 2009). This drop will not be as significant as the 9.7% drop in rates during 2009. This paper's advice to hoteliers who did discount rates without a successful revenue management program in place is to work on quickly recovering rates back to those rates charged at the beginning of 2008.



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