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## WHITE PAPER

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# WHY PRICING DOES NOT EQUAL REVENUE MANAGEMENT FOR HOTELS

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When Dynamic Pricing was first introduced to revenue management the idea of managing transient pricing for hotels on a day to day basis was considered quite new – even radical. Even as recently as a few years ago, many hotels continued to sell at predefined rate levels, and did not manage rates dynamically. Today, however, dynamic transient pricing has taken hold – largely driven by the transparency of rates in the internet distribution era.

As a result of this focus on transient pricing, competitive rates have also become a critical part of decision-making, and competitive rate information has become readily available and widely used. Transient pricing and pricing relative to competition have become highly visible, with Hotel General Managers and others closely watching competitive rate positioning. Finally, as hotels have moved to dynamic transient pricing, many contracted rates have been converted to discounts off of published transient rates. The result of these contracted discounts is that more demand than ever is being managed by BAR & transient pricing.

It is in this highly dynamic pricing environment that we see hotels asking, “Can we properly manage my property’s revenue solely by adjusting rates?” and / or “Why do I still need to manage rate availability?” It is clear that there is significant confusion in the hospitality industry when it comes to the role of pricing in revenue management. This confusion has paved the way for vendors that claim to have complete revenue management solutions, even though those solutions only address the pricing aspect of revenue management, and ignore rate availability management and its benefits. In reality, however, hotels cannot maximize their revenue or profitability solely by managing rate prices.

## Hotels Today Need BOTH Availability and Rate Pricing in Their RMS

To articulate the limitations of “pricing only” approaches, let’s start with the simplest possible example: you have one room left to sell on Thursday, and a customer comes in and offers you your highest possible rate for that day – should you take it? If you are following a “pricing only” approach, your answer is probably “yes” – you’ll receive the highest possible rate for that day.

But the question that you should be asking is: what other demand exists for that room? What other demand is competing for that space? You may well have another customer willing to stay two or more nights that would provide greater profitability for your property in the long run. In this case, “closing” to a one night stay – even if demand for that one night stay is at the highest possible price – is preferable to the option of leaving that rate “open” by selling it at your highest possible rate for the day. This is why we have long advocated that hotels today need BOTH availability and rate pricing in their RMS.

Scientists and academicians focused on hotel revenue management and price optimization recognize that hotel pricing is not like grocery store pricing, where inventory often isn’t a critical part of the decision. Your local grocery store doesn’t need to worry about how much Diet Coke is available to sell when they are pricing that Diet Coke – the local supplier is going to make sure that there’s always plenty of Diet Coke on those shelves. But in hotel pricing, room inventory can’t fluctuate with demand – we can’t just create and eliminate hotel rooms on the fly. As a result, *it’s not enough to know the willingness to pay of any single segment of demand – one must also understand how much room inventory is left to sell, the willingness to pay (or price sensitivity) of all of your channels and segments, and how that demand is distributed in terms of arrivals and length of stay.*

## Contracted Rates, Negotiations and Availability

Another reality for most hotels is contracted rates. In the past, many contracted rates came at a fixed rate (sometimes with day of week differences and seasonal adjustments); some rates were controllable with inventory controls on busy days, while others insisted on “last room availability.” However, as the industry converted to dynamic pricing, many contracts have been converted to “floating discounts” off published rates. In many cases, these contracts can still be managed via inventory controls on busy days (or “closed” as we commonly refer to this). These inventory-controlled negotiated discount contracts provide clarity to the contract partner, while still allowing the hotel to “close” the rates on peak days, where it may be profit-optimizing to bookings from other channels or segments or longer lengths of stay.

Managing floating discount rates in this way allows a hotel to dynamically change pricing, while still ensuring a consistent pricing strategy that is generally acceptable to the contract customer. However, we have seen advocates of “pricing only” approaches tell hotels that they should re-negotiate these contracts

Hotels today need BOTH availability and rate pricing in their RMS.



to allow varying discounts, so that these rates can be managed independently. Imagine asking your contract partners if they would accept a dynamic discount off a dynamic rate (either of which could change at any time). Why would they sign such a contract? Most contract partners are making commitments to provide hotel operators with a significant share of their business – but without having any commitment at all from the hotel company in terms of price or discount, what partner is going to make that commitment?

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Consider the special case of corporate contracts. Most of us recognize that corporate travel is not particularly price-sensitive – at the point of booking. However, corporate travel buyers are price sensitive – at the time of contracting. Corporate travel buyers are well aware that the industry knows that corporate travel is generally price-insensitive – that is exactly why they choose to negotiate fixed rate or fixed discount contracts. The contract partner commits to ensuring that the hotel receives the lion's share of bookings, in return for a commitment to price or discount. Without this protection, most rational systems would charge these customers as much as or more than a typical transient customer – arguably providing no discount at all. In this light, independent pricing of such contracted corporate rates is effectively not participating in negotiated contracts with the corporate customer at all, as such terms will not be acceptable to them.

The right approach to managing contracted rates is to recognize the links between daily pricing and these segments – while also recognizing that these different segments may well have distinct demand patterns

and price sensitivity. Revenue Management systems should also recognize that some of that demand can be controlled by availability as well as price, while some of that demand (due to last room availability clauses) cannot be managed via availability controls. *By using this approach, we are able to support these common types of contracts as they exist, while continuing to optimize revenue through the use of BOTH pricing and availability recommendations.*

## Groups and Group Pricing

Group pricing is another great example of the importance of recognizing the value of room inventory. For simplicity, we will set aside the complexities of associated non-room revenues, including function space – though these are certainly highly relevant subjects to group pricing decisions in general). In determining what rate is the optimal rate to offer a particular group, we need to know not only the willingness to pay of the group, but what other prospective guests will be displaced by the group. In other words, we need to calculate the expected profit from the rooms that a group would take up if the same rooms were sold in the optimal manner to other demand segments, a value commonly referred to as the “displacement cost.”

Contrary to common perception, displacement cost is not a price recommendation, per se, but rather a minimum revenue threshold that the group must provide in order to deliver value at least equal to the expected value from demand from other segments. So, if we have a group that has indicated that it will not pay more than \$100 for each room on a particular night, but our displacement calculations have indicated that we need \$120 per room, then our optimal decision is to decline their offer of \$100. Wondrously, the same displacement cost calculations can be used to find an alternate night for this group where a \$100 rate would be acceptable and profitable.

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## Daily Pricing and the Limitations of “Pricing Only” Decisions

Let’s take another look at “pricing only” in the context of daily pricing. Daily pricing (as opposed to arrival night / length of stay pricing) is favored by many channel partners for its simplicity. However, daily pricing introduces difficulties in optimizing revenues. The reason is that with daily pricing, all customers from a particular segment or channel will pay the same price for each night, regardless of length of stay, and regardless of their willingness to pay. This issue becomes dramatically worse when availability controls are not available or used.

Take the following example of two nights for a particular property. The hotel has 10 remaining rooms available on day one, and 5 rooms on day two. There is demand for five rooms for one night stay for night one – at a Willingness to Pay (WtP) of \$50. There is demand for five rooms for a one-night stay for night two – at a Willingness to Pay of \$150. Finally, there is demand for five rooms for a two-night stay arriving night one – at a Willingness to Pay of \$200.

Customer Segment	Arriving on day	Staying	Remaining Demand	WTP of Demand
A	1	1 day	5 units	\$50
B	2	1 day	5 units	\$150
C	1	2 days	5 units	\$200

A “pricing only” decision here is clear – set the rate for night one at \$50, and the rate for night two at \$150. Unfortunately, because availability controls aren’t used, this decision isn’t actually optimal, and revenue will likely be lost as a result. What happens if all of our one-night demand for day two (segment B in the table above) books first? No rooms would be left for 2-night stay customers (Segment C) on night two, resulting in 5 empty rooms in the hotel on day 1, and an overall revenue from these 15 room nights of \$1,000 (\$250 from customer segment A on night one, and \$750 from segment B on night two).

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The actual optimal decision in this case is to set the rate for night one at \$50, and the rate for night two at \$150 – but then close the latter for arrivals on day 2. With this additional inventory control in place, the revenue in this example rises from \$1,000 to \$1,250 (\$250 from customer segment A, and \$1,000 from segment C) – a 25% increase in the revenue return from these rooms! Furthermore, the occupancy rate of the 15 room-nights goes from 66% to 100%. By using the combination of optimized rate pricing and optimized availability, the value of the decisions increase dramatically.

The above example was offered as a simple illustration for one property, for two nights and three customer segments. It is clear to see that exploding this example to what happens in the real world can quickly become complicated. Simply put, a Revenue Manager with only a Rate Pricing system at her disposal will not be able to manage these situations effectively, thereby losing revenue regularly.

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## In Conclusion: Two is Better than One

With constant attention to transient rates – from GM's, ownership, and even channel partners – it is easy to miss the ongoing importance of valuing inventory and using availability controls. However, as we have demonstrated here, hotels that optimize BOTH rate pricing and availability will outperform hotels that restrict themselves to managing pricing alone. Whether you are managing basic transient rates and controlling for complex length of stay interactions, negotiating contracts, or making overbooking decisions, understanding inventory value and setting appropriate availability controls in conjunction with optimizing rates adds significant value to these decisions.

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