

The future impact of changes in rate parity agreements on hotel chains: the long-term implications of the removal of rate parity agreements between hotels and online travel agents using closed consumer group booking models

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Published version

HAYNES, Natalie and EGAN, David (2015). The future impact of changes in rate parity agreements on hotel chains: the long-term implications of the removal of rate parity agreements between hotels and online travel agents using closed consumer group booking models. *Journal of Travel and Tourism Marketing*, 32 (7), 923-933.

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The future impact of changes in rate parity agreements on hotel chains.

The long-term implications of the removal of rate parity agreements between hotels and online travel agents using closed consumer group booking models.

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Abstract (max 100 words) – The Office of Fair Trading has been investigating the legality of rate parity since 2012, particularly rate parity agreements made between Intercontinental Hotel Group, Booking.com and Expedia. Consequently these major hotel brands and agents have committed to remove rate parity for closed consumer groups. This article identifies confusion over such groups and longer term implications. Smaller agents will enter the market, leading to increased fragmentation and competition. Branded hotels will face tough challenges in protecting prices and value from aggressive agents suddenly facing a more competitive market and independent hoteliers able to establish effective relationships with the new, smaller agents.

1. Introduction

Room rate parity – should it stay or should it go? This is the question that has been asked in the UK since 2012 by many connected to the hotel industry, when the Office of Fair Trading (OFT) began an investigation into the claim that the room rate parity agreement set between Intercontinental Hotel Group (IHG), Booking.com and Expedia may be a form of price fixing, and therefore illegal. Major hotel chains and online travel agents have reacted in advance of the conclusions of these investigations, promising to end the use of rate parity agreements, but only for

bookings made through closed consumer groups. This article assesses the longer term implications of these agreements and will focus primarily on the UK perspective. However, with the involvement of international chains and agents in the UK investigations it is likely to become an issue with wider global implications. In essence online travel agents (OTAs) would only be allowed to promote discounted rates to consumers who were a registered member of their website or company. With this caveat in mind, and after consulting the paper issued by the OFT (2013), the hotel industry may feel these commitments will only affect a limited proportion of business. This, however, would ignore the longer term impacts of the agreements being made. Based on economic theories of markets this article will suggest that even these small changes are likely to have significant implications for the structure of online hotel sales. Smaller OTAs will be able to compete for market share more effectively through discounting and commission sharing models set around the closed consumer groups. The lowered barriers to entry will inevitably increase competition across all online distribution channels. Consequently, in the long term hotels will have to work harder to attract direct business and control their pricing strategies in an increasingly fragmented online market. They may also encounter increased pressure from major agents who are themselves suddenly facing more competition and may become less willing to co-operate with hotel chains.

2. Background.

2.1 The OFT Investigation

To understand the context of these potential implications it is important to first outline the background to the OFT investigation and the evolution of rate parity. Gerrard (2010), a regular contributor to the industry magazine *Caterer and Hotelkeeper*, cites

the complaint made to the OFT by Skoosh, a small third-party booking agent, as what brought the issue of rate parity to the attention of the OFT, the government office responsible for fair business practices in the UK. Skoosh claimed that IHG were refusing to supply room inventory to third parties if they were likely to discount rates below preferred rate parity levels by sharing an element of their commission with the customer. Skoosh had not disregarded any of IHG's rate parity terms and conditions but wished to operate based on this type of business model and by advertising IHG's properties at discounted rates. When IHG refused to supply room inventory on this basis Skoosh felt this was equivalent to forcing them into a position where they were unable to trade profitably by following their chosen business model. Also, based on the legislative measures covered in the 1998 Competition Act, the OFT needed to decide whether the rate parity agreements amounted to price fixing and potentially kept prices higher than the point of offering value to customers by reducing natural competition between agents and hotel brands. The investigation was interrupted by the early reaction of the hotel industry and the major OTAs and their promise to allow all OTAs to discount rates to closed consumer groups (OFT, 2013).

The commitments proposed by Expedia, Booking.com and IHG to the OFT are that OTAs would be able to offer discounts on the headline room rates offered by hoteliers but only to "closed groups". A closed user group is characterised by there being an element of membership in the purchase process, for instance a unique log-in code for a booking website or even a membership fee as for companies such as Voyage Privé. Customers would be required to have purchased one room from the group prior to the commitments coming into force before commencing membership and purchasing discounted rooms. OTAs would be free to publicise the availability of

discounts but could not reveal the extent of the discount from the hotels' headline rates. However, there is already confusion over these definitions and regulations from within the industry. The OFT (2013) states a closed group does not have automatic entry. Consumers must actively opt in to become a member and any online or mobile interfaces must be password protected and require the completion of a customer profile. The trade press is taking a much wider view on the definition of closed user groups stating that they could be brand loyalty programmes, members who download their mobile app (Freed, 2013) or those who have made at least one previous booking with an agent (Alano, 2013). Small to medium OTAs will certainly be seeking to widen the interpretation of what a closed user group actually is as far as possible to allow them the greatest flexibility in discounting to attract new customers and build market share.

2.2 The current purpose of room rate parity

To assess the future implications of these commitments it is first important to define the current purpose of room rate parity for the hotel industry. The literature broadly agrees that room rate parity practice involves the sale of the same room, to the same customer, at the same price across all distribution channels (Gazzoli, Kim and Palakurthi, 2008; Demirciftci et al, 2010). Prior to this investigation the majority of academic literature focused on whether rate parity was being achieved (O'Connor, 2003; Thompson and Failmezger, 2005; Tso and Law, 2005; Murphy, Schegg and Qiu, 2006; Law, Chan and Goh, 2007; Lim and Hall, 2008; O'Connor and Murphy, 2008; Demirciftci et al, 2010; Sipic, 2010; Toh, Raven and DeKay, 2011) rather than its value or reasons for use. The majority of researchers found that rate parity was not achieved, posing the question of why the industry would persevere with a practice so difficult and expensive to achieve in reality. Demirciftci et al (2010)

highlight the high cost of implementing single image room inventory systems that enable operators' systems to interface with all central and global reservations systems that guarantee rate parity. The literature (Kimes, 1994; Wirtz et al, 2002; Murphy, Schegg and Qiu, 2006; Choi and Mattila, 2009; Hayes and Miller, 2011) suggests the answer lies in the industry viewing it as a fairer revenue practice for customers and as a way of managing the increasing complexity of online channel distribution.

Taking the customer as the starting point, both the hotel industry and areas of the academic literature (Kimes, 1994; Wirtz et al, 2002; Murphy, Schegg and Qiu, 2006, Choi and Mattila, 2009) have come to believe that offering rate parity may be the fairest way of managing rate strategies. It has grown out of a concern that the price discrimination strategies originally advocated in the early yield management literature may actually be perceived by customers as unjust profiteering on the part of operators. This may potentially lead to customer dissatisfaction and ultimate loss in revenue. In the late nineties Cross (1997, p.33) defined revenue management as "the application of disciplined tactics that predict consumer behaviour at the micro market level and that optimise product availability and price to maximise revenue growth". This confirms that the original recommendation was to use different prices for different micro customer segments to maximise profits. However, the more recent revenue management literature is now focusing on a more customer-centric approach which focuses on a balance between price and perceived value across all customers (Cross, Higbie and Cross, 2009; Hayes and Miller, 2011). Rate parity appeared to be the industry's response to consumers' perceived unfairness of pricing variations such that cheaper rates were available for the same room, at the same hotel, on the same night, with the same booking conditions. They did not view it as

an anti-competitive practice designed to reduce the number of online agents entering the market.

However, the second major area in which the literature cites the importance of rate parity is in regaining control of the online distribution channels and driving more business through the branded websites (Brewer, Christodoulidou and Rothernberger, 2005; Talluri et al, 2009, Hayes and Miller, 2011). The online market place is certainly complex as, although eighty per cent of the market is controlled by the three main OTAs of Travelocity, Expedia and Orbitz, thousands of other independents, and often hard to control affiliates feed off these sites (Euromonitor, 2012). By getting customers to take up the best rate guarantees, it is hoped commission costs will be saved and customers will have more contact time with the brand, aiding the development of brand loyalty (Morgan-Thomas and Veloutsou, 2013). This does appear to contradict the customer focus mentioned above. If hotel brands are using the practice to control the online market and encourage direct bookings to their brand.com website the result could be a reduction in online competition. It also appears that this may be working as Starwood report only 11 per cent of their bookings coming through third-parties in 2011 with similar figures of 6 per cent for IHG and 7 per cent for Accor (Euromonitor, 2012). Morosan and Jeong (2008) support this viewpoint, suggesting the hotel industry considers OTAs with suspicion in the current market place and aims only to regain control and force bookings through their branded sites rather than work in partnership, although some research actually suggests that these third-party sites might actually be crucial in driving direct bookings as customers use these sites to shop around and as signposts for making bookings direct with operators. Anderson (2009a) termed this the Billboard Effect and his research cited that by just having a presence on a third party site bookings to

the direct site can increase between 7.5 per cent and 26 per cent, although this research focused only one OTA, Expedia. The Billboard Effect as a theory suggests that a hotel's presence on a third-party booking website provides signposts to a hotel's direct website, thereby increasing direct sales. Nonetheless, this seems to further confirm the use of rate parity. If customers use OTAs to direct them to suppliers they will be highly confused if the direct channel price is different to the one posted on the OTA and, if it is cheaper, may well likely return to the OTA to book. However not all the academic literature agrees as Tsay and Agrawal (2004) and later Kang and Brewer (2009) argue that third party channels can actually become direct competitors of a hotel's branded website and this does lead to channel conflict, perhaps supporting the industry's concerns.

3. Methodology

During the OFT's initial investigations primary research was conducted to gain an in-depth understanding of the hotel industry's thoughts on the OFT investigation and what effects they felt they would experience if rate parity was removed. This gave a clear and detailed comprehension of the underlying pricing practices currently used and the operational implications of the commitments made by the OTAs and IHG. Semi-structured interviews were used to collect qualitative data. The focus was on conducting in-depth interviews, which lasted between one and two hours allowing key themes to emerge which exposed the hotel industry's true concerns over the OFT investigation and the future of rate parity. The sample was based on a purposive approach, choosing only those from a set of available contacts if they had some control, interest or involvement in pricing and revenue decisions within their organisation. Glaser and Strauss (1968) advise that the experts must have a range of different experiences and viewpoints to increase the validity of data. Therefore,

the sample was constituted to reflect the major players in hotel pricing and rate parity decisions, covering a range of industry roles including two Revenue Managers, a Reservations Manager, a Sales Manager and a General Manager at hotel unit level, all working for a variety of different hotel chains. The interviews were semi-structured, covering topic areas that investigated how they defined rate parity, how and to what extent it was used in their business, how it affected relationships with customers and OTAs and finally their opinions on the OFT investigation.

The data analysis was based around a thematic analysis following the stages of the creation of codes, the attachment of codes to the primary data, the creation of new themes, the illustration of these themes using network diagrams and then finally using these networks to investigate the patterns between the themes. In essence, data analysis followed the iterative process suggested by Woolcott (1994) that covers description, analysis and interpretation. From the interviews and subsequent data analysis several common themes emerged that will be covered, in-depth, in the discussion below.

4. Implications for the hotel industry of the commitments made by IHG, Expedia and Booking.com in response to the OFT investigation into their rate parity agreements.

From reviewing the literature in section 2 there appears to be a suggestion that the hotel industry may have been using room rate parity to control competition in the online market by reducing the likelihood of smaller agents entering the market. The short-term reaction of the hotel industry to the commitments at both the unit and corporate level will be that as the commitments are narrowed to closed consumer groups only, rate parity will be able to continue unaffected for large proportions of

business. After all, it is important to recognise that from the primary research it was clear that rate parity only applied to transient, public rates and if only removed for closed consumer groups represented a relatively small overall percentage of room nights sold. However, broader economic theory highlights longer term implications that the industry has not yet considered. These will impact not just upon operations but will also have wider consequences for corporate strategy.

4.1 Reduction in barriers to entry and increased competition

The OFT (2012) states that rate parity reduces competitive forces for two key reasons. Firstly, they soften the competition between platforms as if all the rates are the same across different channels customers will no longer shop around and this may have the effect of increasing prices and customers not receiving best value. The industry may argue they are only protecting profits. Secondly, the OFT (2012) suggests that rate parity increases barriers to entry in the third-party online distribution channel market, giving hotel operators the control of their rates and the ability to charge higher prices and gain control of third-parties who may heavily discount their rates.

It is evident from the primary research that hotel operators recognised the need for effective channel management across a growing number of online and offline distribution channels. The data showed that hotel operators were particularly interested in managing the prices set for their product by OTAs. In effect they were practising resale price maintenance through rate parity strategies. Resale price maintenance is a process whereby a manufacturer of a product or service insists that the product/service should be sold at a specified retail price. UK law is often unclear as to whether this is legal, but overall the practice is often viewed with some

suspicion in the UK (OFT, 2012). In the broader global context there has recently been a case in the US where a judge actually overruled a complaint of price fixing. The judge argued that there was no sign of collusion and that hotels were legitimately using the practice to manage the complexity of distribution channels. Of course, it is important to remember that resale price maintenance is a more accepted practice in the US than in the UK (Freedman, 2014). Respondents in the UK were keen to stress that it was their product and their investment and therefore it was their right to dictate the price that third parties could charge;

"It's our brand, it's our rate, it's our pricing strategy, and it's our hotel" (Respondent C).

"I think essentially it has to be the hotel that sets the price" (Respondent E).

Economic theory with regard to pricing looks at how prices in the market are determined and the interplay of supply and demand that impact upon competition. The OFT investigation centred on whether rate parity may actually drive higher prices than would normally be expected and thus hinder customers receiving a fair market price for hotel accommodation. According to economic theory prices may be driven down where customers are price-elastic, where they respond to increases in prices with corresponding drops in demand. Law, Chan and Goh (2007) confirm that the unequal presentation of rates online leads to price-elasticity through price transparency and a tendency for customers to shop around looking for discounts, encouraging a downward trend in prices.

The hotel industry may feel in the short-term that this unequal presentation of rates has been mostly limited. However, the already confused definition of the closed consumer group will allow for OTAs to place their own interpretation on the meaning

of the term and is likely to favour the widest, loosest possible definition to allow for maximum discounting, which after all is how a small OTA can compete most effectively for bookings in the online marketplace. If these OTAs can see an opportunity to compete effectively they will enter the market, increasing competition and the likelihood of hotels facing a downward spiral of rate erosion. With more OTAs in the market the customer will also gain greater access to price information, with the long-term trend being that price information will become close to perfect. Customers will become even more price conscious, accelerating the downward spiral of rates. From this it is not too difficult to imagine a scenario where hoteliers agree to refuse to sell their room inventory through OTAs and break off current partnerships. It is important to remember the power that the branded hoteliers feel they have in their oligopolistic markets and the confidence they have in their ability to sell rooms direct. Consider the low percentage of rooms sold direct from Starwood, as discussed above. Ultimately in the longer term overly aggressive discounting by the OTA's could back fire on them regardless of whether they are small or major players.

4.2 Weakening of brand value and image

Economic theory and marketing practice emphasise that pricing can be used to communicate quality to the customer and thus rate parity may be used to stop third-parties from heavily discounting rates that may reduce brand value and negatively affect opinions of quality (Garrow et al, 2006). To encourage direct bookings and protect brand value hotels may start to class their loyalty schemes as closed user groups. In the long term brand loyalty schemes will become less about point collecting and become more overt booking portals. Hotels will control discounts by offering them only to loyalty club members and not just on the public website. This

would lower the value of OTA's discounting and restore hotels control over their brand value and pricing. Borrowing from another industry, Levis worked to achieve this brand protection in the late 1990s by promoting that only Levi's stores and no other retailers could fit Levi's correctly and provide the opportunity to gain a custom fit. This protected prices and attempted to block the value of other retailers offering Levi jeans at a lower price (Fox, 1996). Keeping control of rates and protecting the messages over brand quality will remain the priority for hoteliers but this challenge will increase.

Through rate parity agreements with at least the major OTAs, hotel operators were able to maintain this level of control and communicate the prices they wanted OTAs to charge, although they stated that this was often only achievable with the major OTAs and the large amount of affiliate websites now trading were more difficult to control in this way. Therefore in the long term the result of these commitments will be that hoteliers will find it even harder to manage their distribution channels, as not only will they need to manage the OTAs but also a growing number of potentially smaller and more disparate closed consumer groups that due to lower barriers to entry will come online. It is also likely that, due to the reduced barriers to entry, the large OTAs will also find themselves under increased competitive pressure from smaller agents. This in turn may cause the major OTAs to be less co-operative with hotels as they need to become more aggressive with their pricing strategies to compete. Hotel operators recognised OTAs as a necessary evil without which they would not be able to fill their hotels and were therefore willing to work with them as partners. With the major OTAs, such as Booking.com, becoming less dominant it is likely that these partnerships will weaken as hotels battle to keep control of their pricing and maintain brand value. However, the majority of respondents in the

primary research actually felt that rate parity offered fairness to the OTAs and was their way of showing their business integrity when dealing with these third parties.

One respondent stated:

"You kind of have to weigh up do I want to lose a partnership because I'm offering someone a cheaper rate and I'm not offering it them necessarily" (Respondent C).

It is interesting to note, though, that this respondent is only stressing the relationships with the larger agents of Booking.com and Laterooms when making this statement. It seems hotel operators' concern is to treat fairly the large OTA's at the expense of smaller intermediaries who do not drive the volumes of business that the corporate brands require to stay profitable.

4.3 The rise of the independent hotels

Of course it is important to remember that the UK hotel industry remains highly fragmented despite the number of big brands (Barrows, Powers and Reynolds, 2012). The research found that branded hotel operators who were the focus of the primary research thought that independent hotels might not be able to practise rate parity and benefit from the control over OTA pricing due to the high costs of the automated systems which make achieving room rate parity easier, at least across the major OTAs. From this it may be argued that branded hotel operators can leverage their use of rate parity to give them a competitive advantage over smaller, independent operators, particularly in the online market. This may end with the new commitments, as independent hoteliers may find it easier to negotiate with the new smaller OTAs entering the marketing, making it easier for them to sell their room inventory and, ultimately, that branded hoteliers would face increased competition from the independent sector. Independent hotels may not need volume deals with

large OTAs. Instead they will benefit from the more personal relationships with smaller OTAs who they will have increasing access to and who they can work in partnership with to develop mutual awareness of their products and services. For branded hotels this will result in a weakening of the power their established relationships with the major OTAs had over independent hoteliers and therefore increased competition once again. Theory around oligopolistic markets, where several big brands dominate the market, also suggests that the very nature of these markets may force prices above the normal competitive level rather than rate parity causing this to occur (Kaplow, 2011). However an increase in competitiveness by independent hotels may threaten the power of these oligopolies, again resulting in rates dropping for the branded hotels in the long term.

4.4 Changing customer perceptions of pricing strategies

The primary research showed that hoteliers themselves were actually somewhat unsure as to whether rate parity was price-fixing and unfair to the customer or not. The confusion of operators is exemplified in the following quotes from the interview transcripts:

"I think the publicity confused things a little for the customer - so the customer read about IHG and others price fixing and thought fixing the prices high, which technically I suppose they are if someone is prepared to sell them at £80 at their cost of commission" (Respondent A).

"I don't think it could be misleading because they don't know what it is...I do think they're fair because the customer doesn't know otherwise" (Respondent D).

It is clear that operators are no longer certain whether they feel it offers customer fairness or not. Ironically, all respondents admitted they felt rate parity reduced price choice for customers and as already stated reduced choice means higher prices, resulting in the consumer not getting the best, fairest deal possible based on the workings of the market. In part this may be due to it being the first time they had been forced to reflect on the outcomes and uses of the practice. However, it is useful to contrast this with the data concerning the brand promises on best rate guarantees. The brand promises outwardly focus very much on customer fairness and they focus on it delivering cheaper prices for the customer;

"You have the right to the very best offer we have" (Marriott, 2013)

It is also important to stress that large areas of the literature suggest that rate parity is viewed as fair to the consumer (Kimes, 1994; Wirtz et al, 2002; Murphy, Schegg and Qiu, 2006; Choi and Mattila, 2009).

Finally, it is important to set this discussion of justice into an overall consideration of the fairness of revenue management strategy. Revenue management is used throughout the industry but there is wide-spread discussion over the fairness of all revenue practices, not just room rate parity (Kimes and Wirtz, 2003; Heo and Lee, 2011; McMahon-Beattie, 2011 and Taylor and Kimes, 2011). In addition, the literature review suggested that rate parity actually grew out of operators feeling that price discrimination was not necessarily the fairest way to treat customers and that early yield management practices were perceived by customers as mere profiteering on the part of the operators. Price discrimination is the sale of the same product at different prices to potentially different customers based on specific criteria as defined by the company (Hayes & Miller, 2011). The literature suggests revenue

management has become more customer-centric (Cross, Higbie and Cross, 2009; Hayes and Miller, 2011) and that customers do not want to check-in next to somebody who is being charged a cheaper price for the same room on the same night in the same hotel with no corporate deal and the respondents did agree with this. Add to this the fact that only the small minority of respondents felt that customers viewed price discrimination as fair and there is a scenario forming that suggests there is an overall challenge in ensuring any pricing strategy offers total fairness to the customer. By removing rate parity you in essence remove the middle ground between rate parity and price discrimination. This gives rise to more opportunities for customers to feel mistreated and the industry will potentially need to develop strategies to cope with a rise in dis-satisfied customers.

4.5 Achieving reciprocal justice

Some might suggest that opaque sites may be a solution as the literature review suggests (Anderson, 2009b; Pizam, 2011). Opaque websites, such as Hotwire.com, allow hotels to advertise room inventory anonymously at discounted prices with the customer unaware of the hotel they have booked until they have committed to the purchase price of the room. In essence, it is suggested that this might offer a sense of reciprocal justice. This maintains rate integrity for the operator but allows customers the sense of justice and fairness that arises from finding a bargain. If opaque sites also become membership only they would also satisfy the regulations around closed consumer groups. However, the industry appears to be wary of opaque sites. The majority commented that they would not work with opaque sites again due to issues of being able to control room inventory, which again suggests operators true priority is to control prices to maintain profit levels rather than providing justice for the consumer. Nevertheless, the industry may have to accept

this as the middle ground. After all, the primary data found that on average across all respondents rate parity was only responsible for between 20-40% of room revenue and that the primary focus for hotel operators was on the corporate market where in fact price discrimination was still used as the predominant pricing method. The use of price discrimination to determine successful corporate rates was mentioned sixteen times by the respondents but rate parity being a key strategy was only mentioned six times. However, the long term implication for branded hotel operators of relying on opaque sites for discounting is that a price dominated market will emerge as for opaque sites price is practically the sole factor of consumer choice. Customers find it hard to differentiate on these websites based on quality, customer experience or facilities and therefore ultimately the power of the brand as a point of differentiation will also be weakened, further increasing the competitive power of the independents.

5. Conclusion and management implications

It is clear that the removal of rate parity agreements for closed consumer groups will ultimately prove of benefit for the consumer, increasing their price knowledge and power in the negotiation process. Entry barriers to small OTA's will lessen, more OTAs will consequently enter the online booking market and resulting heightened competitive forces and price-sensitive consumers will lead to rate erosion. But what of the hotel operator? In the short term they may feel relieved that the commitments apply only to a small proportion of OTAs, those operating as closed consumer groups. However, due to the challenges and loose definition of the closed consumer groups it is felt that many small OTAs will seize the opportunity to widen the interpretation to their own benefit. They will utilise aggressive discounting to grow market share and compete against the major established OTAs. In essence, there

will be a major evolution in the hotel online booking market from one dominated by a few major players to one highly fragmented and increasingly competitive. The effect on the branded hotel operators will be to force them to establish new ways of controlling their channel management and pricing, perhaps through operationalizing their loyalty schemes as booking portals and closed user schemes. What is certain is that the competitive landscape will also change. Independent hoteliers will welcome the introduction of more powerful smaller OTAs who they will find it easier to negotiate with and to form meaningful, profitable partnerships with. As a result it is likely that the branded hoteliers will see the competitive gap closing between them and their nearest independent operators and will be forced to compete not only on price but on service quality. Consequently further research into the reaction of independent hoteliers to the announced commitments would also be of use. To conclude, unless the branded hotel industry takes drastic action and breaks all ties with the OTAs, selling rooms only through direct channels, it is likely they will have to learn to live with these increases in competition and new found lack of control over their pricing strategies.

Words - 5188

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