2010

HeBS digital

End of the OTA merchant model – this time for real

| By Max Starkov

HeBS digital, Inc.
Address: 6W 48th St. 8th Floor, New York, NY 10036
Phone: 212-752-8186 Fax: 212-202-3670
E-mail: sales@hebsdigital.com Web: www.hebsdigital.com

Back in March of 2005 I published an article "The End of the Merchant Model as We Know it", co-written with Jason Price. In this article we argued that the Internet was all about transparency, efficient distribution of information, and inexpensive e-commerce transactions and was by far the most efficient marketing and distribution medium ever invented.In this sense the abnormally high merchant commissions (20%-30%) levied by online travel agencies (OTAs) constituted a temporary anomaly, not the rule. We further explained that there was a direct correlation between the traditional travel agency commission of 10% and the OTA merchant commissions, and that as the travel agency commissions would inevitably go down and one day disappear, so would the OTA merchant commissions, same as it happened in the airline and car rental sectors.

Now, more than five years later, we are revisiting the same topic and trying to ascertain the future of the OTA Merchant Model.

Quick Refresher: Where Did the OTA Merchant Model Come From?

The Merchant Model was not invented by the OTAs and has existed long before Expedia in the form of FIT wholesale pricing arrangements with tour operators and incoming ground operators. FIT companies (FIT=Free Independent Traveler or Tourist, refers to a single traveler or a small group of up to 9 – Wikipedia) like Gulliver's Travel have operated in this space for decades. The only differences are that a) in the past hoteliers did not allow wholesalers and tour operators to publish discounted/wholesale hotel rates (net + markup) if not bundled with other travel services, such as sightseeing tours, air, transportation, etc, and b) the wholesalers had to commit to and often make a deposit to secure a room allotment of any size (the other option was the so called "free sale" where the FIT company had to check with the hotel each time they had a reservation request by a customer, which obviously was highly impractical).

Unfortunately hoteliers did not impose the same restrictions on the online travel agencies, due to a lack of understanding of how the online distribution channel worked. As a result hoteliers saw their discounted rates posted all over the Internet – on OTA sites and thousands of their affiliates – and for many years suffered severe consequences to rate and brand integrity.

As a rule of thumb, the FIT and wholesale/net hotel rates have always been calculated as best available rate in a given season minus 20%-25% i.e. 2-2.5 times the traditional travel agency commission of 10%. The presumption has always been that FIT companies, tour operators and wholesalers are promoting the hotel via brochures, trade shows, print ads, etc thus they 'deserve" a higher commission. On the upside for the hotel, these traditional wholesalers provided incremental revenues and occupancy via guaranteed room allotments and opaque/bundled pricing.

This is definitely not the case with the OTAs who have no firm room allotment commitments and pay no deposits, and, apart from the dynamic packaging model, they do not generate incremental bookings, expose the hotel's "naked" rates in an unbundled fashion, and yet are entitled to the same wholesale commission levels.

The Agency Model (the traditional travel agency model that relies on "success fee" i.e. hotel commission of typically 10% from booking revenue) continues to dominate the hospitality industry's relations with brick-and-mortar travel agencies. Unlike airlines and car rental companies, hotels pay 10% commission to any qualified travel agency (IATAN member) thus continuing to justify the existence of a higher, wholesale commission i.e. the OTA merchant commission.

What is the Current Situation with the OTA Merchant Model?

<u>OTAs gained market share from the direct online channel:</u>

The OTA Merchant Model is very much alive and even gained momentum, mostly due to the industry's desperation as a result of the three year economic downturn. OTAs gained market share at the expense of both the direct online channel and traditional travel agents. In Q3 2010, OTA share of the online CRS bookings for the top 30 hotel brands increased to 37.5% from 25.4% in Q3 of 2008 i.e. by 12.1 percentage points (eTRAK). Why did it happen? During the recession, many hoteliers surrendered to the temptations of the indirect channel, resulting in a significant shift from the Direct Online Channel to the indirect online channel (OTAs). Many hotel companies, including some major hotel brands, have been accommodating the OTAs with bigger discounts, unique promotions (24-hour sales), etc., thus jeopardizing their Direct Online Channel and destroying years-worth of achievements such as rate parity, best rate guarantees and more.

Naturally, I do not envision a scenario where 100% of Internet bookings are made via the direct online channel i.e. via the hotel website. The OTAs and other players in the indirect online channel do play a needed role in certain areas of the travel planning and purchasing process e.g. dynamic packaging (air+hotel+car+tour) for leisure destinations. Even in pre-Internet years, approximately 25% of all hotel bookings in the U.S. came via the indirect channel (travel agents, tour operators, etc).

Now, 15 years after the advent of the Internet distribution channel, the most cost efficient distribution and marketing channel ever, the indirect channel contribution should not be higher than 25%. On the contrary, due to dramatic changes in travel consumer behavior, and the inherent demand to deal with the "manufacturer" of hotel and travel products (i.e. travel suppliers like hotels, airlines, car rental companies, etc.), we should be witnessing a decline in the indirect channel contribution. What we should not be seeing is the current industry average of a 40% OTA contribution.

Cost of direct online channel vs. OTA distribution:

At a typical 25% merchant commission level for independent hotels, the cost per OTA booking can exceed $100-$125/booking (ADR $200-$250/night and LOS of 2 nights). In the same time the cost of a direct booking via the hotel own website is $10-$12, including website hosting and maintenance fees, marketing spend, campaign management fees, website analytics, etc (HeBS Research). Bookings via the major hotel brand websites come at an even lower cost. In other words direct online bookings are 10-12 times cheaper than OTA bookings.

The $5.4 Billion "leakage" from the industry:

As a result of this shift from Direct Online Channel to the OTA channel, including the 12.1% loss in market share to the OTAs experienced by the top 30 hotel brands, revenue "leaked" from hotels to the OTAs in the form of abnormally high merchant commissions will reach $5.4 billion in 2010 alone. Read more in my recent article "Déjà Vu: The Billion Dollar 'Leakage' Continues to Drain the Hospitality Industry". As a reference point, in 2003 when Smith Travel Research (STR) coined the term "leakage," the revenue "leaked" from the hotel industry to the OTAs was only $1.013 billion.

The Internet Booking Tax Controversy:

The OTA Merchant Model has caused another major controversy that is alienating the OTAs from local governments and tourism promotion authorities. A number of local jurisdictions in the U.S. have filed at least 40 lawsuits against some of the OTAs for unpaid tax revenue because the OTAs have been remitting room taxes calculated on the merchant net room rates rather than what the guest paid for the room. Government officials claim that municipalities across the nation are losing an estimated $1 billion per year in tax revenue that can be used toward promoting tourism to the city or in some cases, paying for schools and law enforcement. (Source USA Today, Wall Street Journal and AH&LA).

How Do OTAs Make Money?

Today, hotels, cruise lines and tour operators are the only travel suppliers who still pay commissions to traditional travel agencies and the OTAs. In hospitality this is due primarily to the fact that:

- The industry, in general, is highly fragmented
- The industry is subject to highly choreographed interactions and sometimes very contentious relations among the three main stakeholders: owners, operators and major hotel brands.

Ever since Delta lowered travel agency commissions back in 1995, the airline and car rental sectors have aggressively worked toward the complete elimination of any travel agency commissions.

Industry research shows that hotel bookings constitute an average of 30% of OTA booking volume but generate over 60% of OTA booking revenue, while air tickets and car rentals comprise 51% of booking volume, but generate a paltry 12% of booking revenue, primarily coming from foreign carriers and car rental companies, as well as dynamic packaging (Source: PhoCusWright, HeBS Research). In other words: the OTAs are relying on the hospitality industry for their mere survival.

Just imagine if hotels allow 51% of the hotel guests to stay practically for free and rely on 30% of the guests to pay for 60% of the hotel room revenue.

Here are the typical OTA commissions in the three major travel sectors:

OTA Commission	
Airlines	$0
Car Rental	$0
Hotels	$50-$150 (based on ADRs of $100-$300)

The impact of the current situation can be further illustrated by Expedia, Inc.'s Third Quarter 2010 SEC filing. Hotel bookings constitute 66% of Expedia's worldwide booking revenue, while all other travel segments (air tickets, car rental, vacation packages and cruises) contribute to only 22% of the company's booking revenue (the remaining 12% come from advertising and media). In Q3 2010 Expedia had 130,000 bookable hotels worldwide and 55% of them were under merchant contract.

Why the OTA Merchant Model as We Know It Will Inevitably Disappear?

Here are only some of the important industry developments and trends that clearly show what the future holds for the OTA Merchant Model:

<u>The Internet Has Become the Main Distribution Channel in Hospitality</u>

In Q3 2010, Internet CRS bookings for the top 30 hotel brands constituted 56.9% from total CRS bookings vs. 19.6% GDS Travel Agent and 23.4% Voice bookings (eTRAK). Overall in hospitality, the Internet will generate 45% of all bookings in 2010, including leisure, unmanaged business and managed business travel (HeBS Research). Hotel companies including major brands, operators and owners can no longer tolerate OTA distribution cost that is 10-12 times higher than booking via the direct online channel i.e. the hotel website.

On the other hand, as the most efficient marketing and distribution channel ever invented, the Internet has disintermediated many industries and helped many manufacturers of goods and services to eliminate the need for intermediaries (e.g. OTAs), including the airline and car rental sectors. In this sense the abnormally high OTA merchant commissions (20%-30%) constitute only a temporary "glitch" and are against all online distribution trends and best practices in existence today.

<u>An Industry Case Study Already Exists:</u>

There is already a major precedent in the industry coming from Europe, where Booking.com, part of Priceline and by far the biggest OTA in Europe with over 45% market share, has successfully operated using the Commission Override Model, in which Booking.com gets a travel agency commission plus commission overrides for booking volume, better placements, etc. Booking.com's business model is so powerful and widely adopted by hoteliers in Europe that Expedia-Europe has difficulties keeping up with its main rival and has been forced to adopt a Commission Override Model, the so called Expedia Easy Manage (EEM) program back in Q2 2009, a commission-based program specifically developed to bridge the gap with the market leader Booking.com. The EEM program already has over 8,000 participating hotels.

<u>Traditional Travel Agency Commissions Will Disappear:</u>

As already discussed, the size of the travel agency commission has a direct correlation to the size of the OTA merchant commissions. I expect that over the next five years the current 10% commission will shrink to 8% then 5%, then become a flat fee of $5-$10, and finally disappear for good. The main reasons for this are the decreased importance of this channel and the GDS in general, the shift toward Internet distribution and rapidly changing consumer purchasing habits that favor suppliers, increased online expertise by the major brands and independents alike, and the improved economic situation.

The GDS Travel Agent contribution to the overall CRS bookings for the top 30 hotel brands was only 19.6% in Q3 2010 compared to 31.3% back in 2006 (eTRAK). Travel agency locations in the US have decreased by 6%-10% every year over the past 10 years. From nearly 35,000 travel agencies in the US back in 1995, there were only 15,405 travel agencies in September of 2010 (ARC, HeBS Research) and as per current trends there will be less than 14,500 travel agencies by end of 2011. A growing number of travel agency bookings for hotels are already non-commissionable (preferred corporate rates, group rates, etc)

<u>Direct Correlation between Travel Agency Commission and OTA Merchant Commission</u>

The lower the standard travel agency commission becomes, the lower the OTA merchant commission tolerated by hoteliers will be. If the standard agency commission is at the 5% level, wholesalers will be entitled to commission overrides based on booking volume 5-7 percentage points above the standard commission i.e. to maximum overall commission levels of 10% - 12%. No hotelier will be willing to grant a merchant discount to the tune of 20%-30%.

In this environment the marketplace will not tolerate the OTA Merchant Model with its abnormally high margins and this model will become a thing of the past.

What is the Future of the OTA Merchant Model?

I firmly believe that the OTA Merchant Model will evolve over the next few years as market conditions and industry indicators improve, and as major hotel brands and other smart hoteliers increase pressure on the OTAs to lower merchant commissions and tie higher commissions to higher OTA "booking productivity" and bigger share of the OTA bookings.

In other words, the OTA Merchant Model will be transformed:

- From a net merchant rate model (net rate at 20%-30% below best available rate) and no commitment to room allotments and booking volume
- Into a "Commission Override Model" where higher booking volume production will earn the OTAs better commissions or "overrides" above the existing traditional travel agency commission levels.

- The good news is that these commission override levels will be at a fraction of today's abnormally high OTA merchant commissions of 20%-30%.

What is a Commission Override Model?

This business model has been around for many years now. Travel agency consortia and mega-agencies like American Express have been able to negotiate higher hotel commissions (2%-5% above the standard 10%) for their members based on their commitment to generate higher booking volume. Cruise lines have been rewarding their top producing agencies with commission overrides to the tune of 5%-8% above the traditional agency commission of 10%. In other words, this model is already widely used in the travel industry and in many other retail and service industries.

For example, an independent hotel could structure an OTA commission override scale in the following manner:

- Up to 500 bookings or booking revenue of $125,000 = OTA commission of 10%
- 501 – 999 bookings or booking revenue of $125,001-$249,999 = OTA commission of 11%
- 1,000 bookings or booking revenue of $250,000 = OTA commission of 12%
- 1,500 bookings or booking revenue of $375,000 = OTA commission of 13%
- 2,000 bookings or booking revenue of $500,000 = OTA commission of 14%
- 3,000 bookings or booking revenue of $750,000 = OTA commission of 15%, etc.

Naturally, the first decisive step to move the industry from the OTA Merchant Model to the more industry-friendly OTA Commission Override Model should be undertaken by the major hotel brands that have tremendous negotiation power with the OTAs. All it takes to open the floodgates is one "brave" major hotel brand to negotiate a commission override agreement with one OTA during the next round of contract negotiations.

What Are the Immediate Benefits to the Industry from Adopting the Commission Override Model?

Here are two important benefits the industry will receive from the adoption of the Commission Override Model:

- OTAs will be asked to commit to certain booking volume or booking revenue, tied to certain commission levels, unlike the current situation where typically the OTAs make no commitment to booking volumes, yet they receive abnormally high OTA Merchant Commissions of 20%-30%. In this way the hotel company can better project all major industry indicators such as occupancy, ADRs and RevPARs as well as cash flows based on the expected hotel website revenue+OTA booking volume commitments, etc.
- The issue with the Internet Booking Tax controversy will simply disappear since OTAs will not operate with net rates, rather with gross retail rates thus calculating the tax on the gross (retail) rate.

Conclusion

Over the next five years the OTA Merchant Model as we know it will disappear. It will be transformed into a "Commission Override Model" where OTA commissions will be tied to booking volumes in the form of commission overrides above the standard travel agency commission that exists at the time.

In the same time, travel agency commissions will shrink from the current 10% level to 8% then 5% and then disappear for good in the same manner as it happened in the airline and car rental sectors. This will result in downward pressure on the current OTA merchant commissions, which are by default tied to the standard travel agency commission. OTAs will be able to earn override commissions above the standard travel agency commission only if they commit to concrete booking volumes. Naturally these commission overrides will be at a fraction of today's levels.

To survive, OTAs will have to find additional value proposition and business models, such as further embrace the dynamic packaging model thus turning themselves into typical online wholesale packagers/tour operators, transform themselves into travel search engines (meta search engines) relying more on advertising rather than transaction revenue, and offering advertising programs such as pay-for-position programs, cost-per-click programs, sponsorships and display advertising.

Max Starkov is chief eBusiness strategist at Hospitality eBusiness Strategies
www.hospitalityebusiness.com