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Title:

IMPLEMENTING AREA REVENUE MANAGEMENT IN A FRANCHISED NETWORK

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Abstract: the objectives of this paper are twofold: (1) to illustrate the potential benefit of adjusting the Revenue Management system for a special sell-up effect in a given area; (2) to show the organizational consequences of applying this tactics within a franchised network like in the hospitality industry. Setting booking limit to control where products are available in an area could be coupled with some customer transfers from an outlet to another and improve the profitability of the whole company. However, local managers have to cooperate between them and with the franchiser. In a franchised network, cooperation is effective but unnatural... [present the conflict, both point of view. And the solutions at least]

Keywords: revenue management, area revenue management, hospitality, franchisee, organizational theory.

INTRODUCTION

The Accor group has set up since 2002 a system of Area Revenue Management (ARM hereafter), i.e. an optimization system of the operating revenue of his hotels in the large cities where it is established. Beyond Revenue Management (RM hereafter), the management of an area makes it possible to optimize flows of customers between hotels. From now, this operation only relates to the hotels directly managed within the group (owned, leased or management contracts). For Many hospitality chains are largely franchised (Holiday Inn is 85% franchised, Intercontinental PLC 95%...), the research purpose is to test if it is possible to transpose such an organization to a franchised network. In that case, how can the company managing the network solve organizational difficulties?

Our research uses the general framework of the organizational design, that is a synthesis of decision-making rights theory, agency theory and transaction cost theory, intended to clarify the problems of actors' opportunism inside the franchiser's network. Some suitable solutions are proposed, in particular studying the allocation of the decision-making rights between contractors.

The first section illustrates the ARM. The second section studies the organizational problems that can appear at the time of the implementation of such a system in a franchised network. The third and last section considers conceivable solutions. As ARM, for the time being, has not yet been set up in any franchised network, this article does not present any empirical study.

ADVANTAGES OF AN AREA REVENUE MANAGEMENT STRATEGY

This section begins with a detailed explanation of what is Area Revenue Management and ends with an illustration showing how it improves revenues.

Adaptation of revenue management practice

After reviewing RM, the aim of this part is to explain ARM using the sell-up effect.

In order to maximize operating revenue, RM is defined as the application of control and pricing strategies to sell the right capacity to the right customer at the right area and time, at the right price. According to Cross (1997) RM is the application of disciplined tactics that predict consumer behavior at the micro market level and that optimize product availability and price to maximize revenue growth. Kimes and Chase (1998) sum up that there are two strategic levers: product pricing (both differential and dynamic) and product availability controlling. Controls can be applied either to the number of products available or to where and when there are available. RM has proven its potential impact on profitability in the past.

RM system can be implemented only under certain cultural and technical conditions. Market information must be available by electronic ways¹. Moreover, ARM needs processing some information between local points (the outlet) and the organization's top: that place is

¹ RM strategy holds on 3 conditions on the supply side (fixed capacity; low marginal sales costs; inventory is perishable) and 3 conditions on the demand side (products can be sold well in advance of consumption; yield segments of customers; ability to price both dynamically and differentially). Anyway, most of the modern-day hotel franchising contracts include provision of central reservation system by the franchiser to his franchisee.

called the area. In other words, top managers have to define the strategy, but optimization has to be made in the area and the deeds must be taken in each hotel. ARM is a step of the corporate strategy. The previous steps are the development of optimization software and implementation of on-line booking systems between hotels (Carroll and Grimes, 1995; Smith, Leimkulher and Darrow, 1992). Information on availability and distribution channels can be centralized and accessible to anyone anywhere. Thus, the implementation of ARM guesses that some steps - both technical maturity of the firm and marketing cultural maturity of the managers - have been reached².

A firm that runs local outlets grouped by zone, as downtown or the whole city, could improve its profit by managing a new parameter in its RM system: the operating revenue of an area. An area is defined as a territory of 5 to 25 outlets nearby. Either hotels could cooperate using the same reservation system for example or they could be managed by the same corporation (the franchiser). The lever is where the product is available in the area between hotels (each day).

The challenge that hospitality companies have to face is to think in terms of middle level. Managers (of the corporation) must ensure for instance that fully booked hotels can propose another solution to the client and confirm a booking in the same area within the franchiser's network. This exchange of booking between two hotels aims to minimize the risk of refusing a client in hotel A while some rooms in hotel B are available. This tactics can be seen as setting an upgrading rule for some consumers or as salespeople trying to sell-up some products when the (full) rate is closed. The sell-up effect represents the probability that some customers, when they find that their first choice rate on a date is unavailable, take the next higher rate (on that date). The RM system can take advantage of this phenomenon by

² For the case of Accor see Guilloux (1999) and Guilloux and Beluze (2002).

increasing the chance that the first choice is unavailable. Instead of developing a formal model (which is not our purpose), the next part shows the interest of sell up between hotels from the standpoint of the firm (and its outlets).

How integrating area parameter in a RM system could improve business profits.

Let us take a firm that owns two different hotels in the same city and consider two consecutive nights. The first one, a three-star hotel, is selling each of its two rooms at \$60 per night. The manager A of this hotel knows that he needs no help to sell all rooms at this price. Therefore, he does not need the company’s central reservation or sales agents to sell his products and rooms would not be available on this distribution channel. The second one, a luxury four-star hotel, charges each of its two rooms \$80 or \$100 per night, depending upon length of stay. The actual requested booking is shown in table 1 for two consecutive nights.

Table 1: actual requested booking for the luxury hotel, before optimization.

	Night 1	Night 2
Rack rate for one night = \$ 100	2 bookings requested	1 booking requested
Special rate for two nights = \$ 80 per night	2 bookings requested	

The optimization of the booking on hand suggests however that some controls could be applied profitably, all others things being equal. As demand is greater than supply, the manager can choose between his clients, depending on how long the client intends to stay. The table 2 presents each hotel’s turnover with a local revenue management.

Table 2: Hotel turnover applying yield management.

Hotel ***			
Network booking	Night 1	Night 2	
total revenue			
occ. rate			
mean price			
Revpar			
Owens booking	Night 1	Night 2	
total revenue	\$120,00	\$120,00	\$240,00
occ. rate	2	2	
mean price	\$60,00	\$60,00	
Revpar	\$60,00	\$60,00	
no control	Night 1	Night 2	
total revenue	\$120,00	\$120,00	\$240,00
occ. rate	2	2	
mean price	\$60,00	\$60,00	
Revpar	\$60,00	\$60,00	

Hotel ****			
Shorter stay	Night 1	Night 2	
total revenue	\$200,00	\$100,00	\$300,00
occ. rate	2	1	
mean price	\$100,00	\$100,00	
Revpar	\$100,00	\$50,00	
Longer stay	Night 1	Night 2	
total revenue	\$160,00	\$160,00	\$320,00
occ. rate	2	2	
mean price	\$80,00	\$80,00	
Revpar	\$80,00	\$80,00	
Control	Night 1	Night 2	
total revenue	\$180,00	\$180,00	\$360,00
occ. rate	2	2	
mean price	\$90,00	\$90,00	
Revpar	\$90,00	\$90,00	

Legend: occupancy rate (Occ. rate) means the number of rented rooms per night in each hotel. The revenue per available room (Revpar) is a hospitality performance measure computed from occupancy rate by mean price.

The optimum strategy looks like this. The three-star hotel is fully booked with traditional customers without controlling them. The four-star earns money by controlling who will get a room. The revenue manager optimizes revenue by setting booking limit at only one client with a special rate for a long stay. The business' total revenue is \$600 (\$240 from the three-star plus \$360 from the four-star).

Nevertheless, this strategy is not optimum if managers are supposed to exchange some of the bookings they have with a predetermined price. In this case, manager A could sell up a room to one of his loyal clients, explaining that his hotel is full and that he could obtain a bargain price in the other hotel of the group, say \$90 instead of \$100. Formally, the optimization module estimates the potential money that could be earned from selling-up some products computing expected marginal revenue. This tactics does not change anything in the three-star hotel as long as it has enough demand. The table 3 shows figures about this option for the four-star hotel.

Table 3: Hotels' turnover applying area revenue management between hotels.

Hotel * * *			
Network booking	Night 1	Night 2	
total revenue	\$0,00	\$0,00	\$0,00
occ. rate	0	0	
mean price	\$0,00	\$0,00	
Revpar	\$0,00	\$0,00	
owns Booking	Night 1	Night 2	
total revenue	\$120,00	\$120,00	\$240,00
occ. rate	2	2	
mean price	\$60,00	\$60,00	
Revpar	\$60,00	\$60,00	
control	Night 1	Night 2	
total revenue	\$120,00	\$120,00	\$240,00
occ. rate	2	2	
mean price	\$60,00	\$60,00	
Revpar	\$60,00	\$60,00	

Hotel * * * *			
Network booking	Night 1	Night 2	
total revenue	\$0,00	\$90,00	\$90,00
occ. rate	0	1	
mean price	\$0,00	\$90,00	
Revpar	\$0,00	\$45,00	
owns Booking	Night 1	Night 2	
total revenue	\$200,00	\$100,00	\$300,00
occ. rate	2	1	
mean price	\$100,00	\$100,00	
Revpar	\$100,00	\$50,00	
control	Night 1	Night 2	
total revenue	\$200,00	\$190,00	\$390,00
occ. rate	2	2	
mean price	\$100,00	\$95,00	
Revpar	\$100,00	\$95,00	

This simulation shows that the best RM local strategies are no longer the optimum strategy from the (ARM) corporation's point of view. The optimum mix of customers in the four-star hotel is to select only short stays and to allow only one booking by the network. By the way, the overall turnover is \$630 (\$240 + \$390). What is important to see as a conclusion is that the optimum strategy depends upon the standpoint. The sum of the pieces of a cake does not always equal the whole of the cake. Thus, one should introduce a number of organizational mechanisms (salary, promotion or control) to make sure the overall strategy will be applied or to line up the interest of local managers so they square with the corporate objectives. Under the condition that managers cooperate, ARM increases the potential of RM everywhere but shifts the debate at a strategic level. Managing pricing and availability to increase area revenue could be difficult to implement in most international hospitality firms because such firms do not own all their hotels³. Many hotels around the world are run under a franchising contract.

³ Even in the case of a single company that owns her hotels, the CEO has to build an organizational structure that makes the right incentive to his middle management. Specially, he would set on a rewarding

ORGANIZATIONAL PROBLEMS LINKED TO ARM IN A FRANCHISED NETWORK

How the cooperation of franchisees and franchisers⁴ can be motivated and monitored in an ARM strategy? The problem seems to be important in franchising contracting because firstly franchisees may guess that their franchiser is acting in its interests and, as franchisees think so, the franchiser has to bond him-self secondly.

Problems for franchisees

Taking part in an ARM system can give rise to several problems for the franchisees: (i) increase of control by the franchiser; (ii) customers' allocation between hotels and franchiser; (iii) partial control over the franchisee's portfolio of clients by the franchiser; (iv) increase of franchisee's dependency towards the franchising network. All these elements will be dealt within the following paragraphs.

system when local managers sell some products of the other hotels. Moreover, there are some legal questions to solve as shown by Brewer (2003).

⁴ Many studies have shown that franchise contracts could increase organizational efficiency comparing to a full ownership structure of the network but also agency costs (see Rubin (1978), Mathewson and Winter (1985), Lal (1991), Bhattacharyya and Lafontaine (1995), Brickley and Dark (1987), Norton (1988), Lafontaine (1992) and Sen (1993)).

Control of franchisee by franchiser

Franchisers are paid by the franchisees on the bases of fees resulting from a given hotel's turnover. Setting up an ARM presupposes a transfer of information from franchisee to franchiser and thus enables the franchiser to strengthen the control over the franchisee and his declared revenues.

ARM leads to introducing a distortion of information between franchisees and franchiser assuming that a franchisee can be tempted to minimize what he is supposed to pay to the franchiser, especially when accountancy or fiscal systems are less strictly defined than those prevailing in France or the United States. Thus « free » rooms offered by the franchisee to some of his clients can be questioned by the franchiser at some periods. These so called « free » room could in fact be paying rooms and be due to the franchisee's opportunism to avoid paying royalties to the franchiser on part of his activity. Similarly rack rates can differ from real rates in order to cut royalties on the company's turnover. The occupancy rate is not always known for sure by the franchiser. All these elements can enable the franchisee to reduce what he is entitled to pay to the franchiser.

In order to set up an ARM both parties must deliver additional information. In the present situation this means that the franchiser is enable to increase his control over the company's turnover. Both parties should desire to cooperate and deliberate on trust. Unfortunately, the franchisees' and the franchisers' interests are sometimes conflicting.

The differences in profitability in the franchisers' setting up modes

When there are royalty discrepancies between hotels or between franchisees, the franchiser who is also the area revenue manager is going to be tempted to canalize the clients towards the most profitable outlets.

This share out can go against the interest of the outlets and the franchisees who pay lower fees. Arbitration will therefore have to be done between equitability and effectiveness. The problem lies in fact in the complexity of the ARM system which provides instructions based on a mathematical model. The vast number of parameters does not facilitate a clear explanation of the outcome.

Increasing volatility of operating returns due to adjustment of customers between hotels

The ARM instructions can have an impact on the operating risk of the hotel due to the adjustment of customers flows between outlets. For instance, during periods of high occupancy rate of low star hotels, sellers will suggest to clients who purchase their room in advance, to book in hotels of a higher quality level (of the network) at an attractive price. This shifts an operating risk from the former to the latter hotels.

Moreover, ARM can also enable to transfer part of regular customers from one hotel to another more profitable outlet. This can have an incidence on the management of customer loyalty: offering to regular clients the services of an upgraded hotel can reduce his loyalty to his first choice. This kind of instructions can thus increase the volatility of cash flow of those hotels which are not favored by the franchiser. The ARM generates conflicting interests with a multi-brand franchisee. For instance if he owns other competitor chain hotels he will want to canalize his customers towards his own hotels rather than to send them to the franchiser's hotels.

Intensifying the franchisee's dependence on the franchiser's

In already controlling the hotel retailing, the franchiser intensifies the franchisee's dependence on the franchiser's network to whom he belongs by applying an ARM system.

By controlling the revpar optimization on top of the reservation center he can strongly influence the franchisee's operating return. This situation also reinforces the specificity of the hotel and will not facilitate the change of brand name for the franchisee in case of conflict with the franchiser. The risk is decreasing the profitability of the outlet in case of disconnection to the ARM system provided by the franchiser.

Moreover, the franchiser will benefit from the information on the local market provided by his franchisees. He will therefore have a more global vision of the market which will enable him to evaluate the efficiency of his territory grid. This will facilitate the opening of new hotels in the area. This also means an additional risk of increasing competition for franchised hotels (Current and Storbeck, 1994; Brewer, 2003)

According to Jensen & Meckling (1992) decision making rights must be allocated to people who own specific knowledge. This is the reason why marketing decision rights are in the hands of the General Manager or possibly Revenue Managers if delegated. Their specific knowledge of the local market should enable them to take wiser decisions than a centralized system. Implementing ARM presupposes transferring information from local outlets to a centralized structure. The feedback of information reinforces the power of the franchiser over his franchisees.

Additional billing for the franchisee

This billing can be a source of conflict. The franchisee can imagine that if such an ARM system allows the outlets' turnover optimization, the franchiser will be rewarded by the royalties generated by the additional revenues. The billing of the ARM service does not seem legitimate. These various elements can lead to suspicion and tension between franchisers and their franchisees. A strong cooperation in an ARM strategy can be greatly compromised.

Problems for franchisers

Franchisees are not the only ones to fear about ARM implementation. The franchiser will be confronted with an important problem of bonding his behavior. There could be some conflicts of interests between franchiser and franchisees if the former is supposed to act unfairly by the latter. The asymmetry of information and the complexity of the environment also suggest that no solution could be easily found but bonding and fairness.

The asymmetry of information means that the performance of the system is difficult to evaluate and thus costly to monitor. Thus, franchisees can also be opportunists and charge with a ARM against-performance of their operation in order to renegotiate the franchising conditions. For Spinelli and Birley (1996), they could use a bad performance to renegotiate frequently the additional services offered by the franchiser (as the ARM!). The franchiser's bonding will be as important as it is in know that his interest is to maximize his income and not to make a fair deal between franchisees when their royalties present different contribution margins (Brewer 2003).

Evaluation the fairness of the ARM system could be particularly difficult. People usually have two reference points when judging the fairness of outcomes⁵. Perceived fairness can take into account both predictive expectations and social comparison. The former is the evaluation of outcomes by oneself, with previous experiences. The latter is the comparison of outcomes with someone else, with the same experience. The franchiser has to bond his behavior by showing that he does not misuse its position to draw part of the situation from a franchisee (predictive expectations) and that he carries out a fair treatment between franchisees, independently of its interests (social comparison). A fair treatment of franchisees supposes at least to evaluate their position before the ARM implementation. For the franchisees to perceive the fairness of the system, ARM should be neutral compared to the previous distribution of flows of customers (and their volatility) across the hotels if it reproduces the initial distribution of flows in the network.

The complexity of the environment means that is difficult to know how the franchisees' profit will be influenced by business cycles. It is not easier for example to compare a one year performance with another when the economic environment strongly changes as all hotels do not have the same structure of customers and their booking do not move in the same way. The franchiser should not be able to find the fairest customer transfers for each economic stage of the business cycle. Franchisees will not miss the event of bad economic performance to accuse the ARM and to charge the responsibility for the bad results to the franchiser. To sum up, franchiser has not only to prove the return of his ARM strategy but its fairness.

⁵ We apply the framework used to capture the fairness of yield management for customers. See Kimes (2002) and more recently Choi and Mattila (2003).

SUITABLE ARCHITECTURES FOR IMPLEMENTING ARM.

Some answers could be proposed to these previous questions. We shall specifically deal with (i) the franchiser reputation, (ii) the organizational design of the ARM.

The quality of the franchiser's name gives rise to transaction with franchisee

Dnes (2003) notes that in franchise contracts both franchisers and franchisee may be tempted to choose the most opportunistic way. The author explains that if the franchisers are renowned for cheating whenever possible, they will hardly find applicants for new contracts. This behavior rises the transaction costs. This hypothesis is the most frequent review to agency theory. Transaction cost economics suggests that agents can not always be opportunists because they anticipate that they would bear some costs from all partners (not only franchisees). This approach can be extended by Kreps' (1990) work on trust and reputation. His model concludes that the reputation of partners is essential to the realization of a contract and that operations are not even possible without some level of trust between people.

So, even if the franchiser makes a rational choice in optimizing his revenues by implementing an ARM, he must stay loyal to his franchisees and owe some duties. For

instance as (outlets) revenues are subject to renegotiations⁶, his partners could however question his loyalty should there be too many conflicts of interests between him and them.

Designing organizational architecture: specific knowledge, decision-making rights and rewarding individuals

In their analysis of the institutional devices through which decision-making rights are assigned within firms, Jensen and Meckling (1992, p 251) focus on how the costs of transferring information between agents influence organizations. They assume that the efficiency of an organization strategy depends on the way decision-making rights are located with specific knowledge and on the control system. Those two arguments are developed in farther details.

Wolsperger (2003) notes that if franchisees know their local market, this knowledge is specific in the sense that it can not be transferred without costs⁷. Intangible by nature, this asset generates the operating revenues and helps to balance the dependence relationship between franchisees and franchiser. An ARM centralized system (in the franchiser's hand) would not be able to value this asset whether it increases the dependence upon the good faith of the franchiser for franchisee's operating return and risk. The organizational theory helps us therefore to suppose that franchisees will only accept ARM if they have some decision-making rights. For Jensen and Meckling (1992), determining the optimal place (in

⁶ In the sense that « the franchiser generally maintain a significant degree of discretionary control over the operations of the franchisee ... as well as its sales and marketing functions through, for example, the provision of reservation services » (Brewer, 2003, p 81).

the organization) to process ARM information requires balancing the costs of bad decisions owing to poor use of specific knowledge and those owing to inconsistent objectives of the partners. Agency costs are the sum of the costs of designing, implementing, and maintaining appropriate incentive and control systems and the residual loss resulting from the difficulty of solving these problems completely.

Brickley et al. (1995) illustrate the approach of Jensen and Meckling (1992) in explaining that the organizational performance depends on the length of the 3 legs of a stool: allocation of decision-making rights, performance measurement system and rewarding system. The problem of measuring the performance of RM is well known in the literature. However, measuring the number of customers transferred from a hotel to another and the efficiency of this tactics is a little bit more difficult. Even rewarding systems should be adapted to take into account the new revenue management system (and the new franchiser's power on allocation of the flow of clients between hotels). For franchised network franchisees are quickly rewarded by their outlet's profit, the franchiser could not be able to modify the actual system to the one he wants. Our hypothesis is that an ARM strategy needs to change the rewarding of individual performance before it can apply for success.

To sum up those arguments, it seems that franchisees' involvement in the ARM is the key of success. In others words, franchisees must be able to contribute (with their specific knowledge of the local market) to the decision of sell-up in the system. The French company Accor has implemented a smart ARM structure with its own hotels. This firm has not however incorporated its franchised hotels so far. Local general managers have to choose to follow or not the advice given by the area revenue manager. In others words area revenue

⁷ Occupancy rate can not be aggregated and processed in a central department without losing local value. See Jensen and Meckling (1992) about the cost to transfer specific knowledge.

managers who are employees of the company do not have any power. They are only advisors and have to be persuasive. One of the skills needed to be an area revenue manager (from Accor point of view) is to be able to explain complex strategies with simple words and to persuade local managers of the policy's efficiency (Guilloux and Beluze, 2002). This architecture clears the name of the franchiser for the local hotels as it gives the last word to their managers. Accor's culture in practice always encourages general managers to be self-governing. ARM could be extended to a franchiser's network if autonomy is a reality for franchisees⁸.

⁸ There are however legal constraints due to the anti-trust law. ARM could be seen as exchanging some information between competitors. Nevertheless, this is the same problem as the airline alliance managing code-sharing.

CONCLUSION

ARM is a new level in a Revenue Management strategy. Overall, ARM is very close to tactics that deal with selling up products, except that a transfer of customers takes place between two independent structures (in terms of ownership). However, the increase in franchiser's monitoring over his network due to his new knowledge of the local markets and the customer transfers between hotels is the more important break to the extension of ARM. Tikoo (2002) notes « A franchiser through its central position in the franchise system acts as an organizational learning center that can gather, synthesize, and disseminate local franchisee level information ». The interdependence between franchiser and franchisees could change with the implementation of ARM. Moreover, franchisees' involvement, day by day, should be a key condition for success.

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