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The power of the per-diem rate

Several markets in the United States rely heavily on government demand. Changes in the way allowances for government travelers are established can turn markets, for better or worse.

Daniel J. Voellm, Consulting and Valuation Analyst

HVS INTERNATIONAL NEW YORK

July 2006

Government control is not a common topic for hoteliers. There are, however, numerous markets in the United States that rise and fall with government-related travel. And in all cases, the government also dictates the prices this demand can pay. The per-diem is the allowance for lodging (excluding taxes), meals, and incidental expenses. This article focuses on the lodging rate established by the General Services Administration (GSA) for destinations within the Continental United States.

PER-DIEM IN THEORY

In 2006, there were 420 non-standard areas (NSA) that were subject to a particular rate based on their share of government demand and general market conditions. The standard per-diem rate for all markets not covered by an NSA is currently $60.00. This compares to a per-diem rate for the Manhattan NSA, the highest-rated NSA, of $274.00. Changes in per-diem rates occurred infrequently in the past. As of fiscal year (FY) 2006 (starting October 1), the GSA employs a more sophisticated approach to establish the annual per-diem rates, using four factors: property selection criteria, time frame of data, seasonality, and methodological rate adjustors. Important changes occurred in the criteria for property selection and time frame of data.

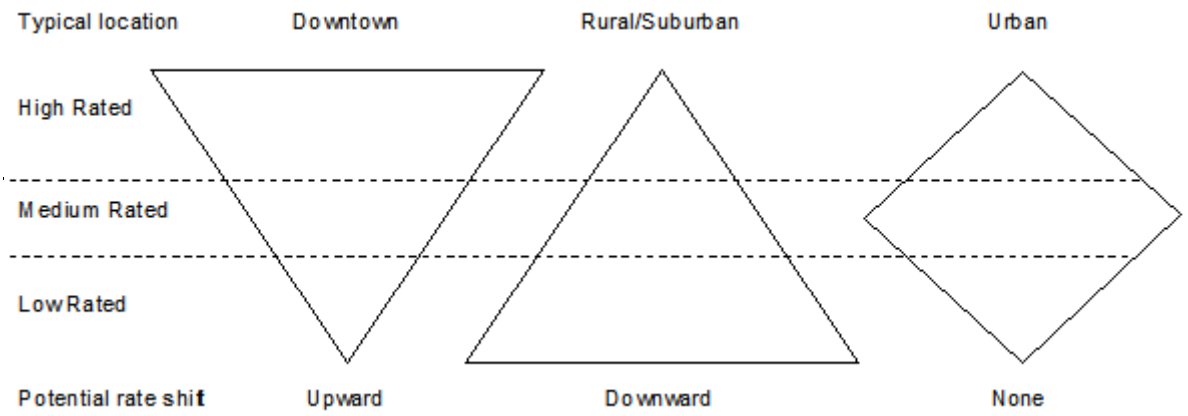
Property Selection Criteria

The Federal Emergency Management Agency (FEMA) monitors the risk hotels are exposed to from natural disasters. Government travelers can be reimbursed only for hotels that are approved by FEMA as being safe. In establishing per-diem rates, the GSA is considering data only from properties that are approved by FEMA.

The GSA broadened the range of hotels included in a market in order to establish the per-diem rate. In 2005, Smith Travel Research's (STR) ranking for mid-scale, upscale, and upper upscale was used for the screening process. As of 2006, all hotels with average rates that fall within the range of these three rate categories are considered. Thus, an economy hotel that posted a higher average rate than a low-rated, mid-scale property will now be included in the sample and has an influence on the per-diem rate.

This change can have different effects depending on the location and profile of the lodging market. A market can contain a large number of lower-rated properties, as in rural areas, or a large number of higher-rated properties in metropolitan areas, such as Manhattan and Washington, DC.

Profile of Lodging Markets – Concentration of Supply



The preceding graphic shows a simplified example of three lodging markets. The markets can be distinguished by a concentration of supply in the three rate categories: high rated, medium rated, and low rated. Based on the new property selection criteria applied by the GSA, per-diem rates in the typical "downtown" market are likely to shift upward, as there is a higher concentration of supply in the higher-rated tier. Specifically, the number of hotels that will be included in the new screening process is likely greater at the end of the market with the higher concentration of hotels, resulting in a shift in the per-diem rate toward that end. In a typical "rural/suburban" location, per-diem rates are more likely to shift downward, while they are more likely to remain flat in a balanced "urban" market.

The following table shows an example, as provided by the GSA, of how per-diem rates were established in FY 2005 compared to FY 2006, based on the average rates (unchanged) of individual properties.

Scenario A – Property Screening Process

#	Tier	FY 2005	FY 2006	
1	Economy	~~$92.00~~	~~$92.00~~	outside range
2	Economy	~~115.00~~	115.00	
3	Mid-scale	104.00	104.00	
4	Mid-scale	122.00	122.00	
5	Independent	~~187.00~~	187.00	
6	Upscale	190.00	190.00	
7	Upper Upscale	163.00	163.00	
8	Luxury	~~180.00~~	180.00	
9	Luxury	~~197.00~~	~~197.00~~	outside range
	Marketwide average rate	$150.00	$150.00	
	Per-diem rate	$145.00	$151.57	

Source: General Services Administration

As indicated in Scenario A, per-diem rates in FY 2005 were based on the average rates of hotels from three segments (mid-scale, upscale, and upper upscale). Average rates included in the analysis ranged from $104.00 at hotel #3 to $190.00 at hotel #6, with a total of four properties producing an average of $145.00 (the per-diem rate) compared to a marketwide average of $150.00. Following the change in 2006, properties from all tiers within the range, from the lowest mid-scale to the highest upper-upscale tier, are included, equating to seven. With the addition of hotels #2 at $115.00, #5 at $187.00, and #8 at $180.00, the average increased to $151.57, compared to the marketwide average of $150.00. Hotels #1 and #9 were out of the range in both cases. The concentration of higher-rated supply in the market increased the per-diem rate by roundly $7.00 in the new approach.

In Scenario B, which follows, we analyzed the property screening process by creating a hypothetical market with 14 properties in six different tiers. Average rate ranges from $35.00 at an economy hotel (#1) to $180.00 at a luxury hotel (#14). We then compared the old and the new GSA property selection criteria.

Scenario B – Property Screening Process

#	Tier	Number of rooms	Screening Process FY 2005	Screening Process FY 2006	
1	Economy	60	~~$35.00~~	~~$35.00~~	outside range
2	Economy	130	~~50.00~~	~~50.00~~	outside range
3	Economy	82	~~62.00~~	~~62.00~~	outside range
4	Economy	90	~~65.00~~	~~65.00~~	outside range
5	Independent	72	~~65.00~~	~~65.00~~	outside range
6	Independent	50	~~70.00~~	70.00	
7	Independent	65	~~75.00~~	75.00	
8	Mid-scale	90	70.00	70.00	
9	Mid-scale	110	90.00	90.00	
10	Upscale	97	110.00	110.00	
11	Upscale	160	120.00	120.00	
12	Upper Upscale	124	150.00	150.00	
13	Luxury	110	~~150.00~~	150.00	
14	Luxury	98	~~180.00~~	~~180.00~~	outside range
	Marketwide total/average rate	1,338	$98.21	$98.21	
	Per-diem rate		$108.00	$104.00	

Scenario B shows the downward shift in the per-diem rate for a rural/suburban market following the change in selection criteria. Based on the old selection criteria, average rates in the sample ranged from $70.00 at hotel #8 to $150.00 at hotel #12, with a total of five properties, producing a per-diem rate of $108.00, compared to a marketwide average of $98.21. Under the new screening process, hotels from all tiers within the range, from the lowest mid-scale to the highest upper-upscale tier, are included. Two independent hotels and one luxury hotel were added that had average rates within the aforementioned range. The eight hotels (#6 through #13) now produce a per-diem rate of $104.00, while the marketwide average remains at $98.21. We note that hotels #1 through #5 and #14 are outside the range and thus are not included in the sample. Although marketwide average rate remained the same, at $98.21, the per-diem rate dropped by $4.00.

Individual hotels can choose to honor the per-diem rate, or demand higher rates when occupancy levels run high. For example, in this scenario, hotel #11 might not be able to attract the same amount of government demand, as the gap between the property's average rate and the per-diem rate increased, although the average rate for the market did not change.

In the following table, we used the same data as in Scenario B under the new screening process (Case I) and generated a special case with one underperforming property (Case II).

Scenario C – Single Property Underperformance

FY 2006 Approach #	Tier	Number of rooms	Case I	Case II	
1	Economy	60	~~$35.00~~	~~$35.00~~	outside range
2	Economy	130	~~50.00~~	~~50.00~~	outside range
3	Economy	82	~~62.00~~	62.00	
4	Economy	90	~~65.00~~	65.00	
5	Independent	72	~~65.00~~	65.00	
6	Independent	50	70.00	70.00	
7	Independent	65	75.00	75.00	
8	Mid-scale	90	70.00	60.00	
9	Mid-scale	110	90.00	90.00	
10	Upscale	97	110.00	110.00	
11	Upscale	160	120.00	120.00	
12	Upper Upscale	124	150.00	150.00	
13	Luxury	110	150.00	150.00	
14	Luxury	98	~~180.00~~	~~180.00~~	outside range
	Marketwide total/average rate	1,338	$98.21	$97.53	
	Per-diem rate		$104.00	$92.00	

Scenario C illustrates the negative effect that one underperforming property can have. Average rates for the properties included in the sample in Case I range from $70.00 at hotel #6 to $150.00 at hotels #12 and #13, with a marketwide average of $98.21 and a per-diem rate of $104.00. Case II is identical to Case I, with the exception that the average rate at property #8 dropped by $10.00. It is not uncommon for a hotel to post a lower average in its first year of operation, during a major renovation, or as a result of a brand change. The underperformance of hotel #8 led to a decline of $0.68 in the marketwide average rate. The $10.00 difference also widened the range for hotels included in the sample, from $60.00 to $150.00. Properties #3, #4, and #5, all with average rates between $60.00 and $70.00, are now also included in the sample. As a result, the per-diem rate in Case II is $92.00, a decline of $12.00 compared to Case I. Again, as there is a concentration of properties at the lower end of the market, per-diem rates are more likely to shift downward.

One of the flaws of the new approach is that it does not take into account the size of individual properties in a market, but weighs all properties equally. This means that a mid-scale convention headquarters hotel with

3,000 rooms is equal to a mid-scale property with 75 rooms. However, a hotel market defines itself by the number of rooms available in a certain tier, compared to the number of properties. Although there is some correlation between the size of the properties and the number in a specific tier, it would be misleading to rely on the number of hotels in determining a market's profile. The performance of a market can be determined by analyzing the occupancy level and average rate, combined as rooms revenue per available room (RevPAR). A market's performance needs to be examined in the context of its profile, a dynamic that is not present in the GSA's approach. Overcapacity at large properties or the strong performance of small properties is not truly reflected in the per-diem rate. We therefore suggest an approach of weighting the average rate of every property in the sample based on its room count, as shown in the following table for Scenario D.

Scenario D – Weighted Per-diem Rate

#	Tier	Number of rooms	FY 2005	Weighted Rate	FY 2006	Weighted Rate
1	Economy	60	~~$35.00~~	-	~~$35.00~~	-
2	Economy	130	~~50.00~~	-	~~50.00~~	-
3	Economy	82	~~62.00~~	-	~~62.00~~	-
4	Economy	90	~~65.00~~	-	~~65.00~~	-
5	Independent	72	~~65.00~~	-	~~65.00~~	-
6	Independent	50	~~70.00~~	-	70.00	$4.34
7	Independent	65	~~75.00~~	-	75.00	6.05
8	Mid-scale	90	70.00	$10.84	70.00	7.82
9	Mid-scale	110	90.00	17.04	90.00	12.28
10	Upscale	97	110.00	18.36	110.00	13.24
11	Upscale	160	120.00	33.05	120.00	23.82
12	Upper Upscale	124	150.00	32.01	150.00	23.08
13	Luxury	110	~~150.00~~	-	150.00	20.47
14	Luxury	98	~~180.00~~	-	~~180.00~~	-
	Marketwide total/average rate	1,338	$98.21	$111.31	$98.21	$111.10
	Per-diem rate		**$108.00**		**$104.00**	
	Weighted per-diem rate (rounded)			**$111.00**		**$111.00**

Weighted rate calculation: Subject rate x number of rooms / rooms in sample

Calculation hotel #9 (FY 2005): $90.00 x 110 / 581= $17.04

Scenario D shows the suggested approach, based on the room count of individual properties. All things being equal to scenario B, we applied the GSA's selection criteria and calculated the weighted average rate per selected property to arrive at the weighted per-diem rate. This is

accomplished by multiplying a selected property's average rate by its room count, and dividing it by the number of eligible rooms in the sample. The sum of the weighted rates of the selected properties results in the weighted per-diem rate. The weighting approach results in a higher per-diem rate based on the market's profile of a concentration of hotels with a larger number of higher-rated rooms available. We note that in Scenario D, the "weighted" per-diem rate remains largely unchanged in both approaches, old and new, as it provides a more accurately computed average rate across the sample. Essentially, a concentration of lower-tier properties with a small room count will have a negative impact on the per-diem rate, and vice versa. As a consequence, the marketwide rate will be driven down, adding more low-tier properties to the sample and bringing per-diem rates further down. A per-diem rate measured by the weighted marketwide average rate would limit the magnitude of this effect.

Time Frame of Data

For the time frame of data analyzed, the GSA used more recent data in the new approach to establish the per-diem rate. The old approach used data that was more than two years old, which did not reflect current market conditions. The new approach uses the fiscal year results of periods ending six months before the new per-diem rates are to take effect.

A second change is that weekends are not considered in the new approach, only average rates from Monday through Thursday. This will affect leisure markets that thrive on weekends, bringing the overall marketwide average rate down.

As a result, markets with a significant share of government demand might have more higher-rated hotels that are unable to attract government demand following decreases in the per-diem rates. This downward shift of government demand creates excess capacity at the upper end of the market. Depending on the nature of the market, whether it has a strong leisure orientation or a relatively high number of luxury hotels, the paradigm will change, for better or worse.

PER-DIEM IN PRACTICE

The following will give two examples of how competitive sets of hotels in two markets were influenced by changes in per-diem rates over the recent past.

Oak Ridge, Tennessee

The following table shows the monthly average rates of a sample of five Oak Ridge properties (limited-service and full-service) from January 2003 to March 2006 (STR), and the respective per-diem rates. Based on our market research, we estimate that 55% of the accommodated demand is generated by the government segment, year-round.

Oak Ridge, Tennessee – Market (STR) vs. Per-diem (GSA)

	2003		2004		2005		2006	
Month	**Actual**	**Per-diem**	**Actual**	**Per-diem**	**Actual**	**Per-diem**	**Actual**	**Per-diem**
January	$56.30	$55.00	$58.20	$55.00	$65.15	$60.00	$70.98	$60.00
February	57.40	55.00	59.34	55.00	67.14	60.00	72.73	68.00
March	57.31	55.00	61.55	55.00	68.10	60.00	75.83	68.00
April	59.96	55.00	62.32	55.00	71.62	60.00	—	*68.00*
May	60.18	55.00	64.07	55.00	70.92	60.00	—	*68.00*
June	58.31	55.00	62.63	55.00	68.47	60.00	—	*68.00*
July	57.68	55.00	60.74	55.00	67.29	60.00	—	*68.00*
August	59.45	55.00	62.32	55.00	64.88	60.00	—	*68.00*
September	59.36	55.00	62.60	55.00	69.27	60.00	—	*68.00*
October	59.44	55.00	66.66	60.00	68.26	60.00	—	*72.00*
November	59.16	55.00	65.35	60.00	69.79	60.00	—	*72.00*
December	58.93	55.00	62.08	60.00	68.40	60.00	—	*72.00*
							Through March	
Annual Average Rate	**$58.62**	**$55.00**	**$62.53**	**$56.26**	**$68.43**	**$60.00**	**$73.61**	**$63.83**
Non-government Rate Growth			**12.0%**		**12.9%**		**14.9%**	

This sample of hotels with a total of 508 rooms represents roundly 72% of the Oak Ridge hotel market. Hotel managers practiced aggressive pricing policies for their non-government demand in 2003 and 2004. We note that the standard per-diem rate increased from $55.00 to $60.00 in October 2004. This market became a non-standard area (NSA) for per-diem rates in February 2006; per-diem rates increased by $8.00, from $60.00 to $68.00. In addition to this increase, local hotel managers maintained an aggressive pricing policy, posting stronger rate growth for their non-government demand. By year-end 2006, the market is likely to post significantly higher average rate levels, thus increasing per-diem rates for FY 2007 to $72.00. This trend will continue until non-government rates plateau or new supply enters the market. Overall, this relatively small market benefits from becoming an NSA and from strong weekday non-government demand that absorbs notable rate increases.

Williamsburg, Virginia

The following table shows the monthly average rates of a sample of seven Williamsburg properties (limited-service, extended-stay, full-service, and all-suite) from January 2003 to March 2006 (STR), and the respective per-diem rates. Based on our market research, we estimate that 20% of the accommodated demand is generated by the government segment, year-round.

Williamsburg, Virginia – Market (STR) vs. Per-diem (GSA)

	2003		2004		2005		2006	
Month	Actual	Per-diem	Actual	Per-diem	Actual	Per-diem	Actual	Per-diem
January	$66.18	$59.00	$65.01	$59.00	$70.89	$79.00	$67.19	$67.00
February	65.79	59.00	70.47	59.00	74.62	79.00	68.39	67.00
March	75.03	59.00	85.96	59.00	95.05	79.00	83.87	67.00
April	106.65	99.00	111.36	99.00	100.37	101.00	—	*82.00*
May	99.94	99.00	114.98	99.00	103.51	101.00	—	*82.00*
June	113.24	99.00	116.56	99.00	117.39	101.00	—	*82.00*
July	129.72	99.00	131.06	99.00	132.70	101.00	—	*82.00*
August	131.89	99.00	127.06	99.00	131.51	101.00	—	*82.00*
September	92.68	99.00	96.20	79.00	94.49	101.00	—	*67.00*
October	102.12	59.00	93.89	79.00	90.47	67.00	—	*70.00*
November	83.83	59.00	84.82	79.00	81.83	67.00	—	*70.00*
December	77.92	59.00	83.32	79.00	78.03	67.00	—	*70.00*
							Through March	
Annual Average Rate	**$101.52**	**$79.05**	**$101.18**	**$82.39**	**$103.74**	**$87.01**	**$75.25**	**$67.00**
Non-government rate growth			**-1.5%**		**1.8%**		**-4.2%**	

Williamsburg, Virginia, provides an example of a market where per-diem rates were lowered following the new GSA approach. In this leisure-oriented market, with strong seasonality and high weekend demand, the new approach significantly depressed rates in the market and narrowed the gap between the winter off-peak and the summer peak season. The sharp decline in per-diem rates might require hoteliers to lower rates to maintain occupancy. Overall, the market will register a downward shift in terms of average rate. Government travelers might stay more frequently at lower-rated properties, as managers at higher-rated properties are unable to honor the low per-diem rate. Unless higher-rated, unaccommodated weekday demand exists in the market or will be induced, the more upscale properties are likely to register decreases in occupancy.

Managers in an NSA must have a good understanding of the nature of government-related demand. For some, it might be a reliable source of demand when bookings do not pick up as fast as expected. Others might not be able to honor the per-diem rate as it is too low, and they need to search for other sources of demand.

CONCLUSION

As shown by the two examples above, the new approach for establishing the per-diem rate can have different impacts, depending on the nature of the market. In suburban/rural markets where more properties are at the lower end of the market (not necessarily with a large fair market share), marketwide rates can be affected by the lowering of the per-diem rate. Rate-sensitive demand that used to be accommodated at lower-end properties will then compete with government demand for rooms, shifting overall demand to the tier with the highest concentration of individual properties. We therefore recommend a more accurate model by weighting properties according to their room count, which better reflects the actual

performance of the market. The weighted average rate is a more accurate indicator for how much a government traveler should receive as an allowance.