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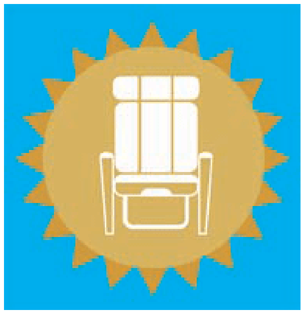

Frequent flyer programs can earn big money for airlines but has the focus on short-term revenue gains jeopardized long-term loyalty?

In 1981, under the leadership of Bob Crandall, American Airlines launched A Advantage, recognized as the industry's first true frequent flyer program (FFP).

AAdvantage was very much a child of its time, benefiting from deregulation and computerization. Without the former, an FFP was unnecessary, while the latter made it possible. Within months of the launch of A Advantage, United Airlines, Delta Air Lines and Trans World Airlines (TWA) had implemented their own versions and FFPs became a mainstay of airline marketing, particularly for the high-yield business traveler. Even Southwest Airlines, which originally resisted the temptation to have its own scheme, joined the party.

More than 30 years later, most estimates suggest that there are at least 130 airline loyalty programs and more than 150 million members.

Airline FFPs have been transformed in the meantime. Most airlines have recognized that the programs could be operated as profit centers in their own right rather than appearing on the books as marketing costs. And that has raised the question of whether short-term cash or long-term loyalty will be the driving force going forward, especially as FFPs continue evolving into alliance and even non-affiliated schemes.

From past to future

Ravindra Bhagwanani, Managing Director of FFP consultancy Global Flight, agrees there will be two main FFP developments. "The larger carriers will continue to focus on the cash generation aspect of FFPs while smaller carriers will differentiate by using them much more as a true Customer Relationship Management (CRM) tool," he says. "Personally, I see the second option as much more promising and hope that larger airlines will not overstretch the system by looking solely at short-term financial gains as this can quickly fall back on them."

However, in the current economic climate, it is hard for airlines to ignore a money-spinner and the evidence suggests that FFPs can make a big difference to the bottom line. "FFPs are a major direct cash generator for larger carriers through the sale of miles to credit card and other partners," admits Bhagwanani. "Without that revenue source, there would be very few major airlines in North America in business today."

When United filed for bankruptcy in 2002, the only part of its operations that was making money was its FFP. Aeroplan, promoted heavily by Robert Milton when he was CEO of Air Canada, raised $250 million in 2007 for just 12.5% of the company.

Marketing benefits

Partners pay good money to airlines to be involved in an FFP because the schemes are such powerful marketing tools. Qantas reported more than $1.1 billion in partner payments in the 12 months to 30 June 2011, a valuable cash asset. The largest US programs—American, Delta and United—each generate more than $1 billion annually.

Also a consideration is the saving airlines make on mass marketing. The targeted advertising of an FFP is far more cost-effective and to an extent negates the need to rely on mass media.

There are costs involved, of course. Aside from the opportunity cost of the seat, there is the direct cost of flying an extra passenger in terms of meals and fuel use. There are also costs in running the FFP, including staff salaries, IT implementation and maintenance, and communication costs such as enrollment brochures and loyalty card production. An FFP will also normally pay partners an agreed per mile rate if a customer decides to spend his miles on that partner's product rather than the host airline.

Then there is the question of liability. While it has been reported that the time elapsed between earning and burning miles is about 30 months and that some 17% of points are never redeemed, the issue of airline liability is an important one. CNBC reported in May 2011 that there are 15 trillion unclaimed miles in the marketplace.

Airlines typically use one of two methods to account for their liability:

- The Deferred Revenue Method recognizes redeemed frequent flyer miles at the amount for which the award credits could be sold separately.
- The Incremental Cost Method only applies the marginal cost of redeemed miles to the balance

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Each methodology has pros and cons, but there is a significant difference in the final amount entered into the books.

When Delta Air Lines chose to revalue its FFP under the Deferred Revenue Method following its Chapter 11 reorganization, for example, its FFP liability increased from $412 million to $2.4 billion.

The reason for the change is that it allows the airline to report higher revenues on award redemption. This doesn't affect cash flow but it does allow for a more robust financial statement and help bolster a company's standing in the financial community.

Overall, frequentflier.com estimates airlines effectively give cutomers a 10% to 20% rebate on ticket purchases.

Not surprisingly, most airlines stand firmly behind their loyalty programs, believing them to offer the best
of both worlds—a cash generator and a driver of loyalty. Alaska Airlines has some three million members in its FFP and Rick Rasmussen, Director of Alaska Airlines' Customer Loyalty and Marketing Programs, says the program is an important part of the brand, the customer experience and the airline's financial performance.

Manoj Papa, Head of South African Airways' Voyager scheme, which has some 2.4 million members, agrees that FFPs are now an intrinsic part of the airline business model. "Passengers are inclined to select an airline where they are a member of the FFP program over other airlines that fly the same route," he says. "This selection often happens even where other airlines have lower fares or may be perceived to have better service or product."

Indeed, IATA's Airs@t product (www.iata.org/airsat) shows that FFPs are the second factor behind schedule convenience in a customer's choice of airline. For business travelers, an FFP is far and away the most important element in deciding which airline to use.

But there is another side to the story. In today's market of alliances, codeshares and consolidation, customers fly with loyalty to groups larger than a single airline. And that makes determining the future loyalty of a customer something of a minefield.

The pros and cons of partnership

Papa believes the many types of partnerships add value to the FFP strategy, strengthening the member proposition in terms of accrual and redemption opportunities.

"They provide SAA and Voyager with exposure and awareness opportunities since our code is carried on the network of the partner and hence reaches millions of members," he says. Papa notes that accessing partner databases also allows sales campaigns to be launched successfully beyond the borders of the airline's own database.

But David Mackrell, General Manager, Loyalty, Air New Zealand, warns that there are drawbacks. "These arrangements are often complex and require good, clear communication to customers for them to be able to make the most of such an FFP benefit," he admits.

Indeed, while there may be consumer benefits to be had from such alliances, some observers believe there is a lowest common denominator effect from loyalty program co-participation—there's simply less incentive to be innovative or extra-generous.

This could have serious consequences for an airline's brand and its long-term customer base. As Tim Winship, Publisher and Editor of FrequentFlier.com, stresses, "An airline's loyalty program has more power to undermine a carrier's brand image than it has to enhance it.

"When an airline's loyalty program is felt to be stingy, for example, that negative perception tends to degrade the carrier's overall image, while the perception of a generally customer-friendly program seems to have a more neutral effect on a carrier's image," he adds.

Air Canada found itself locked in a bitter legal dispute when it put an expiration date on its Aeroplan miles. And while all airlines retain the right to change the terms and conditions and constant activity is a must, many now see the wisdom in an open-ended redemption period.

Then there are programs such as Air Miles, which offers free flights despite having no airline affiliation. Such schemes clearly have implications for the long-term customer relationship. Partners can change and customer loyalty is to the scheme and not an airline.

Alaska's Rasmussen isn't convinced though. Appropriately recognizing and rewarding customers for their business is the key. "A well-run frequent flier program has the ability to reinforce brand loyalty by helping to attract and retain good customers, and increase customer satisfaction," he says.

Industrial scale

Other issues hit upon the future of frequent flyer programs. The Norwegian government banned reward miles for domestic flights to promote competition among its airlines. The premise is that larger airlines can overpower smaller carriers through their FFPs. Norway has since partially lifted the ban but the complaint remains.

"It is indeed true that smaller airlines need to be a bit more innovative to overcome the size-related disadvantage," says Global Flight's Bhagwanani. "But if you look beyond the headline figure of membership numbers at more meaningful key performance indicators, you realize quickly that smaller FFPs are often actually much more successful than the large ones. But, on the other hand, there are too many "me too" programs out there, which don't result in the benefits for the operating airline that they should, and represent only a cost factor."

A more positive development is technology advances that have the potential to merge revenue gain with one-to-one CRM and a more efficient travel process.

next flight and proactively offers me an incentive to book with the airline." The functionality associated with a database has improved enormously, as have the skills to expertly mine the information. Winship's dream could soon become a reality.

At Alaska Airlines, Rasmussen says the carrier can use data to tailor a customer's experience when they visit the website. "For example, if a customer is a member of our Board Room lounge program, we could display a message when they visit the website that shares information about upcoming special events in the lounges," he says.

Travel agent sales could similarly benefit from improved customer data. IATA's New Distribution Capability (NDC) project will address airline requirements for innovation in global distribution. A foundation standard will be presented at the World Passenger Symposium in October 2012 in Abu Dhabi.

There is a potential innovative use in security too. "FFPs can serve as an important platform for pushing next generation travel services such as biometrics, known traveller programs, and standardized boarding tokens to the frequent traveler," says Ken Dunlap, IATA Global Director of Security and Travel Facilitation. A loyalty card could become a permanent boarding pass, for example.

Offering greater product differentiation will in turn generate valuable information. Rasmussen believes that "customer data allows the carrier to make better decisions about how, when and where to grow our airline based on the travel behavior of our customers". Using the data beyond the FFP could be the key to a better business model.

Ultimately, airline seats remain a powerful currency. The FFP is a channel to a brighter future if airlines learn to exploit the magnet that is a free flight. Partner companies are clearly happy to pay for that hook and customers clearly appreciate the concept.

Frequent flyer programs and the environment

Frequent flyer programs are often cited as an environmental concern because they promote travel—and especially trips that might not otherwise be taken if a traveler had to pay for the flight. "But it is about responsible travel," says Paul Steele, IATA Aviation Environment Director, "carbon offsets are freely available."

Cathay Pacific offers customers the option to buy carbon offsets with frequent flyer miles. And regardless of whether or not a flight contains a passenger using reward miles, that flight is still scheduled and will take off and land as planned.