LOYALTY MARKETING REPORT SERIES FOR 2011

Loyalty by the Billions:

IdeaWorks analyzes how frequent flier programs pour cash into airline coffers

Researched and Written by Jay Sorensen
Edited by Eric Lucas

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Thirty years ago the chairman of a leading European-based airline declared his disgust for frequent flier programs. He called them an “American disease” that would hold no allure for the more sophisticated Europe-based traveler. History has proven the folly of this belief. Europe now boasts more frequent flier programs than the number offered by US-based airlines, and the FFP phenomenon has spread worldwide. Beliefs are sometimes hard to dispel, and too many airline executives still think frequent flier programs are ruinous for the bottom line. It’s impossible for critics to ignore the $7 billion accrued in 2010 by the programs associated with five global airlines. IdeaWorks offers this report as a rebuttal to anyone who says, “Frequent flier programs cost too much money.”

American Airlines is credited with introducing the first frequent flier program in 1981.[1] This invited an almost immediate response by United Airlines and Delta Air Lines, both of which quickly introduced competing programs. The rest of the world took a bit longer. For example, KLM’s program began in 1991[2] and programs for Lufthansa[3] and Japan Airlines[4] followed later in 1993. Today, airlines all over the world - - from small to large - - have embraced loyalty marketing, but holdouts remain.

Low cost carriers seem to be among the last to seek the revenue opportunity provided by frequent flier programs. Ryanair’s disdain for loyalty marketing is well known. The carrier’s 2008 annual report actually points to “wider seats, business lounges, and frequent flyer clubs” as services not really wanted by their customers. Other major players without a program include AirAsia, Air Arabia, and EasyJet. But even these carriers know there is money to be made; Ryanair, AirAsia, and Air Arabia now offer co-branded credit cards.

Tom Stuker’s recent achievement of 10 million flight miles on United Airlines is evidence of the power of FFPs. At 15 cents per mile, that’s revenue of $1.5 million from a single customer.

Let’s face it - - consumers enjoy reward travel. And major airlines have always enjoyed the marketing power these programs offer. But savvy managers know these programs also provide piles of cash from the sale of miles and points to partners, the a la carte fees associated with reward travel, and the revenue rewards members give the airlines when they buy more travel. With billions in revenue delivered each year, loyalty marketing is a cure - - not a disease.

1 “15 Greatest Financial Innovations of the 20th Century” article dated June 2011 at Kiplingers.com.
2 Milestones in KLM’s History page viewed July 2011 at KLM.com.
3 Lufthansa Background document dated June 2010 at www.Lufthansa-usa.com.
4 History of JAL page reviewed July 2011 at JAL.com.

Co-branded credit cards become the biggest client

Frequent flier programs produce ancillary revenue from an array of sources. The foremost financial benefit is the incentive for customers to spend more money with the host airline. United's 10-million-mile customer may be influenced by a number of factors but chief among them are the perks, attention, and rewards associated with the Mileage Plus program. Job number one requires a program to harness the economic power of a carrier's top customers. That's why an estimated 1.25 percent of American's 64+ million frequent flier members delivered 26 percent of the carrier's worldwide passenger revenue in 2009.[5]

Beyond being a very powerful marketing tool, many programs have become major contributors of bottom line cash benefits. During 2010, approximately 62 percent of American AAdvantage miles were sold for cash, with just a third actually accrued by members flying on the airline.[6] In effect, these programs have become another method to sell travel . . . one mile at a time.

Miles and points are purchased by individual members, program partners and even other airlines. Among these, banks loom as the primary buyers. The vast majority of the 114 billion miles sold by American during 2010 were purchased by Citibank, which is the primary issuer of credit cards linked to the carrier's AAdvantage program. Very likely the bank paid more than $1 billion for the miles accrued by cardholders. Each mile accrued through card activity is purchased by a bank for the airline to deposit to the mileage account of the cardholder. The same process applies for all partner related mileage activity for hotel stays, car rentals, and retail purchases. Miles or points purchased by partner companies are deposited into member accounts.

All of this partner activity quickly adds up to millions and billions of dollars and euros. The global leader is the newly combined behemoth of United and Continental, which yields annual frequent flier program revenue of $3 billion. Qantas is the world's best performer with amazing results of $158.51 per member and is followed by Alaska Airlines at $120.26.

Frequent Flier Programs – Revenue Disclosed or Estimated			
Airline	Annual Revenue	Revenue/Member	Revenue/Passenger
United Continental	$3,000,000,000	$32.97	$20.59
Delta Air Lines	$1,600,000,000	$19.51	$9.84
American (estimated)	$1,368,000,000	$20.42	$13.01
Qantas Group	$1,141,240,000	$158.51	$27.55
TAM	$505,764,144	$63.22	$14.64
Alaska	$372,800,000	$120.26	$15.98
Iberia	$23,430,000	$5.86	$0.93

Revenue disclosed by airlines in financial filings during 2010; may comprise exclusively co-branded credit activity or may include other partner activity. Membership totals found in annual reports or published sources.
American Airlines estimate based upon disclosure of miles sold multiplied by assumed average price of 1.2 cents/mile.

[5] "Understanding the Power of American's Elite Program", 2010 EzRez Loyalty Guide by IdeaWorks, page 85.
[6] Form 10-K Annual Report of AMR Corp. for 2010.

Consumer-credit economies, such as the US, Australia, and Brazil, provide airlines an obvious opportunity to build revenue through large credit card portfolios. The higher per member statistics might be influenced by a conservative accounting approach which only counts "active members" whereas other carriers may disclose everyone holding a card regardless of whether miles or points have been recently accrued. Per passenger statistics may provide a better method of comparison. Here too, the same carriers shine, with Qantas realizing $27.55 per passenger and United Continental at a very strong $20.59.

Frequent flier programs have become a significant component of the consumer banking industry. American Express was compelled to specifically disclose the impact Delta's SkyMiles program has on its global credit operations. Per the 2010 annual report, the SkyMiles Credit Card co-brand portfolio accounts for approximately 5 percent of the company's worldwide billed business of $713.3 billion. That's more than $35 billion of actual Amex card activity . . . which happens to exceed the annual revenue of the airline.

Banks have thus become major clients for airlines. Delta receives $1.6 billion from its SkyMiles program with the vast majority representing reward travel purchased by American Express in the form of program miles. By comparison, the entire US government is a far smaller customer; it only spent a bit more than $692 million on travel with Delta in a recent year.[7] Air Canada describes a similar relationship with its frequent flier program in its 2010 Annual Report. Among all the carrier's corporate clients, Aeroplan is Air Canada's "single largest customer."

Mingled with all this credit card activity is a significant quantity of miles and points purchased by partners such as hotel chains, car rental companies, and retailers. These partners may lack the buying power of banks, but their participation adds benefits for consumers. Accruing miles through traveling and shopping makes a program more valuable to the member. And when these accrual opportunities are insufficient, members have demonstrated an amazing desire to purchase more miles direct from the airline.

Selling miles and points direct to members

Consumers act like frequent flier miles and points are an alternate form of worldwide currency. Miles are versatile and can be redeemed by members to benefit friends or relatives around the world. Members have a seemingly unquenchable thirst for reward travel; the recent trend to add hotel, car rental, and retail reward opportunities has only strengthened the value equation for consumers. Miles and points can be readily exchanged through legitimate channels such as Points.com and, much to the chagrin of airlines, within a black market of clandestine opportunities to buy miles or barter them for goods.

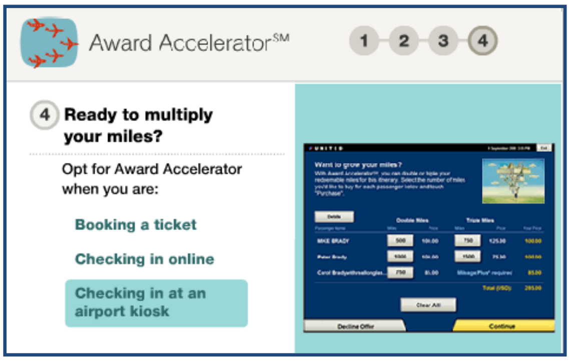
Sometimes miles are more exchangeable than actual currency. During 2008 trading ceased for Iceland's national currency.[8] Icelanders were unable to exchange their kronas for dollars, euros, or yen. Currency counters at airports in Europe put up signs advising travelers that kronas would not be traded. But throughout the year, members of Icelandair's frequent flier program enjoyed uninterrupted ability to redeem points for air travel, hotel accommodations, and conduct exchanges through Points.com.

[7] Top Travel Contractors for Fiscal 2008 in the August 15, 2009 issue of Government Executive magazine.
[8] "Iceland's Krona Currency Trading Halts as Kaupthing Taken Over" article dated 9 October 2008 at Bloomberg.com.

Similar to a central bank, airlines exercise nearly total control in the valuation of miles. Raising the number of miles required for a reward ticket lowers mileage value, while providing more reward seat availability effectively increases value. Adding travel and merchandise reward options improves value perception and usability. Airlines can also flood the market with miles through co-branded credit card bonus offers or flight-related promotions. Readers may recall the 100,000-mile and 60,000-mile credit card offers made by banks and airlines during the past few years.

For many members the allure of miles is too compelling to ignore - - especially when a desired reward is slightly beyond the reach of an existing account balance. For these consumers, instant satisfaction is often provided by a quick purchase of miles direct from the airline. Frequent flier program managers find the idea too tempting to ignore and have devised a multitude of methods to sell miles direct to members. United has created two branded products to promote bonus miles at practically every step of the travel experience.

- **Award Accelerator.** Mileage Plus offers the ability to double and triple miles earned on a flight for a fixed fee. For example, earning double miles on a JFK to LAX flight would cost $74 or approximately 3 cents per mile. The benefit is actively promoted at the carrier's website, during the booking process, and even at airport check-in kiosks.
- **Personal Miles.** Members may buy miles in 1,000-mile increments to add to their account at any time. Quantities start at 2,000 miles at a price of $75.25 and up to 60,000 miles for $2,257.50 at a price of 3.76 cents per mile. Preplanning is required as miles are posted to the account within 48 hours after purchase.



United offers an online tutorial to guide members through the process of buying miles.

The preferential rate paid by banks is usually 1.0 to 1.2 cents per mile, or $10 to $12 for every 1,000 miles accrued by a cardholder. For the airline, each 25,000-mile reward could ultimately be backed with partner revenue of $250 to $300. The per-mile price paid by consumers is always far higher and usually averages 3 cents per mile. The same 25,000-mile reward would deliver $750 if every mile were purchased at member direct prices. That's an attractive premium when compared to the average domestic fare of $337 as reported by the US Department of Transportation.[9]

Airlines do discount the price of miles sold to members with occasional reductions up to 50 percent. The majority of miles are probably purchased by members looking to "top up" before redeeming for a reward. But impulse offers made by carriers online during booking and at airport kiosks create significant sales. It's truly amazing how consumers have embraced all of these offers. Consumer survey results reported in *Travel Weekly* indicate 14 percent of travelers have purchased bonus miles from an airline.[10] Industry sources suggest 10 percent of program membership (on an annual basis) might be a reasonable statistic to assume for economic modeling purposes.

[9] Annual U.S Domestic Average Itinerary Fare in Current and Constant Dollars for 2010, USDOT.
[10] "2011 Consumer Trends" article with PhoCus Wright survey results, 25 July 2011, *Travel Weekly*.

The revenue potential is amazing. Let's assume 10 percent of United's 58 million Mileage Plus members[11] (excluding Continental membership) purchase a minimum of 1,000 frequent flier miles. Multiplying that sale of 5.8 billion miles by an average discounted price of 2.5 cents per mile delivers revenue of $145 million. Another set of assumptions to arrive at the same number would have 5 percent of members purchase 2,000 miles - - which is United's minimum purchase quantity for its Personal Miles product. These examples explain why savvy program managers are eager to sell miles and points direct to consumers.

Airlines can find rewards oh-so-rewarding

The phrase "free reward travel" has gradually disappeared from airline advertising. Government taxation and rapidly rising fuel costs are the primary culprits. Taxes have become significant and are now paid by members. Airline executives have learned the benefit of attributing a portion of the price of travel to the sinister expense of jet fuel. With high fuel costs now a permanent part of the aviation business, the fuel surcharge remains an ever-handy tool for airlines to isolate a portion of the revenue base from fare discounting. Its application to frequent flier programs introduces a new revenue stream from a very unlikely source: reward travel.

Airline executives are realizing a simple fact. Reward travelers are also airline customers. They can be charged fuel surcharges and can generate a la carte revenue from baggage charges, travel insurance commissions, and seat assignment fees like any other passenger. Let's review Air France's reward policies for an example of how this works. The example uses a roundtrip Flying Blue reward between New York and Paris for February 2012. For comparison, economy class travel would cost $847 including taxes and surcharges.

This reward choice would cost 50,000 miles plus payment of $123 for taxes and $420 for surcharges. The latter is not a government-inspired fee but merely adds more revenue to the carrier's bottom line and presumably is related to the cost of fuel. The surcharge provides a sizeable revenue boost from reward travelers on Air France. But the airline can also benefit from the sale of a la carte services to reward travelers in the same manner as fare-paying passengers. Ultimately, Air France could collect $761 for this reward request.

Revenue from Reward Travelers – Air France	
$420	Passenger surcharges for JFK – Paris, roundtrip economy class
Optional Services Available to Reward Travelers	
$22	Reward travel booked through the call center
$75	2nd checked bag – outbound flight
€75 ($104)	2nd checked bag – return flight (paid in euros)
€50 ($70)	Exit row seat for extra legroom – outbound flight (paid in euros)
€50 ($70)	Exit row seat for extra legroom – return flight (paid in euros)
$761	**Total surcharge plus revenue potential**
Sources: Air France website, Air France call center agents, and XE.com currency site, September 2011.	

[11] United Continental Holdings Inc. profile at Reuters.com reviewed September 2011.

But wait, there's more. Reservation changes would add $70 and cancelling a reservation and the return of miles costs $70. The application of fuel and insurance surcharges to reward travel is commonplace among airlines, but exceptions do exist. For example, Delta doesn't apply surcharges for reward travel on its flights, and neither would it charge the fee to SkyMiles members choosing Air France between JFK and Paris. But the carrier has set its JFK – Paris base reward level at a slightly higher 60,000 miles.

Travel related services should be promoted to reward travelers in the same manner as fare-paying customers. Reward travelers are equally good candidates for booking hotel stays, arranging car rentals, and buying travel insurance at the carrier's website; these generate commissions for the airline. A la carte services can be sold during the booking process or through follow-up email contact. These can include seat assignments, fast-track security, priority boarding, and pre-paid meals. Elite status should be noted to avoid selling services already provided to the member as a free benefit.

There is a caveat, as revenue opportunities for an airline translate into added cost for the consumer. Airlines must consider the delicate balance between ancillary revenue and the value of loyalty. Programs that assess fees at every opportunity risk establishing a reputation that endangers the primary purpose of a frequent flier program. Likewise, carriers that don't promote a la carte services to reward travelers are ignoring the full ancillary revenue potential of their frequent flier programs.

Elite-style credit cards boost a la carte revenue

The worlds of a la carte fees and frequent flier programs are also combining to create new co-branded credit card offers. Several airlines, such as Delta and Continental, have launched initiatives to provide free checked baggage as a benefit for their basic credit cardholders. Airlines and partner banks have expanded the trend by bundling more elite-style perks into cards which include hefty annual fees. These cards are powerful marketing tools that combine a pre-paid approach to fees with the loyalty benefits of the frequent flier program. It's a virtuous cycle in which the consumer lowers their per-trip cost of the annual fee investment by flying the airline more frequently.

American Airlines and Citi Cards announced the Executive AAdvantage World Elite MasterCard in July 2011.[12] The name is a mouthful and the long string of adjectives is designed to depict this as a very special card. The $450 annual fee places the card in the realm of the Platinum Card from American Express. Here's a sampling of some of the card's annual perks:

- Admiral's Club membership for immediate family or up to two traveling guests.
- Priority check-in, airport screening and boarding privileges, regardless of fare paid.
- Waived baggage charge for first domestic checked bag for cardholder and up to eight companions traveling under the same itinerary.
- 10,000 AAdvantage Elite Qualifying Miles (EQMs) after the first $40,000 in purchases within a calendar year.

[12] American Airlines AAdvantage press release dated 18 July 2011.

The card offers additional attractive features. Fees associated with foreign transactions are not charged, double miles are accrued for American Airlines purchases, and the card itself uses chip technology which eases merchant acceptance outside the US.

Why would an airline want to give cardholders so many perks? First, the features make the card attractive to more consumers. This simply creates a larger portfolio which sells more miles to the issuing bank. The second answer is more complex. The inclusion of traditional a la carte services such as airport club access and checked baggage does deny the carrier future ancillary revenue opportunities.

IdeaWorks believes airlines which issue these cards have struck a deal with their bank partner for a share of the larger annual fee. The annual fee for a basic Citi AAdvantage card is $85, which suggests American might receive the entire $365 premium charged for the fully-bundled Executive AAdvantage World Elite MasterCard. In addition, the airline might receive 1 to 1.2 cents for each of the 25,000 sign-up miles provided to new cardholders. That's a bonus of $250 to $300 for American.

These numbers don't reflect disclosure by American and are based upon trends in the industry. But with new individual Admirals Club memberships priced at $500 per year, you can bet American is getting some portion of the annual fee. American is not the only player, with similar cards available from Air Canada/Aeroplan, Delta, Continental, and United. These programs offer annual benefits such as lounge access and/or free checked baggage to raise the competitive bar against non-airline rebate and reward cards. It's a good outcome for consumers and airlines. Program members enjoy more choices and can opt to pay an annual fee for services they value. Airlines can use co-branded credit cards as a new platform to sell annual subscriptions for a la carte services.

Perks open the pocketbooks of top fliers

This report identifies a variety of methods airlines use to tap their frequent flier programs for ancillary revenue. Miles and points offer universal appeal and can be sold to banks, retail partners, and even direct to members. Co-branded card cards can be enhanced to deliver more services with elite-style perks that permit carriers to share annual fees with issuing banks. Successful frequent flier programs also deliver revenue in the more direct manner of selling more airline seats. After all, they are called "loyalty programs" and are designed to encourage customers to buy more often.

Elite tiers recognize the most frequent of frequent fliers. These allow the airline to focus on a smaller group of customers with greater service and marketing precision. Rather than be all things to everyone, many airlines have decided to lavish attention on the top 3 to 5 percent of customers as measured by flight activity. The VIP treatment includes special services to make travel more convenient, comfortable, and rewarding.

The revenue power of elite programs is easily demonstrated at the status thresholds. These define the amount of revenue or trip activity required for a member to gain access to the perks of the tier. The allure of elite status encourages members to concentrate their purchasing power with their program of choice. And this is accomplished by remaining loyal to an airline (and its partners) even when competitors offer a better combination of schedule convenience, service quality, and price. This is the sweet spot airlines seek to tap when designing program attributes designating how members qualify for each tier.

SAS Scandinavian and its EuroBonus program offer a Basic tier and two elite tiers branded Silver and Gold. Similar to other legacy airline programs, the perks provided for elite members include business class check-in, larger checked baggage allowance, bonus points, lounge access, and fast track security access. The airline disclosed in its 2010 Annual Report that global EuroBonus membership is 2.7 million with 4.7 percent having Silver status and a more exclusive group of 2.2 percent at the Gold tier.

IdeaWorks evaluated the traffic and revenue statistics of SAS Scandinavian to estimate how the airline might benefit from the threshold effect of its elite program. EuroBonus requires 20 one way flights (or 20,000 points accrued by flying) to attain Silver status, which is the entry level tier. It's easy for some members, especially those who live in hub locations, to choose SAS Scandinavian for the majority of flights. But other members must change travel behavior to achieve elite status. They may create more reasons to travel or merely avoid the temptation of flying on a competing carrier - - but it's a gain purely due to the carrier's elite program. This incremental activity reflects the threshold effect for the host airline.

It would be reasonable to estimate 25 percent of Silver tier members added incremental flight activity to attain elite status. IdeaWorks based its calculations on flight-based tier qualification and further assumed these members flew an average of three additional one way trips (15 percent of the 20-trip tier requirement). SAS Scandinavian flew 21,532,000 passengers during 2010 and generated passenger revenue of 25.833 billion Swedish kroner.[13] Converted to US dollars at a rate of one Swedish kroner equaling $0.155 yields passenger revenue of approximately $4 billion and an average one way systemwide fare of $186. This fare was applied to the incremental trip calculation to determine the revenue benefit associated with the Silver tier. The same method was used for the Gold tier estimate with an additional 6 one way trips associated with incremental activity (15 percent of the 40-trip tier requirement).

IdeaWorks estimates SAS Scandinavian might realize a $34.7 million incremental revenue benefit from the threshold effect of its elite program. The true revenue benefit is probably much higher as the assumptions are intentionally conservative. For example, business travelers undoubtedly pay higher average fares for last minute and business class travel.

Estimate of Incremental Travel Activity – SAS EuroBonus		
	Silver Tier	Gold Tier
Threshold Flight Requirement	20 one way flights	40 one way flights*
Members at Tier	128,000	60,300
Calculating the Threshold Effect		
25% of Members with Incremental Trips	32,000	15,075
Average Incremental Trip Activity/Member	3 one way trips	6 one way trips
Systemwide Average Fare for SAS	$186	
Revenue from Incremental Trips	$17.86 million	$16.82 million
Total Revenue Estimate	**$34.7 million**	
**Norway-based members have a lower threshold of 35 flights.*		
Membership levels disclosed in the SAS Group Annual Report & Sustainability Report 2010.		

[13] SAS Group Annual Report & Sustainability Report 2010

Helping profits become more frequent

Airline executives back in 1981 never imagined the complexity unleashed by the simple concept of offering free tickets to repeat customers. The big leap occurred when credit cards became part of the story by injecting outside cash into airline coffers. The industry's initial response was to pocket the money to help boost battered balance sheets. The long term solution has always been to operate these programs in the manner of a successful business.

Frequent flier programs have become products unto themselves. Many customers now expect satisfaction from the experience of accruing and redeeming miles . . . in addition to flying. Airlines have learned revenue success is supported by on-time, pleasant flights and is enhanced by a full-featured frequent flier program. Given the opportunity, there is a customer base at every airline that will readily respond to the charms of reward travel, co-branded credit cards, and elite status.

10 Points for Generating Cash from Miles and Points

- Delight (don't frustrate) your members with attainable and available rewards.
- Attract the best partners by creating a large and engaged member base.
- Carefully select a bank partner as it will someday provide the most cash to the program.
- Promote the direct sale of miles to allow members to top up balances for redemptions.
- Tap into impulse buys by selling bonus accrual during booking and check-in.
- Cultivate reward travelers as you would any a la carte opportunity.
- Remain true to your brand identity when considering the balance between ancillary revenue and the value of loyalty.
- Consider elite credit cards to provide subscription-style access to a la carte services.
- Add incremental revenue by adding an elite tier program.
- Reinvest a portion of program profits to build a better program.

The intangible benefit of loyalty marketing has always been difficult to measure. For most airlines, the competitive disadvantage of lacking a program is impossible to comprehend. That's the attraction of a multifaceted approach to program design. The core loyalty benefit represents a combination of reward and recognition of a carrier's best customers. This is supported by the unmatched communication capabilities delivered by the database and the protective competitive armor created by member engagement. The extra benefit of incoming cash should help tilt the most skeptical airline executives into the category of loyalty marketers.

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About IdeaWorks: IdeaWorks was founded in 1996 as a consulting organization building brands through innovation in product, partnership and marketing, and building profits through financial improvement and restructuring. Its international client list includes the hotel, airline, marine, railroad, consumer products and health care sectors. IdeaWorks specializes in ancillary revenue improvement, brand development, customer research, competitive analysis, partner-marketing strategies, cost reduction programs and business restructuring. Learn more at IdeaWorksCompany.com.

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