IdeaWorks

Airline Industry Analysis

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Airline Bankruptcy:
Its Impact on Frequent Fliers, Award Tickets and Mileage

United Airlines and US Airways total frequent flier liability represents nearly 16 million unused award tickets.

September 21, 2004, Shorewood, WI. Frequent fliers may be surprised to not see their names included among the list of creditors in the bankruptcy filings of United Airlines and US Airways. Yet with nearly 16 million outstanding award tickets, and if the bankruptcy courts could apply an average fare of $250 to each ticket, frequent fliers would loom as the largest creditors with their award travel having a market value of nearly $4 billion.

Frequent flier members have many reasons to be alarmed about the bankruptcy filings by major U.S. carriers and the impact an airline shutdown would have on travel awards:

- The status of unclaimed miles and travel awards is only protected by the court's acceptance of management's argument that preserving a frequent flier program is critical to an airline's exit from bankruptcy.
- Frequent flier members are not considered creditors; unredeemed miles and award tickets are treated as a liability and not as a debt. If an airline moves into liquidation, frequent flier members are unlikely to receive relief from the bankruptcy court.
- The looming size of 16 million tickets makes it unlikely remaining airlines would accommodate all outstanding award tickets.
- The Federal regulation designed to compel airlines to accept tickets from failed airlines is set to expire on November 21, 2004 and does not specifically address award travel.

As members of the Star Alliance, United and US Airways, provide frequent flier award access to a global network of 15 airlines. This network of airlines, which includes Air Canada, Lufthansa, Scandinavian and Singapore, may represent the only redemption option open to frequent fliers after a shutdown of services.

Accounting for Mileage Liability

Due to the significant impact on corporate finances, U.S. based airlines now include financial information about frequent flier programs in their annual reports.

Financial estimates rely upon the incremental cost of carrying a passenger and includes items such as fuel, insurance, beverages and the administrative costs associated with issuing tickets. The incremental cost of providing an average travel award is quite low, and appears to range from $13 to $90 in a recent analysis performed by IdeaWorks of the largest 14 U.S. airlines offering frequent flier programs.

Under incremental-cost accounting methods, United recorded frequent flier award liabilities of $717 million for 2003 with an estimated 9.7 million potential award tickets outstanding. US Airways posted frequent flier award liabilities of $85 million with over 6.2 million potential award tickets outstanding in 2003. These amounts allow for mileage that is projected to remain unused or expire from member accounts.

However, the liability amounts become unwieldy if actual passenger fares are applied to the unused tickets. To the airline, $13 to $90 may be an acceptable cost for accounting purposes. However, to the customer - - the replacement cost of travel is substantially higher.

Applying a modest roundtrip fare of $250 generates “spreadsheet busting” results. United’s 9.7 million unused tickets would represent a liability exceeding $2.45 billion, with US Airways over $1.5 billion for its 6.2 million unused tickets. Added together, the combined market value of the unused award travel is nearly $4 billion.

Bankruptcy and Frequent Flier Programs

Airlines are quick to protect their frequent flier programs during the initial bankruptcy process. United and US Airways included motions to “continue customer programs” in their first-day bankruptcy filings. The airlines made the argument that redeeming awards rarely involves meaningful cash expense and describe the competitive importance of their frequent flier programs.

United and US Airways used nearly identical words in their motions, “Failure to honor the obligations of Mileage Plus will alienate United’s best and most loyal customers and thereby severely harm United’s competitive position and its reorganization efforts.”

Nowadays, frequent flier programs are virtually inseparable from their co-branded credit cards. United and US Airways vigorously argued to preserve the co-branded credit card agreements as a method to maintain an important member benefit and to ensure access to the lucrative cash payments the airlines receive from their partner banks.

US Airways noted in its first-day filings, “Likewise, the Bank of America Agreement generates significant revenues for US Airways and also promotes loyalty among a large group of US Airways’ customers.” Bank of America is the issuer of the US Airways co-branded Visa credit card.

But concern for frequent flier program members, and their outstanding mileage balances, is largely limited to airline's "ordinary course of business." Airlines entering the liquidation phase, in which operations cease and the assets are sold, are likely to demonstrate little concern for unused award tickets or unredeemed miles. The 30 largest creditor list for US Airways ranges from the $1.4 billion owed to the Brazilian aircraft manufacturer Embraer to the nearly $700,000 owed to the Metropolitan Washington Airports Authority. The top creditor lists of United and US Airways don't include mention of its frequent flier program members.

Acceptance of Award Tickets and Mileage

Airlines operating under the guidance of a bankruptcy court do make every attempt to make the experience seamless for their frequent flier program members. First-day motions approved by the court usually allow the airline to offer full frequent flier benefits to include mileage accrual and award partnerships with other airlines. Members should notice no difference when redeeming miles for award travel on the bankrupt airline or its airline partners.

Frequent flier program members are likely to experience a far different scenario if a shutdown occurs. Unused mileage will likely be rendered worthless in the event of liquidation. Competitors might poach higher earning members through special offers; they might even purchase the membership list of the failed airline.

The fate of award tickets that have been issued by the failed airline, but remain unused by the member, is less certain.

After a shutdown, other airlines are required by Section 145 of the Aviation and Transportation Security Act to carry "ticketed passengers" on a standby basis for a limited time for no more than $25 each way. But these Federal regulations have not been thoroughly tested for award travelers. The question of whether frequent flier awards qualify as "ticketed passengers" remains unanswered by Congress and the Department of Transportation. But the issue may be made entirely moot, as the regulation is set to expire on November 21, 2004.

Frequent fliers might request award travel on partner airlines as a method to preserve award benefits after a program ceases to exist due to liquidation. United and US Airways are the only U.S. based members of the Star Alliance. The major global alliances have yet to experience the shutdown of a U.S. airline member.

History may provide some answers. Ansett Australia Airlines joined the Star Alliance in 1999 as a full member. The airline entered bankruptcy on September 12, 2001 and ceased to operate on September 14. Within two weeks, the Star Alliance announced its member airlines would honor award travel for paper-printed tickets issued prior to the shutdown of the airline.

The Star Alliance also specifically clarified that unused mileage balances in the Ansett program could not be redeemed for travel on member airlines of the Star Alliance. The potential scope of award travel liability is likely to be a factor in a decision by the Star Alliance to continue the acceptance of award tickets after the shutdown of a major airline partner.

Generally, paper award tickets are more easily accepted by other airlines in the event of liquidation. US Airways and United Airlines offer the option of paper ticket issuance; additional fees may apply. Consumers should be aware that once an airline shuts down . . . so does its computer system. Possession of a paper award ticket may represent the only evidence a traveler can provide to another airline.

The safest option for frequent flier program members concerned about program viability is to redeem mileage and complete travel before a shutdown occurs. Unlike creditors - - frequent flier program members are not required to have the permission of the bankruptcy court to "cash out their miles."

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 brand development, customer service improvement, customer research, competitive analysis, creating partner marketing strategies, cost reduction programs and business restructuring. IdeaWorks brings value as a consultant by researching the expectations of the customer, learning from the wisdom of the client organization and applying innovative ideas to create solutions for clients and consumers.

Sources for the Frequent Flier Program Analysis: Unless indicated otherwise, all data is from the most recent Form 10-K filed with the SEC, and filings made with bankruptcy courts.

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