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## **Frequent Fliers Reach New Heights with More Than 15 Million Reward Trips During 2005**

*Balance sheet liability for unused miles also increases for the top frequent flier programs to a record \$3.8 billion.*

The IdeaWorks Company has analyzed the 10-K annual report filings of the largest U.S. airlines to determine frequent flier reward activity for 2005. By any measure, frequent flier programs have a large impact on the U.S. airline industry in terms of travel activity, competitive behavior, program revenues, and company balance sheets.

The airlines and frequent flier programs analyzed by IdeaWorks provided a record 15,581,000 reward tickets to their members during 2005; that's more than the number of passengers carried by JetBlue Airways<sup>1</sup> during the same period and represents 3% of the passengers carried on the airlines analyzed. These airlines also posted a record reward liability of \$3.82 billion for miles earned but unused by program members.

### **Annual Reports Form the Basis of the Analysis**

Form 10-K annual reports filed with the SEC by the following airlines were researched by IdeaWorks in the completion of this report. The "Top Nine Airlines" are listed in alphabetical order with the names of their frequent flier programs:

<b>Top Nine Airlines with Program Names</b>
<b>Alaska Airlines</b> (Mileage Plan) • <b>America West Airlines</b> (FlightFund) <b>American Airlines</b> (AAdvantage) • <b>Continental Airlines</b> (OnePass) <b>Delta Air Lines</b> (SkyMiles) • <b>Northwest Airlines</b> (WorldPerks) <b>Southwest Airlines</b> (Rapid Rewards) • <b>United Airlines</b> (Mileage Plus) <b>US Airways</b> (Dividend Miles)

The Top Nine Airlines are among the largest U.S. airlines based upon total 2005 system enplanements reported by the U.S. Department of Transportation (USDOT) and also meet the criteria of operating their own frequent flier programs.<sup>2</sup>

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The USDOT reports the Top Nine Airlines carried more than 518 million passengers during 2005 on domestic and international flights. The frequent flier programs listed in the table also serve the codeshare passengers carried by the regional and commuter affiliates of the Top Nine Airlines. The pool of customers served by these frequent flier programs jumps to 659 million passengers when the operations of their affiliated feeder and commuter airlines are included. The activity analyzed in this report captures more than 88% of the 745 million passengers that flew on all US-based airlines during 2005.

Other large carriers, such as JetBlue Airways and AirTran Airways, have relatively young programs and are not included in this analysis. Frequent flier program activity is often not significant enough to warrant inclusion in the annual reports filed by these airlines. America West and US Airways are in the process of merging, but filed separate frequent flier program information for 2005. Results for 2006 are likely to be expressed under the single US Airways Dividend Miles brand.

### **Reward Activity Increases During 2005**

Total reward activity for the Top Nine Airlines generated a record 15,581,000 free ticket redemptions during 2005 and represents an increase of 6.5% over 2004. All of the Top Nine Airlines posted increased 2005 reward activity with the exception of two carriers: American Airlines which issued the same number of rewards during 2004 and 2005, and US Airways which posted decreased reward activity.

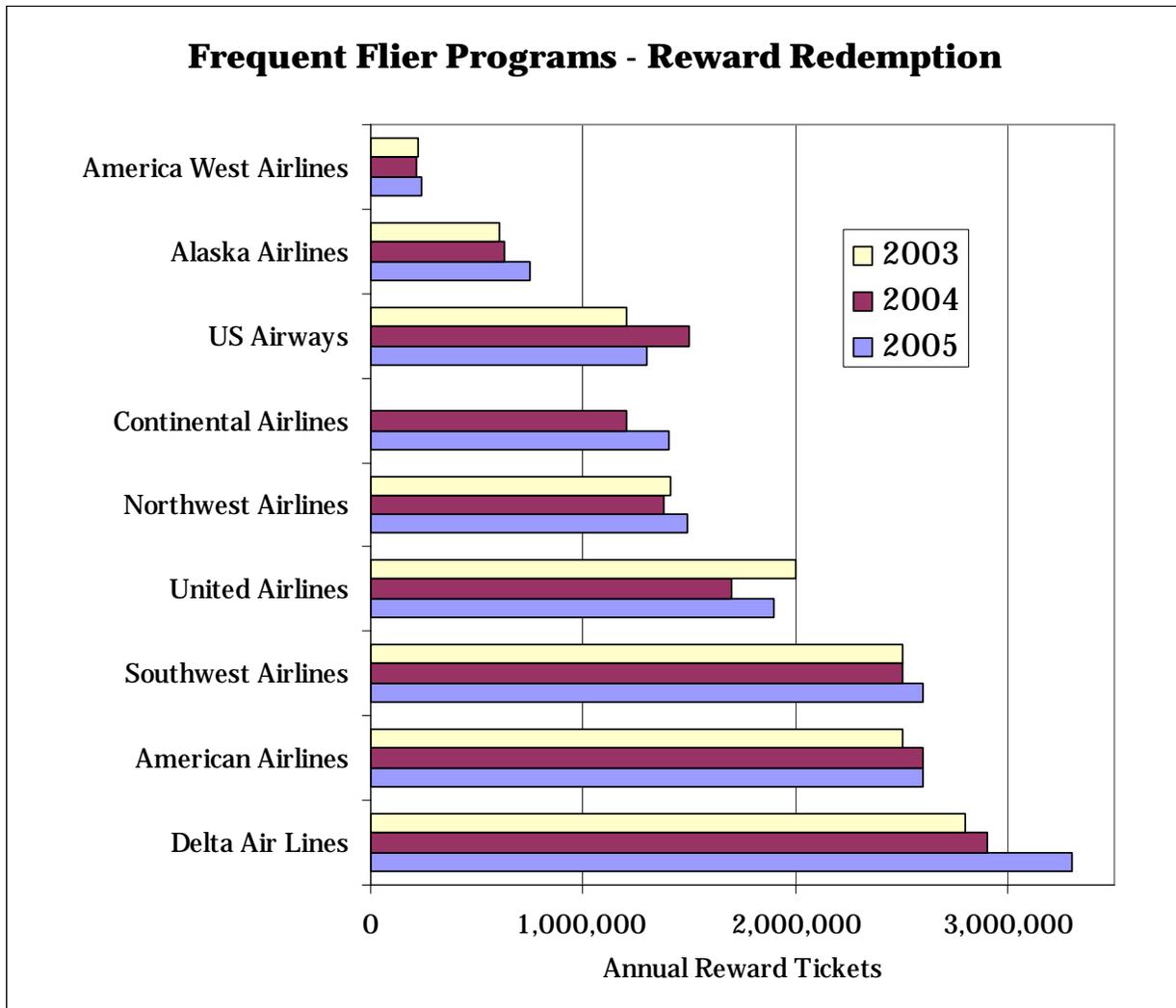
<b>Reward Ticket Redemption by Airline – 2005 and 2004</b>		
<b>Airline</b>	<b>2005</b>	<b>2004</b>
Delta Air Lines	3,300,000	2,900,000
American Airlines	2,600,000	2,600,000
Southwest Airlines	2,600,000	2,500,000
United Airlines	1,900,000	1,700,000
Northwest Airlines	1,492,000	1,380,000
Continental Airlines	1,400,000	1,200,000
US Airways	1,300,000	1,500,000
Alaska Airlines	750,000	631,000
America West Airlines	239,000	215,000

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The increased level of reward redemption for 2005 is in contrast to the drop that likely occurred during 2004. IdeaWorks estimated a drop in reward redemptions of 2.4% from 2003 to 2004. The following table lists reward activity for the prior 3 year period:

<b>Total Reward Tickets – Top Nine Airlines</b>	
2005	15,581,000
2004	14,626,000
2003	14,981,000

Reward travel on Continental for 2003 was estimated by IdeaWorks and was not included in its annual report. The need to rely upon estimates ended in 2004 when all Top Nine Airlines began listing reward redemption statistics in their annual reports.



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Delta Air Lines, and its SkyMiles program, clearly leads all other airlines in the number of reward tickets provided to its frequent flier program members. It's the third year in which Delta has led the pack; the magnitude of the gap between SkyMiles and other programs seems to have increased during 2005.

US Airways was the only program to report lower reward redemptions for 2005. This is surprising because the combined system of US Airways and US Airways Express actually grew during 2005 and 2004. For example, the number of seats available to consumers increased by 5.6% from 2003 to 2005 in terms of Available Seat Mile (ASM) growth and the combined airlines flew 4.9% more passengers from 2003 to 2005.<sup>3</sup>

Perhaps the decreased reward activity was due to the growing influence of America West's extremely effective control of free seat allocation, otherwise known as revenue management. America West reported 1.7% of its capacity (when measured as Revenue Seat Miles) was occupied by reward travelers during 2005. The other Top Nine Airlines reported far higher reward travel occupancy ranging from 7.0% to 9.1% of RSMs.

### **Reward Liability Leaps Ahead Again**

Unused miles continued their record flow onto the balance sheets of the Top Nine Airlines during 2005. While reward redemption increased by 6.5% during 2005, total reward liability increased by an even greater 13.9%. The following table lists the reward liability assigned by the airlines to their 2005 and 2004 balance sheets:

<b>Reward Liability by Airline – 2005 and 2004</b>		
<b>Airline</b>	<b>2005</b>	<b>2004</b>
American Airlines	\$1,500,000,000	\$1,400,000,000
United Airlines	\$923,000,000	\$840,000,000
Alaska Airlines	\$467,000,000	\$409,000,000
Delta Air Lines	\$291,000,000	\$211,000,000
Northwest Airlines	\$248,000,000	\$215,000,000
Continental Airlines	\$236,000,000	\$195,000,000
US Airways	\$147,000,000	\$73,000,000
America West Airlines	\$10,000,000	\$13,000,000
Southwest Airlines	Not reported	Not reported

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Subtle differences do exist from airline to airline in how liabilities are calculated. Airlines generally apply a reward liability to frequent flier accounts having balances in excess of the minimum required for a domestic reward (typically 25,000 miles). The cost per reward is nominal and represents the direct cash cost of carrying a passenger in a seat that would otherwise remain unused.

For example, Delta Air Lines and US Airways appear to apply a cost of approximately \$40 per domestic reward. Both carriers multiply the number of frequent flier accounts having more than 25,000 miles by the \$40 expense to determine their outstanding reward liability. The following table displays the total reward liability posted by the Top Nine Airlines for the last three years. Reward liabilities for Continental and America West were estimated by IdeaWorks for 2003 and are included in the total calculated for that year.

<b>Total Reward Liability – Top Nine Airlines</b>	
2005	\$3,821,800,000
2004	\$3,356,300,000
2003	\$2,874,000,000

Airlines also calculate the number of miles earned but unused by members of their frequent flier programs. Many programs have expiration dates or merely cancel the mileage balance of inactive accounts. This occurs when consumers open an account, earn a few miles, and then fail to access the account again. Members may also move to another city, or change careers, and this hampers the ability to remain active in a particular program.

Whatever the reason, the impact is the same - - an amazing quantity of accrued miles are simply deleted by the airlines every year. This “breakage” phenomena is inherent in any miles or points accumulation scheme. The airlines listed below disclosed in their 2005 annual reports the percentage of miles earned but not used:

<b>Earned Rewards Expiring Before Redemption</b>	
Alaska Airlines	12 %
Southwest Airlines	14 %
United Airlines	17.8 %
US Airways	24 %

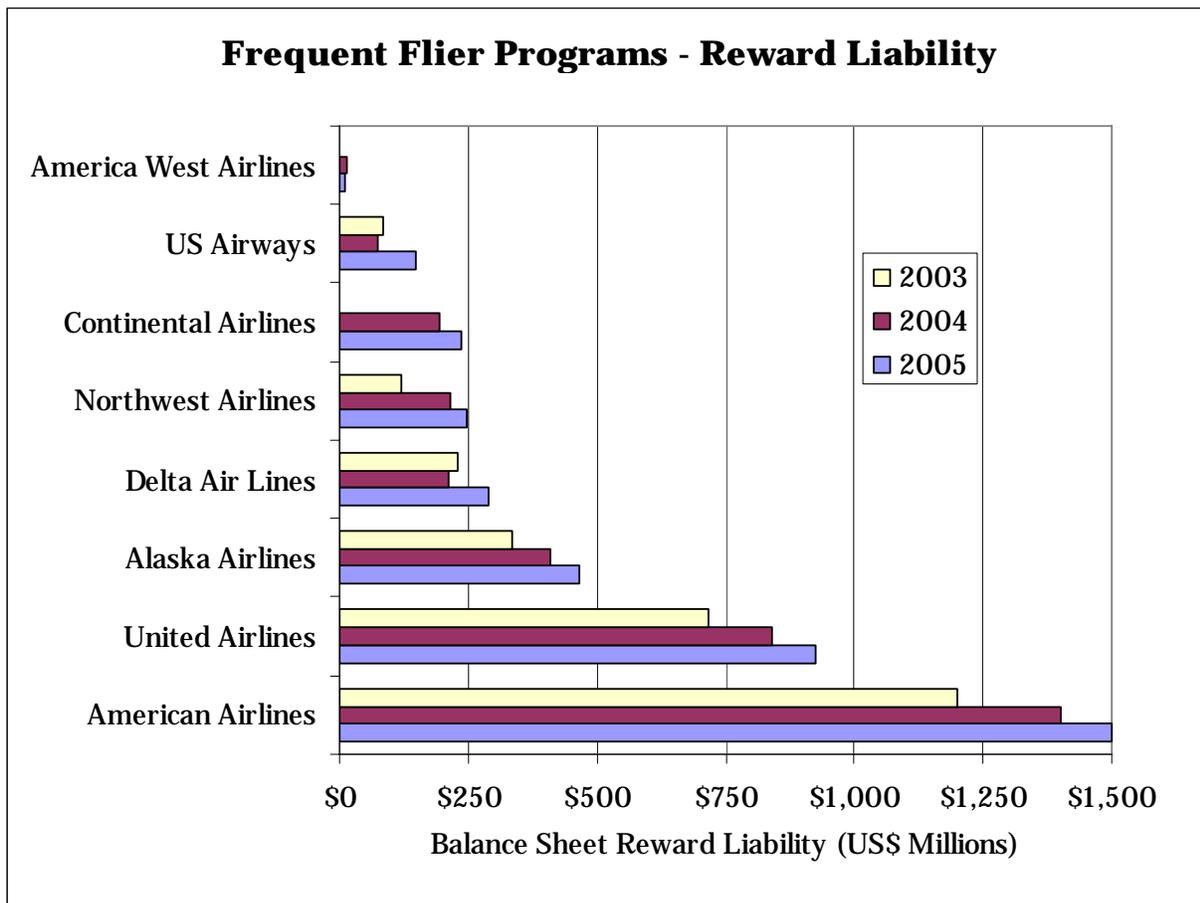
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Mileage accrual contributes to increased reward liability. During the early history of frequent flier programs, miles earned through flight activity represented the only source of accrual. The addition of bonus partners, such as hotel chains and car rental companies, only represented a small piece of the overall mileage accrual pie. The big change occurred when credit cards became frequent flier program partners; the mileage accrual linked to charge volume forever changed airline economics.

Unfortunately for consumers, most programs continue to treat reward travel as a free benefit for loyalty to the airline by placing tight controls on reward availability. Airlines now earn handsome revenues from the miles sold to bonus partners for hotel stays, car rentals and charge activity. What was once a gift has slowly morphed into a cash producing loyalty currency and a significant balance sheet liability.

The following graph displays the reward liability posted by eight of the airlines included in this analysis. It does not include Southwest Airlines, which indicates its 12-month expiration policy (which increased to 24 months during August 2005) renders its liability a non-material item to disclose on its balance sheet.



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Differences exist between these airlines in terms of size and the method used to account for reward liability. However, United Airlines and American Airlines are generally regarded as having the largest credit card programs which may explain why their reward liabilities are the largest in the industry - - and very likely the largest in the world.

### **Credit Card Relationships Create Reward Liability**

Annual report filings by the airlines sometimes include details about airline credit card programs. This is due to the manner in which the finances of airlines and the banks issuing their credit cards have become inexorably linked. For example, JP Morgan Chase Bank, the issuer of United's credit cards, extended \$1.7 billion in credit during United's bankruptcy process. Chase Bank also prepaid United for the purchase of miles which is the likely source behind the \$679 million prepayment referenced in United's 2005 annual report. United also notes its Mileage Plus unit contributed in excess of \$800 million in revenues during 2005.

If the amount paid by Chase represents a one year prepayment for bonus miles, then United is generating nearly 4% of its total airline revenues from its credit card program. Many airlines get about a penny for each mile sold to their bank partners. Using this rate generates a whopping 67.9 billion mile accrual courtesy of the relationship with Chase. At 25,000 miles each, this equals 2.7 million domestic reward tickets. That's far more than the 1.9 million reward tickets redeemed by Mileage Plus members during 2005 . . . and represents more than 26% of all reward tickets outstanding on United's balance sheet.

These statistics were largely divulged as a result of United's bankruptcy process. The same level of detail about the AAdvantage credit card program has not been provided by American Airlines in its annual report. American is often regarded as having an even larger credit card portfolio through its relationship with Citi bank. IdeaWorks believes the miles earned through these credit card relationships now exceed 60% of the total miles accrued by their frequent flier program members.

In-depth analysis of the information provided by Alaska Airlines in its 2005 annual report provides more details on the liability issue facing major airlines. Alaska ended 2005 with a total outstanding balance of 95 billion miles held by its members, which represents an increase of 9 billion miles from December 31, 2004.

Alaska Airlines also noted its Mileage Plan members redeemed 750,000 roundtrip rewards during 2005. Multiplying this amount by Alaska's standard reward level of 20,000 miles generates an outflow of 15 billion miles. Alaska also reports its Mileage Plan program generated revenues of \$180 million during 2005 from the sale of miles to bonus partners. Typically, airlines sell the majority of bonus miles to their credit card partners at an average price of a penny per mile. This would suggest Alaska's bonus partner activity contributed 18 billion miles to member accounts during 2005.

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Calculating mileage outflow and inflow leaves a balance of 6 billion miles generated by a source unnamed in Alaska's 2005 annual report. These miles were likely contributed by the very traditional source of flight activity by Mileage Plan members. These calculations by IdeaWorks suggest a huge impact on reward liability. Alaska's bonus partner activity of 18 billion miles dwarfs the 6 billion miles generated from flight activity. IdeaWorks believes more than 70% of the miles earned by Mileage Plan members are now generated by Alaska's Mileage Plan credit card.

The examples provided by United Airlines and Alaska Airlines provide ample evidence that miles sold to credit card banks and other partners are having an immense impact on frequent flier programs and their reward liability.

### **Observations and Conclusions**

The issuance of this report largely relies upon information provided by the Top Nine Airlines in their annual reports. The growing impact of global airline alliances and the addition of non-travel rewards is adding complexity to frequent flier programs. This is making the task of financial reporting more difficult for each airline. IdeaWorks has compensated for this complexity by changing its concentration to core measures such as reward activity and liability. Caution is warranted when making direct comparisons between airlines because the measurement basis used might not be the same.

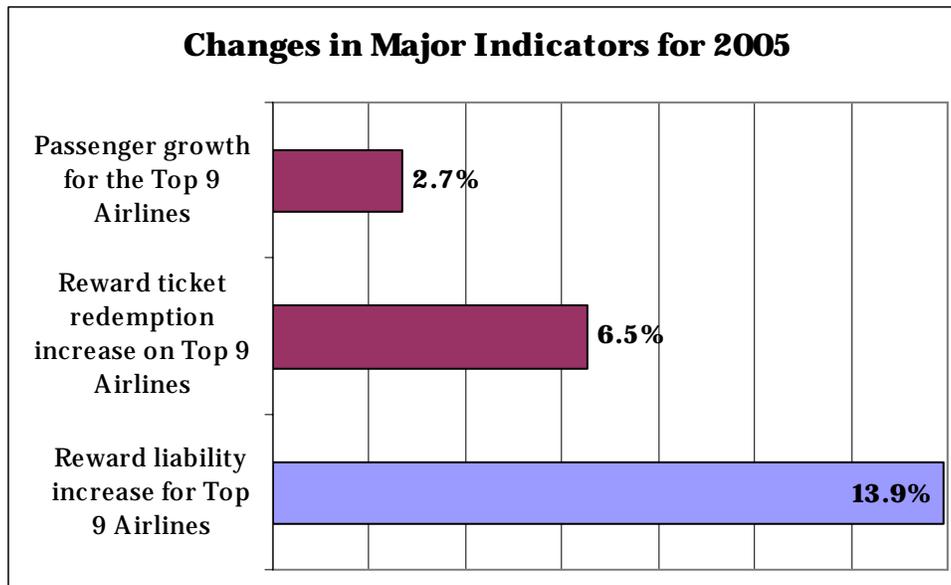
Analysis of the information does suggest frequent flier program members are earning a stunning amount of miles through credit card charge activity. These miles have cascaded onto airline balance sheets and have swelled member account balances. Concurrent with this increased mileage accrual, the airline industry entered a period of financial decline. The need for cash was never greater and the airlines can hardly be faulted for selling every available seat - - even at the expense of keeping an adequate number available for reward travelers. In this regard, 2004 may have been the low point for frequent flier program members. IdeaWorks calculated the value of a frequent flier mile dropped to a record low of 1.4 cents<sup>4</sup> and reward redemptions dropped nearly 2.4% from the prior year.

The storm clouds may have cleared a little during 2005 with reward redemptions becoming more prevalent. Members were able to claim 6.5% more reward tickets during 2005 and IdeaWorks calculated a 12.7% jump in the value of a frequent flier mile. Increased reward travel suggests it may have been easier for frequent fliers to redeem miles for free tickets during 2005. This may provide evidence the airlines are reacting to the consumer perception that reward availability has been too constrained.

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Or, 2005 may simply represent a momentary break in stormy weather for members of the major frequent flier programs. While reward travel has picked up, the number of miles entering the system continues to leap ahead at an alarming rate. The graph below demonstrates the disparity between miles exiting the system as reward redemptions and miles entering the system as reward liability.



When measured by passengers enplaned, the Top Nine Airlines grew 2.7% during 2005.<sup>5</sup> This growth, and the likely increase of frequent flier mileage accrual, can explain a portion of the 13.9% jump in reward liability. However, the 2005 reward liability is on top of an even larger increase that occurred in 2004. The scale of these increases creates a looming problem for the industry. Miles seem to be piling up faster than the airline industry can remove the accrued miles from their balance sheets.

This trend will continue until the airline industry provides additional reward opportunities or decreases the rate of mileage accrual. Decreased accrual has already occurred as customers swap their airline credit cards for alternative bank cards promising hassle-free rewards. The airlines may recover this business by making their credit cards more attractive through annual fee waivers and more bonus miles. Alternative rewards have been launched by many of the Top Nine Airlines and most notably by United with its recent introduction of its new hybrid currency called Choices.

However, the dilemma facing the Top Nine Airlines and their frequent flier programs remains. Will these changes be sufficient to alter the widely held perception that too many miles are chasing too few seats?

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**Sources and Endnotes:** Information describing frequent flier reward travel and liability is from the form 10-K reports filed by each of the Top Nine Airlines. Other information and statistics were gathered from the sources listed in the endnotes listed below:

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<sup>1</sup> U.S. Department of Transportation statistics for 2005 indicate JetBlue enplaned 14,662,026 passengers during 2005.

<sup>2</sup> U.S. Department of Transportation, Bureau of Transportation Statistics, "BTS Releases 2005 Airline System Traffic Data" April 27, 2006.

<sup>3</sup> US Airways and US Airways Express December 2005 Traffic Report. Available Seat Miles (ASMs) for 2005: 57,061,936, 2004: 56,652,283, 2003: 54,016,268. Passenger enplanements for 2005: 49,450,143, 2004: 48,656,601, 2003: 47,124,755.

<sup>4</sup> The IdeaWorks Company, "Frequent Flier Miles Gain Value But Redemption Remains a Consumer Complaint," report issued May 11, 2006.

<sup>5</sup> U.S. Department of Transportation, Bureau of Transportation Statistics, "BTS Releases 2005 Airline System Traffic Data" April 27, 2006.