

Aviation perspectives

The future of frequent flyer programs: Will you win or lose?

Volume 3



Two of the largest US airlines have announced significant changes to their frequent flyer programs (FFPs) starting in 2015. The new programs will award members with points based on how much they spend rather than the number of miles they fly. With more than

300 million

members enrolled in US airline frequent flyer programs and an estimated 7 percent of all miles flown paid for with FFP points, many passengers are being affected by the changes to how airlines award points are calculated.¹



A big question for flyers is whether they will be disadvantaged by the changes to frequent flyer programs recently implemented by two major US airlines. The short answer is yes and no: some will be worse off, others will be better off, and the majority will not notice much of an impact. People who travel on last-minute or business fares will generally do far better under the new, spend-based programs, while those who fly on advanced-purchase, reduced-fare tickets will generally earn fewer award points. Nearly 45 percent of the flying population falls into these two categories. For most other customers, the changes on average are much less dramatic, with a loss of 45 award points on a one-way trip.²

Figure 1: Characteristics of winners and losers in a spend-based program

Winners*

Premium fare passengers | Last-minute travelers
Business travelers | Short-distance travelers
Direct itineraries



Losers*

Discounted fare passengers | Advanced purchasers | Price-sensitive customers
Long-distance travelers | Layover itineraries

*The categories defined under “Winners” and “Losers” are not absolute.

Source: PwC Analysis

1 Total members, including members enrolled in multiple programs and inactive members, http://www.frequentflyerservices.com/press_room/facts_and_stats/current_membership.php;

Award passenger miles as a percent of revenue passenger miles weighted by total revenue passenger miles as reported in 2013 airline annual filings.

2 Analysis includes the 500-mile per segment minimum currently offered by one US major carrier and one non-aligned carrier. If we remove the 500-mile minimum control from our analysis, the average reduction in miles drops from -46 points per one-way trip to -24 points per one-way trip.

An overview of frequent flyer programs

FFPs emerged out of the competitive environment created by the Airline Deregulation Act of 1978. The first FFP was launched in the US two years later by a major carrier seeking to reward its best customers. Three other major carriers quickly followed suit, and before the end of the decade, all major US carriers had created FFPs to build brand loyalty and help retain their most valuable customers.

To implement FFPs, airlines needed a way to track customer value. Technology platforms at the time were unable to track customer revenue or profitability, so airlines adopted miles as a proxy for customer value and rewarded points for distance flown. There have been efforts over the past two decades to improve on this methodology, such as rewarding extra points for the most expensive fare classes and to premier members, but they have fallen short of addressing the central problem: miles fail to adequately recognize airlines' highest value customers—those who bring in the most revenue per trip. The decision to move to a spend-based FFP allows airlines to reward their highest spend customers for airfare and ancillary purchases. This kind of program is similar to retail and hospitality loyalty programs, which award points to members primarily based on how much they spend.

The impact of spend-based FFPs on passengers

To evaluate the impact of an industry-wide shift to spend-based FFPs, we looked at points awarded to passengers under two program types: miles flown (legacy model) and fares paid (emerging model).³

As we see in Figure 1, on average, nearly 40 percent of all domestic passengers benefit in a spend-based program, 15 percent break even, and 45 percent are worse off. The largest impact of program changes is at the extremes: 20 percent of passengers will gain more than 500 points on a one-way trip and 25 percent will lose more than 500 points on a one-way trip, representing a notable redistribution of award points to the airlines' higher spend customers. On average, passengers lose 45 award points on a one-way trip.

Figure 2 shows that whether one wins or loses depends on the relationship between the fare paid and the miles flown. Big winners purchase 67 percent higher than average price fares on below average distance flights. Big losers purchase below average price fares on 70 percent above average distance routes.

Figure 2: Overall impact on passengers of a spend-based program

Impact of change to spend-based	% of passengers	% difference from avg. fare	% difference from avg. miles flown	Avg. points gained/lost per one-way trip
Positively impacted by > 500 points	19%	+67%	-30%	+1,024
Positively impacted by 100–500 points	20%	-6%	-34%	+274
Breakeven: impacted by +/- 100 points*	14%	-24%	-27%	+1
Negatively impacted by 100–500 points	23%	-23%	-1%	-289
Negatively impacted by > 500 points	24%	-14%	+70%	-980
Average		-	-	-46

*Breakeven defined as +/-10% of avg. 1-way miles issued

Bar size indicates degree of impact (points gained/lost)

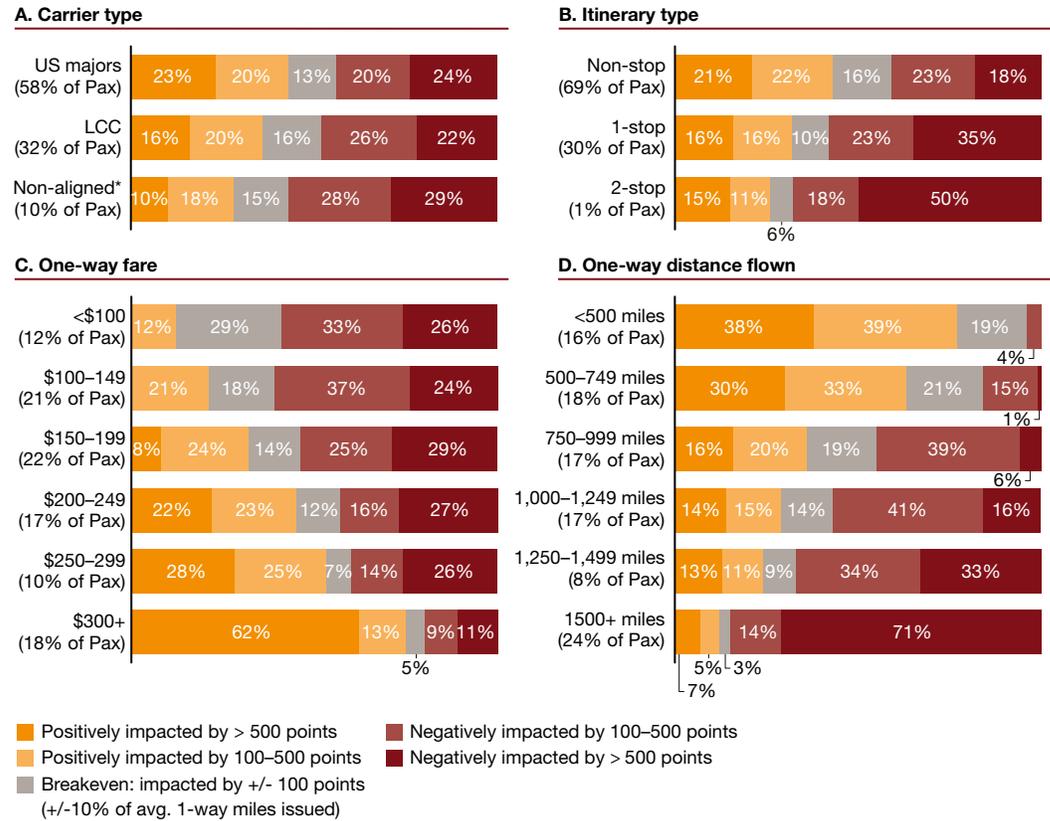
■ Positive impact ■ Negative impact

Source: PwC Analysis, BTS Airline Origin and Destination Survey (DB1B) Market Table, Q1–Q4 2013

³ Analysis for the spend-based model used a five points-per-dollar accrual rate, the accrual rate that two US major airlines published for their 2015 programs. Accrual and redemption rates are competitive levers that FFPs can use to strategically manage the value of their currencies. International and non-contiguous US travel was excluded from analysis.

Figure 3 shows that on average, passengers flying low cost carriers (LCCs), non-aligned carriers, or itineraries with multiple stops are worse off in spend-based programs than they are in miles-based programs. Passengers flying on high cost fares and passengers flying on short-distance flights are on average better off in spend-based programs.

Figure 3: Percent of passengers impacted by spend based program

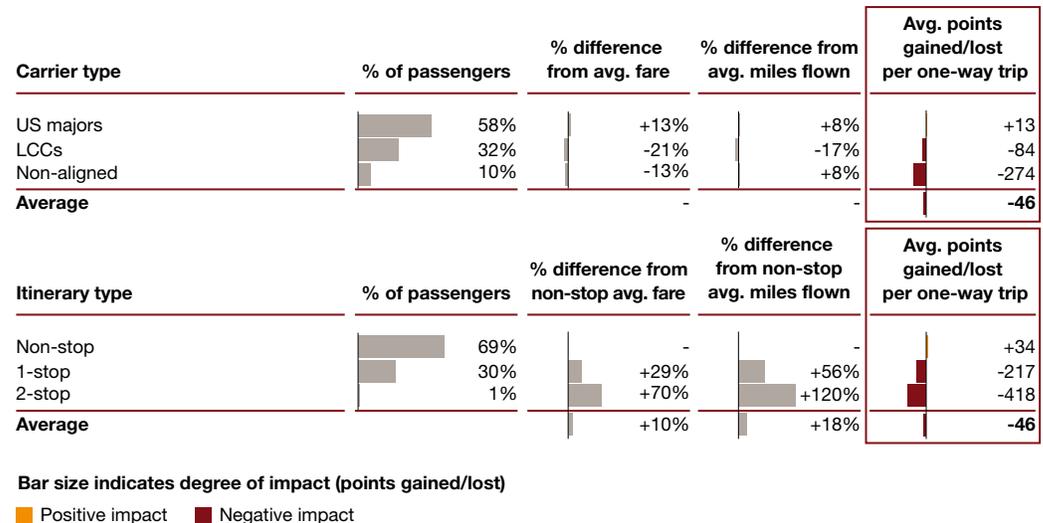


*Non-aligned carriers defined as non-LCC carriers that are not part of an alliance.

Source: PwC Analysis, BTS Airline Origin and Destination Survey (DB1B) Market Table, Q1-Q4 2013

Figure 4: The relationship between fares paid and miles flown by carrier type and itinerary type

Figure 4 illustrates the relationship between fares paid and miles flown in determining whether a passenger is better or worse off in a spend-based program. Passengers on US majors or non-stop itineraries do better because they pay higher than average fares, but only fly marginally longer distances than average. For example, passengers flying non-stop on a US major carrier on average gain 154 points per one-way trip.



Source: PwC Analysis, BTS Airline Origin and Destination Survey (DB1B) Market Table, Q1-Q4 2013

Whether any individual passenger benefits depends on a variety of factors, including carrier type flown, the number of legs flown, fare paid, and distance traveled. In order to better understand the impact of each factor, we illustrate the gains and losses for different passenger segments that are representative of each of these flying behaviors.

Segment 1

Business Bernie

(Price-insensitive, travels on mainline carriers)

Bernie tends to fly primarily on mainline carriers and for business reasons. As Bernie is a business traveler, he is less price-sensitive than leisure travelers.⁴ Bernie's purchase behavior reflects the fact that he is more concerned with getting to his meetings on time than he is with the cost of his ticket.

Bernie has been and will continue to be one of the airlines' highest spend customers. He is the big winner in a spend-based scheme. Bernie prioritizes non-stop flights on one of the major airlines, and both of these factors are to his advantage in earning FFP points. Bernie earns 155 more points per one-way trip when he flies direct on a mainline carrier. As Figure 4 shows, this is because average fares for US majors are nearly 15 percent higher than the average for all airlines.



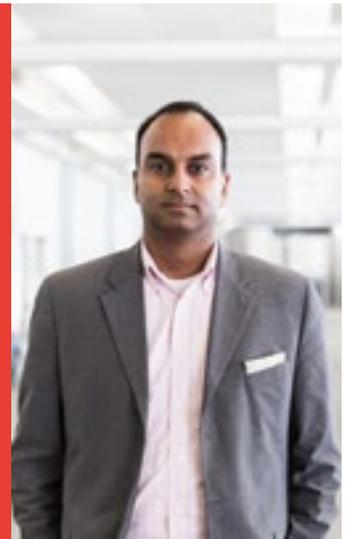
Segment 2

Commuter Carl

(Price-insensitive, short-haul traveler)

Carl lives in Boston, but has to fly to New York and Washington, DC frequently for business. His trips are almost exclusively less than 1,000 miles on a one-way trip, and sometimes he flies several times per week. Most of his flights are booked at the last-minute because he has to work around his clients' schedules. Like Bernie, he is relatively insensitive to price.

Carl earns more points under a spend-based FFP. This is because travelers flying short distances are better off than ones flying long distances, since average fare per mile flown is higher for short distance than for long distance flights, (Figure 6). This is particularly true if travelers are less price-sensitive and willing to pay higher than average fares.



⁴ All else being equal, business travelers are less price elastic than leisure travelers (Air Travel Demand: IATA Economics Briefing, Number 9, 2008, pg. 25).

Segment 3

Metropolitan Molly

(Non-stop, direct traveler)

Molly lives in New York and flies direct to most places since New York is a hub or focus city for multiple airlines. The percent of non-stop passengers that benefit from the change to spend-based (45 percent) is almost equal to the percent who are negatively affected, and non-stop passengers gain an average of 35 points per one-way trip. However, most passengers who have to make one or two stops are worse off (Figure 3 shows that 60 percent of one-stop and 70 percent of two-stop passengers are worse off by more than 100 points). As segments are added, the average distance increases by more than the average fare, which rewards layover passengers with fewer points under the spend-based scheme. However, 70 percent of all passengers fly non-stop routes and only 1 percent fly two-stop routes.



Segment 4

Value-seeking Valerie

(Price-sensitive, long-haul traveler)

Valerie is the most price-sensitive flyer and travels primarily for leisure. She plans her vacations in advance and aggressively looks for the best deal. She is willing to accept a layover in exchange for a lower fare.

Valerie is the biggest loser under a spend-based scheme. She flies longer distances on discounted fares, which will earn her fewer reward points than under legacy reward schemes. She used to accumulate a lot of points when she flew to a vacation destination on inexpensive tickets, but she can no longer accumulate the same number of points this way. Passengers flying long distance on discounted fares are much worse off in spend-based FFPs, indicating a desire by airlines to end the common practice of 'mileage runs,' which are discounted fare flights taken specifically to gain reward points.





Figure 5: Average number of points gained or lost in a spend-based program (by distance and fare)

	One-way fare paid						Average
	<\$100 (12% of Pax)	\$100-149 (21% of Pax)	\$150-199 (22% of Pax)	\$200-249 (17% of Pax)	\$250-299 (10% of Pax)	\$300+ (18% of Pax)	
<500 miles (16% of Pax)	33	258	531	752	979	1,731	437
500-749 miles (18% of Pax)	(216)	24	254	503	759	1,404	366
750-999 miles (17% of Pax)	(502)	(257)	(20)	230	481	1,145	82
1,000-1,249 miles (17% of Pax)	(703)	(463)	(234)	10	261	1,010	(21)
1,250-1,499 miles (8% of Pax)	(990)	(729)	(501)	(260)	(16)	818	(151)
1,500+ miles (24% of Pax)	(1,636)	(1,272)	(1,190)	(962)	(754)	29	(727)
Average	(285)	(282)	(266)	(112)	1	703	(46)

Figure 5 shows that the big winners in spend-based programs are passengers that pay high fares for short-distance itineraries. This model rewards their revenue contribution to the airline more fairly. The big losers are passengers who fly long-distance itineraries on low cost fares. While these passengers earn fewer award points in spend-based programs, they also contribute far less revenue to the airline per trip.

Box size indicates degree of impact (points gained/lost)

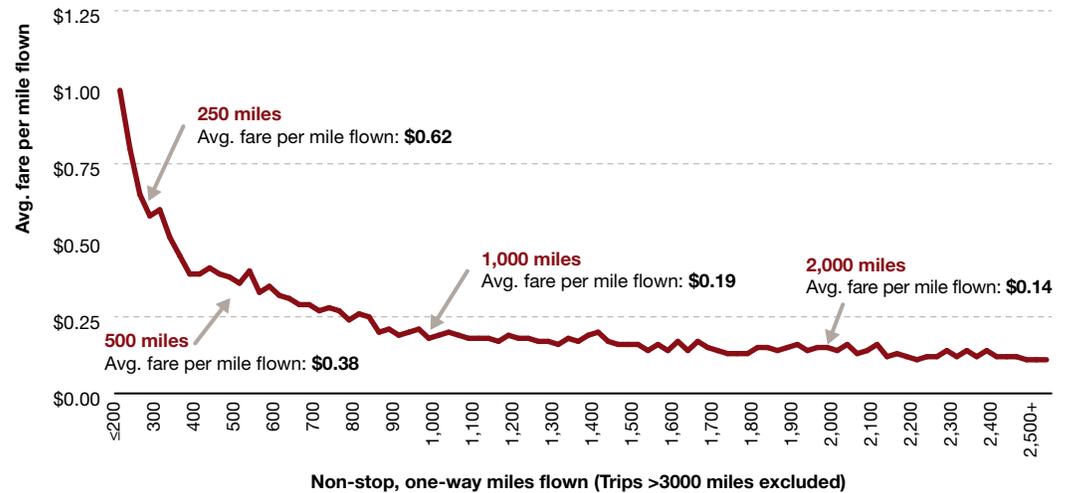
Positive impact Negative impact

Source: PwC Analysis, BTS Airline Origin and Destination Survey (DB1B) Market Table, Q1-Q4 2013

The average fare per mile is inversely related to the distance flown, so shorter flights on average will gain more points per mile flown in spend-based programs (Figure 6). For example, the average fare per mile for a 500-mile, one-way itinerary is double that of a 1,000-mile itinerary. In other words, a spend-based program awards on average twice as many points per mile flown on a 500-mile flight as on a 1,000-mile flight because average fares are comparable.

Note: Figure 6 is based on non-stop itineraries and does not include 500-mile minimums in order to isolate the relationship between miles flown and fares paid.

Figure 6: Average fare per mile flown



Source: PwC Analysis, BTS Airline Origin and Destination Survey (DB1B) Market Table, Q1–Q4 2013

What's next for frequent flyer programs?

Worldwide, as of 2013, almost 10 trillion frequent flyer points have been earned but not yet redeemed.⁵ At a value of one cent per point,⁶ the balance sheet liability for airlines is almost \$100 billion. As this liability continues to grow with the expansion of FFP partnerships, and as planes fly with fewer vacant seats as a result of improved load factors, it is increasingly difficult for customers to redeem points for airline tickets.⁷ Faced with looming liabilities, FFPs may be forced to devalue their currencies or adjust their redemption propositions to avoid carrying this liability on their balance sheets.

The impact of dynamic redemption

Several airlines have made changes to the availability of award seats in order to combat availability constraints. While most airlines are continuing to offer fixed awards, some are increasing the number of award levels. However the added complexity and other commercial considerations are driving a trend of eliminating one size fits all “alliance” wide award/redemption charts. On the other hand, many low cost carriers with spend-based FFPs also have fare-based (‘dynamic’) redemption with awards tied to ticket costs. Under dynamic redemption, each point has a calculated value associated with a redemption product. A customer might redeem 15,000 points for a \$300 fare; if the fare increases to \$350, the redemption price jumps to 17,500 points. A shift to dynamic redemption models could see the elimination of award charts all together.

5 WSJ, The Road to Redemption: Which Airlines Are Generous With Frequent-Flier Award Seats and Which Aren't, May 2010; Colloquy, Fare Game: What Marketers Can Learn from Frequent Flyer Program Changes.

6 One penny per point is a commonly accepted generalization of loyalty currency value.

7 WSJ, The Road to Redemption: Which Airlines Are Generous With Frequent-Flier Award Seats and Which Aren't, May 2010

The challenge of ‘miles chasing seats’

A dynamic redemption model could resolve the problem of ‘miles chasing seats.’ However, a central problem with moving to a dynamic redemption model is that it reduces ‘reward aspiration’—the idea that one can accumulate points to cash them in for an expensive flight to a vacation spot far from home that one might not have been able to purchase with cash. For many, it is this potential to maximize the value of award points beyond their perceived cash value that motivates their flying behavior and willingness to spend on accrual flights. For the airlines, award charts remain a relatively inexpensive and proven way to maintain the ‘game’ aspect that drives participation in customer loyalty programs. A long-term impact of ‘dynamic redemption’ may be a shift in FFP member behavior. Rather than seeking aspirational moments, members would see FFP points as a cash equivalent and use the points more frequently to offset personal air travel costs.

New revenue recognition standards

The new revenue recognition standard, ASU 2014-09, Revenue from Contracts with Customers (Topic 606), issued in May 2014 is effective for annual reporting periods beginning after December 15, 2016. This new standard is placing greater importance on effective liability management.⁸ Historically, the “incremental cost” method of FFP accounting was permissible, and this method considered FFP points to be marketing incentives. However, the new standard treats points as goods and services (i.e., a separate element) for which the consumer pays, requiring the FFP to defer the portion of the airfare transaction revenue that represents the FFP points’ fair value until the points are redeemed. The fair value of the points will be greater than the incremental costs of the award travel, and the associated deferred revenue will begin to have a more material impact on financial statements potentially creating incentives for FFPs to expand the diversity of award redemption options or increase the number of points required to redeem a reward in order to accelerate revenue recognition.

‘Everyday’ accrual and redemption opportunities

As FFPs face capacity and regulatory pressures to devalue currencies, they must also compete for “share of mind” in a crowded loyalty environment. In order to increase relevance and compete with credit card loyalty programs, FFPs have begun shifting focus from traditional, travel-based redemption products to products such as shopping and dining options. One carrier recently launched the option for members to redeem miles for food and beverages in one of their hub airports. Several have launched new ways to accrue points at local merchants. ‘Everyday’ or ‘local’ options offer opportunities to use reward points outside of travel and could help to reduce growing liability balances, while also increasing the relevance of FFPs. These new options to earn and use miles for non-travel related awards are likely to increase over the next few years.

⁸ PwC, In Depth: A look at current financial reporting issues, June 2014 (revised September 2014)

Conclusion

The move from a miles-based FFP to a spend-based program permits airlines to more closely align awards with their highest value customers—those who contribute the most revenue per trip—by redistributing benefits from price-sensitive passengers to premium fare-paying passengers. Additionally, the move to revenue-based accrual allows airlines to expand their FFP to include all airline-related purchases, such as ancillaries. The actual impact on any individual customer depends on travel behavior, including carrier, trip segments, trip distance, and fare price.

From an airline’s perspective, the move to a spend-based model is a way to improve financial results while instilling fairness for its higher-spend customers. The premise of rewarding one’s best customers has worked well for other loyalty programs in the hospitality and retail industries. However, it is a change from the way the major US carriers have operated in the past and may diminish the allure of FFPs to budget and leisure flyers. While many major US-based carriers may follow suit, others may decide that the spend-based model is not a good fit with their business, network, and customer strategies. In fact, a miles-based FFP may prove a competitive advantage and attract passengers who stand to lose under a spend-based model.

Airline FFPs may continue to differentiate through dynamic redemption models. While dynamic redemption models can help reduce award liability, they also reduce award aspiration for members that hope to redeem points for a ‘good deal.’ As a result, airlines will need to balance potential financial benefits against the possible erosion of loyalty—and consequent loss of business—from price-sensitive travelers. And, as with all important passenger-facing decisions, airlines considering a change to their frequent flyer programs must ensure alignment between those planned changes and their long-term business and customer strategies.

Methodology

Our analysis focuses on mainland US domestic travel on the 11 largest US airlines.⁹ This group represents 98 percent of passengers carried by US-based airlines on domestic routes, a significant majority of the public potentially affected by FFP changes. We excluded international flights because they increase the variability between network carriers with extensive global networks and small carriers and LCCs that have much smaller or non-existent global routes.

Carriers were grouped into categories by their network and alliance characteristics into US majors, LCCs, and non-aligned carriers (carriers not affiliated with an alliance). To maintain consistency across carriers, we applied the same methodology regardless of current program types. We assumed an accrual rate of 5 points per dollar to be consistent with the rates that the two US major carriers published for their 2015 programs. Accrual and redemption rates are competitive levers that FFPs can use to increase or decrease currency value to customers.

Premier bonuses were excluded from analysis because there is significant variation in the way premiers are treated by airlines. We included the 500-mile per segment minimums currently offered by one US major carrier and one non-aligned carrier, but we did not include 500-mile per segment minimums that pertain only to premier passengers for other US carriers. Five hundred mile minimum policies guarantee that passengers earn at least 500 miles per segment.

9 Dataset: BTS Airline Origin and Destination Survey (DB1B) Market Table, Q1-Q4 2013; fares exclude taxes and fees. The Airline Origin and Destination Survey is a 10 percent sample of airline tickets from reporting carriers collected by the Office of Airline Information of the Bureau of Transportation Statistics. Contiguous domestic one-way itineraries with three or fewer segments were included. One-way fares below \$10 (7.2 percent), above \$1,000 (0.4 percent), and where distance data was unavailable (0.2 percent) were excluded.

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