FLYING TIMES FOR AIRLINE FREQUENT FLYER PROGRAMS (FFPS)

- Rakesh Tripathi, Nikhil Gupta, Subhajit Mazumder

Abstract

Frequent flyer programs are increasingly becoming a lucrative source of ancillary revenue as well as creating a competitive advantage for their parent airlines worldwide and particularly in emerging economies' aviation markets. FFPs enable airlines to enhance customer loyalty and generate higher footfalls in flights. FFPs serve as a powerful marketing tool for airlines and must be viewed as a strong medium to profitably engage customers. FFPs are a major cash generator for carriers, big and small, through the sale of miles to banks, credit cards, and other program partners (hotels, cabs, restaurants, etc.).

There are quite a few examples of successful FFPs, like AIMIA (Aeroplan, Canada), Multiplus (Brazil) and Qantas (Australia) which have brought revenue and good fortune for their respective parent airlines. The largest and well established US FFPs, such as those of American, Delta, and United Airlines, generate more than $1 billion annually.

This point of view synthesizes our learning and experience acquired during our engagements with leading FFP programs for airlines globally and in emerging markets, to design a business model, with the focus on program structure (majorly accrual structure) and methodologies on how to account the financial liability arising from it. This will certainly help airlines in launching, reinvigorating, and bolstering their frequent flyer programs.

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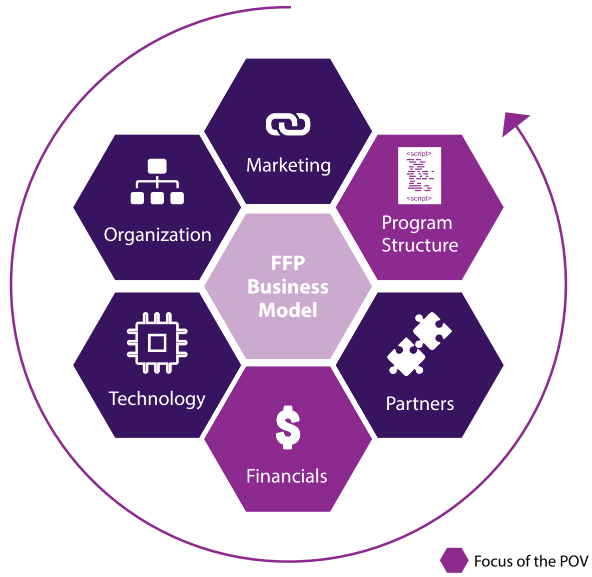
A world class FFP focusses on each and every aspect of customer experience across multiple touchpoints and aligns it with its strategy and business model. In order to achieve this objective, FFPs need to focus on each and every business function which may have an on customer experience. **Two of the most important among them are Program Structure and Financials.**

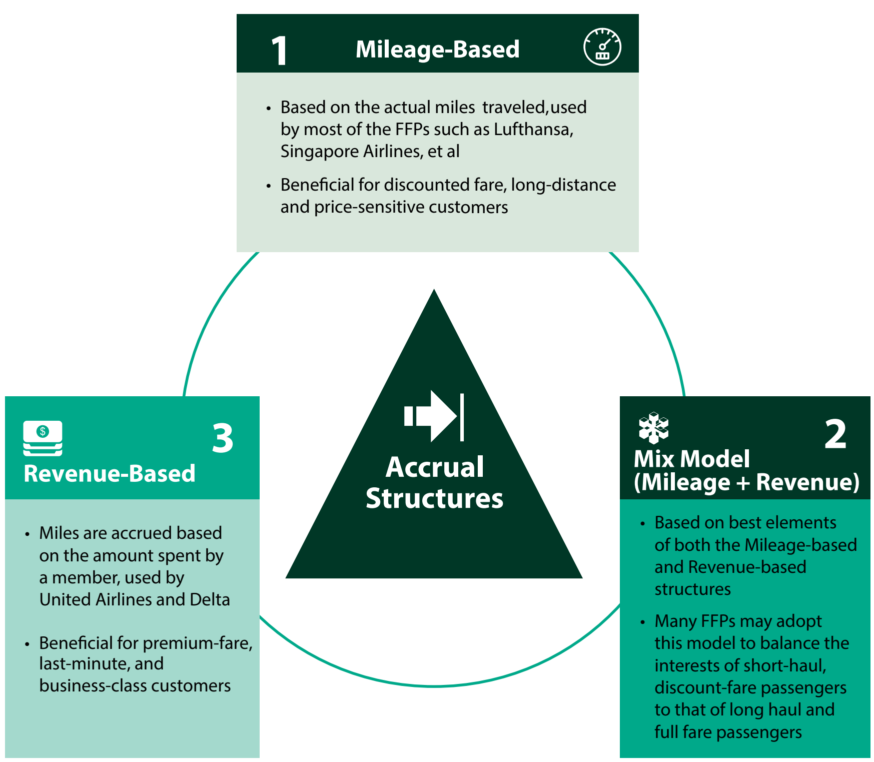
A right program structure (accruals, tiers, earn-burn ratios) can greatly affect the performance of an FFP. Similarly, while making changes in accrual structure, financial liabilities should also be kept in mind so that the liabilities are under control and are properly accounted.



Reference Framework for a world class FFP

Designing the right Program Structure

Defining the right accrual structure in itself is a very complex activity which can make or mar an FFP. Generous earning of miles helps in attracting the members by awarding higher miles than the competition. However, on the flip side, it also creates a higher liability for the airline. **The two accrual structures, mileage-based, used by leading airlines such as Lufthansa, Singapore, American Airlines, etc. and revenue-based, used by United and Delta, and are predominant**. Mix or hybrid is one of the new models which may also emerge during the course of time. A high-level comparison of the salient features of both the programs are done so that it enables airlines in taking a specific direction towards their goal of implementing the right accrual structure.



Salient Parameters	Mileage-Based	Revenue-Based
Basis of accrual	Miles flown Actual miles flown (Say, for a distance of 100 miles, a $200 & $2000 ticket will **earn the same miles** provided rest of the factors are same, i.e., class, cabin, tier, etc.) ↓	Fare / spend, price of the tickets Fare paid (Say, for a distance of 100 miles, a $200 & $2000 ticket will earn **different miles ($2000 will earn more)** provided rest of the factors are same, i.e., class, cabin, tier, etc.) ↑
Suitable for airlines	Low cost / no frills, discounted airlines, mostly running on short / medium haul routes (Room for price differentiation is less) →	Full service airlines, running on long-haul routes, national & international (Room for price differentiation is much more, economy-to-business-to-first class) →
Target audience (Profile of customers)	Non-elite, leisure, discounted fare, price-sensitive, advance purchasers, and long-distance travelers ↓	Elite, business / first-class, company-sponsored / premium-fare, short-distance, and business travelers ↑
Complexity of implementation	Easy to implement ↑	Complex to implement (Due to factors such as multiple price points in the same cabin / class, tiers, compatibility of conversion with program partners, etc.) ↓
Cost-saving opportunities	Mostly all customers are treated as equal, marketing spend is more as it has limited customer-profiling differentiated treatment based on value of a customer ↓	Not all customers are treated equal, differentiated treatment and targeted benefits to high value customers, so marketing spend is less ↑
Ability of members to earn awards ($ spent/mile)	Less-to-moderately expensive ↑	Moderately-to-highly expensive ↓
Achievement of elite tier	Slow-to-moderate ↓	Moderate-to-fast ↑
Availability of award seats	Lower (Members chasing the award seats are more) ↓	Higher (Members chasing the award seats are low due to differentiation in miles awarded to members based on price) ↑

↑ Upside → Neutral ↓ Downside

Case in point

- Two major US airlines, United and Delta, have announced a shift from miles-based reward programs to fare-based reward programs
- As per Hopper's analysis, on an average, United flyers will benefit on 60% of routes under the new program while for Delta's SkyMiles policy changes will result in 56% of routes earning more miles
- The members who will be the biggest losers are those who mainly earn miles through discount flights and biggest winners will be those who are company-sponsored / premium-fare travelers
- Both programs have a maximum amount of miles that a frequent flyer will earn on a single itinerary

In revenue-based programs, due to dynamic pricing of the tickets based on the demand, the prices at which a ticket is bought may vary for a certain cabin / class. This makes earning of miles very dynamic and members may end up earning different miles in the same class.

Hypothetical scenario to calculate the accrual of miles for mileage- and revenue-based program

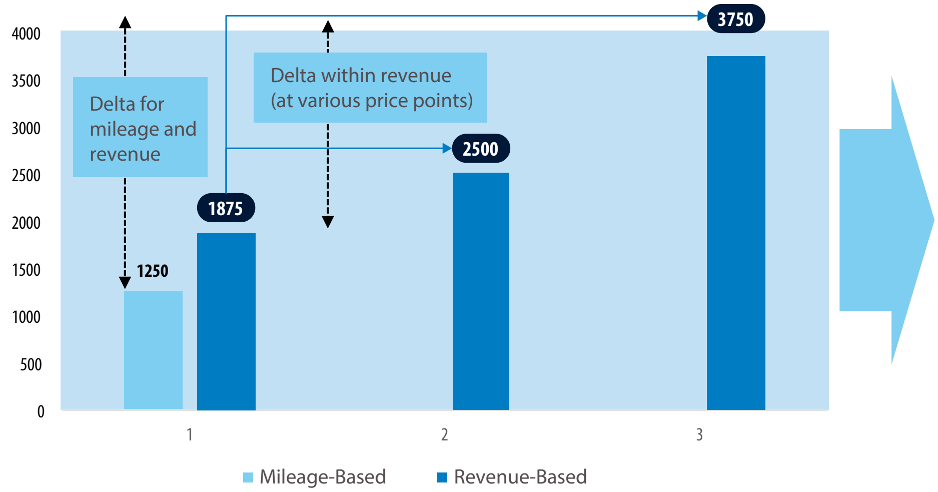
To further illustrate this point, following is a hypothetical scenario built to compare the earning of miles for a typical mileage- and revenue-based accrual structure. All the data points are assumed and are used only for illustrative purpose.

A typical scenario: Calculation of earnings for Mileage- and Revenue-based program

Cabin	Class	% of Miles	Miles to destination	Miles Earned (Based on Mileage) A	Typical Prie (Tickets bought at various prie points)	Miles Earned (Based on revenue / price)	% Change (B-A)
Economy	A, B, C, D (only for illustration)	125%	1000	1250	1500 (1)	1875	50%
					2000 (2)	2500	100%
					3000 (3)	3750	200%

(1) Hypothetical Scenarios

A typical comparison of scenarios for Mileage- and Revenue-based FFP



1. The adjacent figure (based on a hypothetical scenario) shows whether one gains or loses in earning miles depending on the Accrual Structure which considers fare paid and the miles flown for calculating the miles.
2. FFPs should make a fine balance and strategize before adopting a particular accrual structure.
3. This largely depends on the customer profile, routes (short & long haul) and typical fares.

There is also an emerging model for the FFPs who are not comfortable with either mileage-based or revenue-based accrual structures. Though it has complex implementation challenges, the mix or hybrid model has the best of both worlds.

It can cater to both, price-sensitive, advance-purchase customers as well as premium-fare and business-class travelers.

FFPs can follow a mix accrual structure with certain cabin-class combinations offered for mileage or spend-based accrual. This is done based on the customer profile, mix of short-haul and long-haul routes as well as distribution of cabins and classes depending on the airline. Following is a sample snapshot:

Mix Model Accrual Structure (Illustrative)	
Revenue-Based Accruals*	**Mileage-Based Accruals***
Cabin - First Classes - A1, A2	Cabin - First Classes - NA
Cabin - Business Classes - B1, B2	Cabin - Business (Discounted, Promotional Fares) Classes - B3
Cabin - Economy Classes - E1, E2 (Premium Economy)	Cabin - Economy Classes - E3, E4 (Discounted Economy, Promotional Fares)

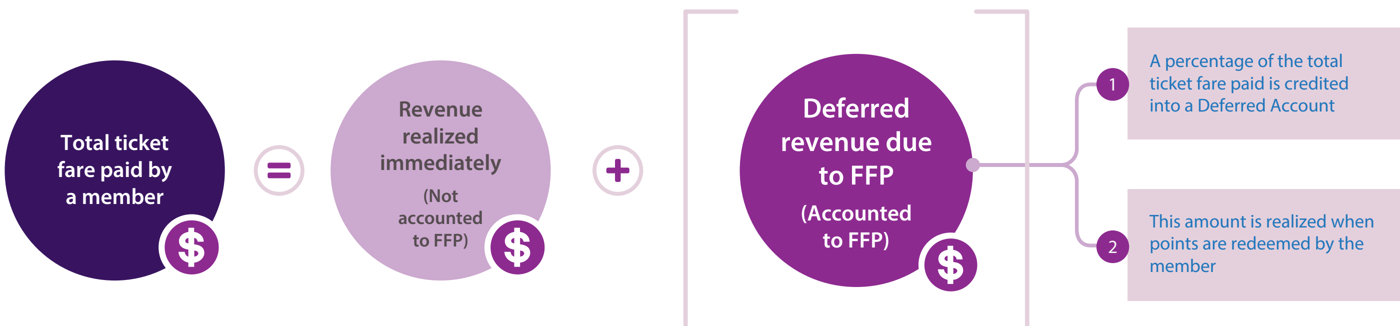
**All the details are only for illustration purpose*

Summary

The shift of FFPs from a mileage-based accrual structure to a revenue-based structure **allows FFPs to reward their most revenue-generating customers—though they may not be their most loyal customers, by skewing the benefits towards premium-paying customers rather than price-sensitive ones.** This may also alienate the value and leisure customers who might gravitate towards airlines having a mileage-based program. Hence, it is a very strategic decision for airlines to adopt a particular accrual structure based on their long-term business plans and growth strategy.

Financials:

The most prevalent method among the airlines is **incremental cost method** where all the additional per-person charges that are incurred by the airline such as food, third party insurance, etc., are taken into consideration to calculate the costs associated with the FFP. This method considers FFP as a cost center. The other method, **which is recommended by IFRS and is followed by leading programs globally is Deferred Revenue Method.** In this system of accounting, revenue recognition is linked to the redemption of miles / points and is directly attributable to the revenue generated by FFP.



A high-level summary of both the approaches are discussed below

FINANCIALS

1. Incremental Cost Method

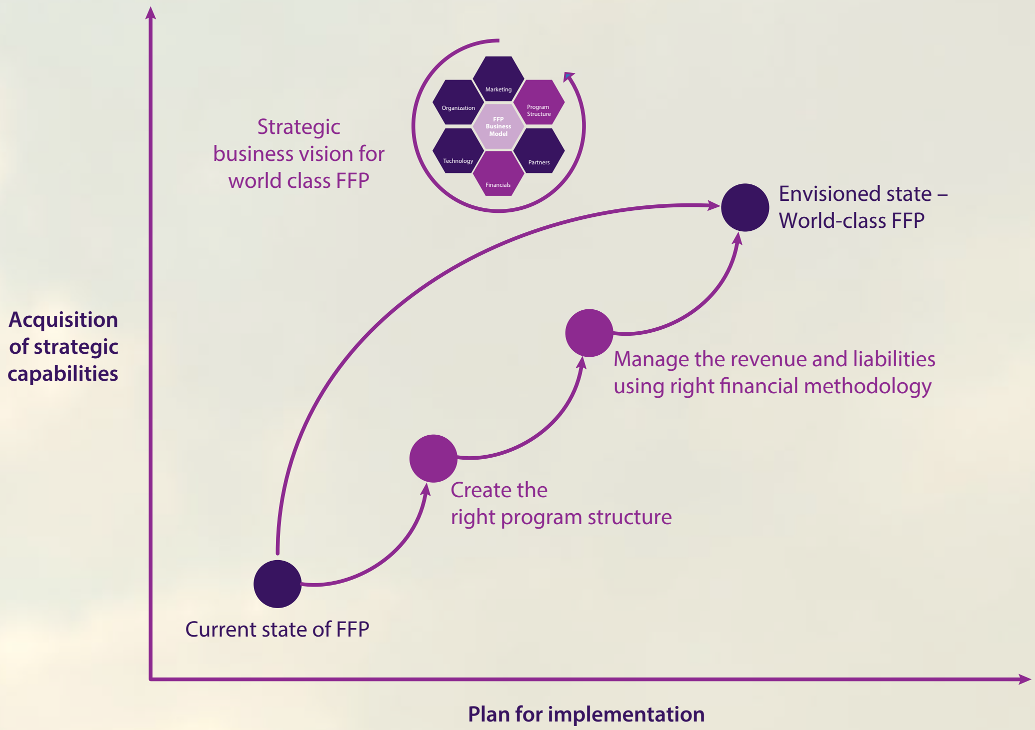
- Treats FFP as cost center — N (Negative)
- Revenue is realized immediately based on additional cost incurred — N (Negative)
- Transfer Pricing is used between airlines and FFP to book revenues — N (Neutral)

2. Deferred Revenue Method

- Treats FFP as profit center — P (Positive)
- Revenue is deferred till redemption of loyalty points (linked to ticket fare, value of mile & redemption rates) — P (Positive)
- Recommended by IFRS (Adopted by multiple FFPs) — P (Positive)

P Positive | N Neutral | N Negative

The FFPs just need to take the first steps in designing the program structure and resulting financial methodologies for accounting the liabilities to reach closer to their strategic vision of a world-class FFP and achieve the envisioned state. This will enable them to create a best in class program, and as mentioned earlier, create a major competitive advantage for their respective airline.



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