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30 years of frequent flyer programs

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ABSTRACT

Since American Airlines launched the first frequent flyer program in the US on May 1, 1981, the programs have ballooned in size leading to skepticism around the airlines' ability to manage both liabilities and members' satisfaction. Over time program changes have addressed a number of idiosyncrasies in the original model by aligning customer value better to rewards offered. More appropriate earn and reward structures were developed and clearer reporting standards introduced. In this article we review how the programs evolved over the last 30 years and introduce three typologies of frequent flyer programs: legacy programs, advanced programs and autonomous next generation programs. The article concludes that airlines operating autonomous next generation programs are more likely to run a frequent flyer program that is sustainable and transparent, resulting in increased profitability.

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1. Introduction

In 2011, American Airlines celebrated the 30th anniversary of its AAdvantage program, and they are not alone. Delta Air Lines, United Airlines and others have programs of similar age. Over the last 30 years, these and other programs have witnessed a significant development. Fig. 1 outlines some of the most important milestones in the evolution of the frequent flyer programs (FFP) we will follow in the article. The history of FFP programs, considered to have started with the AAdvantage program, has been characterized by a series of inventions that improved airline's revenue streams, reduced customer switching tendencies, improved the effectiveness of direct marketing campaigns and increased customer recognition. Over time the programs have gone from inward looking cost-focused departments to widely open, interlinked value-generating enterprises. In Fig. 1, we can see the 30 year history unfold: FFP affinity credit cards, FFP alliances among airlines, FFP alliances with other industries, and finally FFP initial public offerings (IPO). There have also been periods of uncertainty involving ethical issues, mileage liabilities and the taxing of benefits. The programs remain important to airlines today but have little resemblance to what they were 30 years ago.

Here we identify how programs have developed over the last 30 years. We ask, what were the characteristics of these changes? What drove them? A priori, we identified three typology stages of FFP development that also define the structure of our article: legacy programs, advanced programs and autonomous next generation programs. For the analysis, we made use of a combination of sources. In addition to reviewing the existing academic literature, we have relied on white papers, research notes and presentations produced by industry stakeholders including the airlines, experienced consultants and analysts – all key informants on the 30 year history of FFPs.

2. Phase 1: the early years – start of the legacy programs

The deregulation of the domestic US air transport passenger market in 1978 and the commercialization of flight reservation systems removed both technical and legal constraints and enabled American Airlines (AA) and its peers to launch FFPs.[1] The original idea, to reward AA's best customers, came in 1978 from someone outside the industry, namely Bill Bernbach, CEO of Doyle Dane Bernbach, an advertising agency for American Airlines (Petersen, 2001).[2] The concept of the legacy program was simple: reward high-frequency customers by giving them a free ticket after they reach a certain threshold of travel. Because the marginal value of

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[1] Deregulation began in 1977 with the US air freight industry, followed by the passenger markets in 1978.

[2] The idea to offer rebates to customers was by no means entirely new as such programs existed in other industries in various forms. In the US copper tokens were introduced as early as 1793 to trade for store items. In 1891 trading stamps were introduced (Blue Stamp Trading System) to be redeemed for rewards, and a similar system in the UK and Ireland in 1958 (Green Shield Stamps).

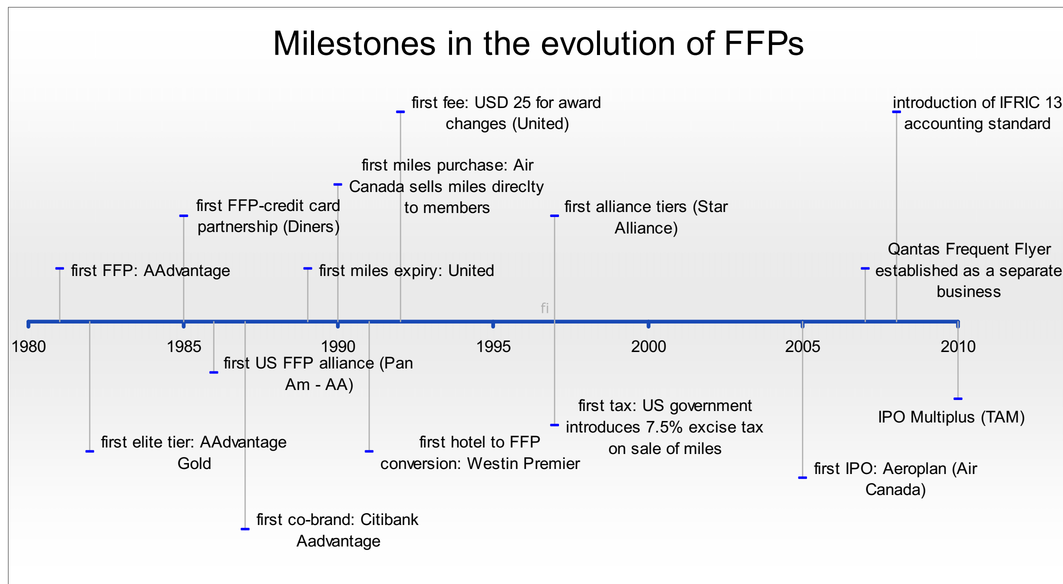

Fig. 1. Milestones in the evolution of FFPs.

FFP miles increases as the member gets closer to the threshold, FFPs give consumers an incentive to concentrate all of their flying within a single carrier (Lederman, 2007).

By the time the program launched, Bernbach's original idea of offering a "loyalty fare" (discount) as a reward, had evolved into a first class ticket to Hawaii with a companion upgrade certificate (Petersen, 2001). The early programs shared a number of characteristics: they offered incentives based on miles[3] flown or sectors, for example Southwest's Company Club launched in 1987 was based on total trips flown, and were managed by teams in the airline's sales and marketing departments. Efforts to identify and track the airline's best customers were not new. Many airlines were already running different forms of clubs to recognize and reward their best customers, including United's Executive Air Travel program and American Airlines' American Traveler. Deciding which seats were available for redemption was done by the revenue management department, typically through a fixed allocation of seats based on the type of aircraft in combination with black-out periods[4] done in an effort to minimize two of the three main cost factors associated with award travel: dilution and displacement. Dilution occurs when an award passenger travels on an award ticket and, as result, foregoes purchasing a commercial ticket. Displacement, on the other hand, refers to a situation whereby an award passenger's seat on a plane could have been sold to a fare-paying passenger. The third cost element of award travel is the variable cost (marginal cost) related to transporting an additional passenger such as the cost of fuel, catering, ground services and reservations systems. Minimizing the dilution and displacement cost allowed the airlines to control the cost of award travel to a low level, and reduced the outstanding liability by valuing it using the marginal cost approach. The resulting low valuation on the balance sheet enhanced the attractiveness of selling miles to business partners at rates that far exceeded their marginal cost.

The next step in the development occurred in June of 1982, when American Airlines introduced the Gold tier to its program. Ever since, airlines have followed suit and offered special membership tiers to recognize high-value or high-frequency customers, commonly referred to as elite programs. Once a member becomes used to the rich benefits offered, it becomes far less attractive for him or her to defect to a competitor, unless enrolled as a new member at a higher tier (called elite-matching) a practice used to overcome these artificial barriers to exit. Legacy programs typically used frequency and/or distance traveled, often adjusted for cabin or inventory class, as a yardstick for qualification in the higher tiers of the program.

Also in 1982, American Airlines teamed up with Hertz and Holland America Cruises to offer joint marketing programs. With the increasing proliferation of programs, airlines realized that the miles could, in fact, be marketed to partners in an effort to generate external revenues. Legacy programs initially focused on travel-related partners such as hotels, cruises and car rental companies. In determining how much to sell a mile for, airlines used the equivalent commercial value of an award ticket as a base rather than the internal incremental cost, helping to explain why selling miles to partners was so lucrative for airlines. Given that the average selling price of a mile is between 1 and 3 cents per mile (Stellin, 2008), and the direct cost of a traditional 25,000 mile award ticket (including food, beverage, fuel, reservations processing, liability insurance, and other miscellaneous expenses) is less than $15 (Nunes and Dreze, 2006), it is easy to see how lucrative the business of selling miles has been for the airlines.

2.1. The introduction of co-branded credit cards

In 1987, co-brand or affinity credit cards were first introduced by American Airlines with the Citibank AAdvantage card, turning out to be the most important commercial development in the history of the programs. Under the co-brand credit card scheme, the member earns miles for eligible spend on a co-branded credit card (co-branding refers to the fact that the card typically carries the brand of the airline or FFP in addition to the credit card or bank brand).

Airlines realized that the co-branded credit card partners would deliver significant revenue streams given the reach in terms of customers and eligible spend. Sorensen (2008) estimated that frequent flyer credit cards generated more than $4 billion in

[3] Airlines use different loyalty currencies including points, kilometers and miles. For the remainder of the paper, we will use miles.

[4] Black-outs refer to time periods or flights during which no seats were made available for redemption to reduce displacement of paying passengers.

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