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Does the reward match the effort for loyalty program members?

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ABSTRACT

Many loyalty programs (LPs) are structured so that members accrue points, and these points have effectively become a currency, with a dollar-value. Multiplying the points dollar-value by the number of points required to redeem a catalog reward item gives the "points price." Our primary objective is to compare a points price with a corresponding market price to see if LP members are being fairly rewarded for their points-earning effort. To achieve this, we examine almost 7000 catalog items for six LPs spread over three countries and find that, on average, the points price is higher than the market price, which is not good for the viability of LPs. We subsequently undertake a survey of members from the Fly Buys LP to see how much they care about points prices exceeding market prices. We find that if the points price exceeds the market price by as little as 10% then more than half the LP members are somewhat or very annoyed, many to the extent of wanting to quit the LP.

1. Introduction

Loyalty programs (LPs) are now widespread across airlines, retailers, hotels, car rental companies and credit card firms, to the point where the average US household now belongs to 12 LPs (Wagner et al., 2009). Despite the high uptake of LPs, there is growing evidence that some consumers are becoming disenchanted with the reward they receive for their effort in earning loyalty points. This is typified by the following comment in relation to the frequent flyer program operated by Qantas, Australia's national airline (Choice.com 2013).

> "I would never convert points to purchase – definitely not good value," says Naomi Stephens. "If you flew Qantas from Sydney to LA round-trip five times as an entry-level bronze member you'd still be 11,590 points short of the LG 32" LCD TV."

This anecdote from a consumer report bemoans the effort required to redeem an item from a LP reward catalog. However, what is often overlooked is whether that same item can be purchased for a lower price outside of the LP. Take the LG TV above, for example, which requires 86,500 points. We later show that this is the dollar equivalent of $666, what we call the "points price." It turns out this exact same TV can be bought at a reputable electronics retailer for $439, over $200 less than the LP points price. If the consumer in this anecdote is already cynical about the rewards offered by this LP, how would she feel when finding out that after taking 10 long international flights her "reward" is to be charged more than $200 above the market price? The purpose of this study is to (i) use theory to explain why the *anti*cipated negative consumer reaction to higher points prices will be diminished or amplified, (ii) calculate the dollar value of a loyalty point and use it to contrast points and market prices for almost 7000 products across six LPs to judge whether or not consumers are being fairly rewarded for their loyalty, and (iii) survey LP members to gauge their reaction to LP catalog prices exceeding market prices.

It is important to note that our study is concerned only with the redemption of loyalty points, and does not consider the accrual of loyalty points. Previous studies have looked at the design of LPs to examine how much a consumer has to spend to receive a loyalty point (e.g., Dorotic et al., 2012; Roehm et al., 2002). However, that is not the purpose of this study. Instead, our focus is very unique: we examine the fairness of what a LP member has to "spend" in terms of loyalty points in order to redeem a LP catalog item vis-à-vis the market price for the same item. This is the first study to examine this aspect of LPs in detail.

2. Structure of loyalty programs and its effect on consumers

From a firm's perspective, the benefits of a LP include greater customer retention (Nunes and Dreze, 2006; Singh et al., 2008), increased share of wallet (Demoulin and Ziddа, 2008, 2009; Lewis 2004; Leenheer et al., 2007; Meyer-Waarden, 2007; Verhoef,

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2003), higher purchase frequency (Demoulin and Zidda, 2008), reduced negative consumer evaluation subsequent to service failures (Bolton et al., 2000) and lower consumer price sensitivity (Demoulin and Zidda, 2008). A LP also facilitates a firm's collection of customer information and creates communication opportunities between a firm and its customers (Butscher 2002).

Despite these numerous benefits there remain lingering doubts about the effectiveness of LPs (Shugan, 2005; Dowling and Uncles, 1997; O'Brien and Jones, 1995), with some studies finding that LPs are ineffective (Magi 2003; Sharp and Sharp, 1997). Part of the reason for these mixed findings is that LPs vary enormously in their design, and design has a large influence on LP effectiveness (d'Astous and Landreville 2003; Liu and Yang, 2009; Nunes and Dreze, 2006; Roehm et al., 2002; Zhang and Breugelmans, 2012). Firms are becoming increasingly creative in their LP design in an effort to enhance LP effectiveness and stay ahead of competitors (Zhang and Breugelmans, 2012), but the viewpoint and welfare of consumers is rarely considered (Lacey and Sneath, 2006). This is why we examine the consumer perspective to see if they are concerned about points prices exceeding market prices for LP rewards.

The use of points is especially common in so-called multi-vendor loyalty programs (MVLPs), or "coalition" LPs, which are comprised of a consortium of service providers (such as grocery stores, assorted retailers, banks, gas stations, telecommunication providers and utilities). Such MVLPs have the advantage that a consumer needs to carry just one instead of separate loyalty cards. Furthermore, they can accumulate points more rapidly as there is a larger range of service providers and therefore more opportunities to earn points.

Now that points are commonly used as a reward mechanism for LPs they have become a currency in their own right (Dreze and Nunes, 2004). Having accrued loyalty points consumers who are members of a MVLP are commonly rewarded for their loyalty by "purchasing" products from a catalog. Likewise, members of a frequent flyer program can book "free" flights using their accumulated points. A hitherto unexplored question is whether these rewards are financially beneficial to LP members. Specifically, is the "purchase price" of a reward (using points) higher or lower than if the same item had been purchased on the open market? What is the expected consumer reaction to higher points prices? On the one hand, a LP member might legitimately argue that the points are costless since they shop at LP partner stores anyway. On the other hand, consumers might reason that they *earn* points by paying higher prices at LP partner stores and direct more of their business to LP stores, thereby forgoing the opportunity to "shop around" for lower prices. In this case, it might be expected that consumers would be angered to learn that LP catalog prices exceed those charged at other retailers who are not part of the LP. Hence, our first objective is to use theory to anticipate consumer reaction to points prices exceeding market prices.

Our second objective is to assess how LPs perform in terms of fairly rewarding their members. We do this by calculating the dollar value of a loyalty point for five MVLPs and one airline frequent flyer program to assess the overall financial benefit (or otherwise) that consumers receive in exchange for earning their loyalty points. We find that 4 of the 6 LPs have overall negative financial benefits for LP members, one is about equally balanced, while just one LP delivers overall positive financial benefits. That is, in the main, consumers are not fairly rewarded for their points-earning effort. Given the risk of consumer annoyance, LP managers should be concerned if their program is not designed to reward members fairly in terms of the perceived effort they put into earning points in exchange for rewards.

Our final objective is to determine whether or not consumers are concerned about points prices exceeding market prices for LP catalog items. We achieve this by conducting a survey of members from a large MVLP. In the survey we pose a question based on the points value for an item listed in the LP catalog which actually costs less when purchased from another reputable retailer. We find that more than half the LP members are somewhat or very annoyed to find out that the LP catalog price is higher, with 19% of these annoyed LP members being sufficiently angry to consider quitting the LP.

3. Conceptual framework

Later our empirical results will demonstrate that there is wide variation in the difference between points and market prices across products within a MVLP catalog. Moreover, many products cost more when "purchased" via the LP catalog, especially those that are inexpensive. What we need to consider now is whether consumers *care* about products redeemed from the LP catalog costing more than the market price. An obvious reason that consumers may be indifferent towards the points price exceeding the market price is they may consider loyalty points to be free. By this we mean that consumers might argue that they were going to purchase from a retailer with a LP anyway and so the points are a "bonus" for making those purchases. Therefore, if it costs the equivalent of $110 in points to buy a product from a retailer's LP catalog but the market price is $100, it is technically true that the points price exceeds the market price, but the points might be perceived to come at no cost to the consumer and so they may *not* feel they are being unfairly rewarded.

However, a counter argument to this mindset is that consumers may channel more of their purchases through LP retailers in an effort to accrue more points. Indeed, Leenheer et al., (2007) find that a consumer's share of wallet increases for firms with a LP. Hence, some consumers might forgo the opportunity to shop elsewhere for cheaper prices, thereby accruing more points from firms within the MVLP. In fact, consumers are likely to be aware that they pay higher prices when shopping at retailers with a LP because some high-profile retailers have abandoned their LPs in favor of everyday low prices (e.g., Safeway in California and Jewel in Chicago). The implication is that when consumers shop at a store or fly on an airline that has a LP they implicitly pay for the "free" points via higher prices. For this reason, consumers may not consider loyalty points to be free.

Evidence that consumers may consider points to be earned, rather than free, is provided by Dorotic et al. (2014) who find that consumers accelerate their points accrual just prior and just after redeeming a reward. Furthermore, Kwong et al. (2011) report a tendency for consumers to hold onto their points rather than redeem them. In addition, their study reveals that consumers are more likely to spend their points when it is easier for them to compute the percentage savings. Equity theory can be brought to bear on this situation, as we now explain.

3.1. Equity theory

If consumers perceive they earn points, at least in part, then the likelihood is they will be annoyed to discover the points price often exceeds the market price for a MVLP catalog item. The reason for this has its roots in equity theory (Huppertz et al., 1978), also known as distributive justice (Oliver and Swan, 1989). As Oliver and Swan (1989, p. 25) comment "…the notion of 'fairness' is almost synonymous with equity in that it explicitly implies a form of distributive justice." According to equity theory, LP members should perceive unfairness when they pay more for a LP catalog item using their loyalty points (converted to dollars) than they would pay for the same item purchased with cash at a retailer