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Delta, Alaska Airlines, and Aeroplan Create Solutions for the Reward Availability Problem

Innovation and accountability are key factors in addressing an issue that many consumers complain about and many airline executives prefer to ignore.

Consumers have a love-hate relationship with frequent flier programs. They love the promise of free travel and perks but hate the restrictions placed on reward travel. Airline executives are less ambivalent – they universally love the revenue. American Airlines definitely "feels the love" from the $1 billion it's about to pocket from the advance sale of miles to its credit card partner Citigroup.[1] But airline executives do vacillate on the issues of mileage liability and reward seat availability. Some carriers provide plenty of reward seats, while others are downright stingy.

This report describes the actions of progressive management teams at Delta Air Lines, Alaska Airlines, and Aeroplan who use innovative methods to make frequent flier programs more attractive to consumers and investors. These companies realize solutions must be implemented to mitigate the effect of capacity cuts on reward travel. Rather than wait for frustrated frequent fliers to stop using co-branded credit cards, these airlines are making changes to ensure frequent flier programs continue to deliver big revenue from the sale of miles and points to partners.

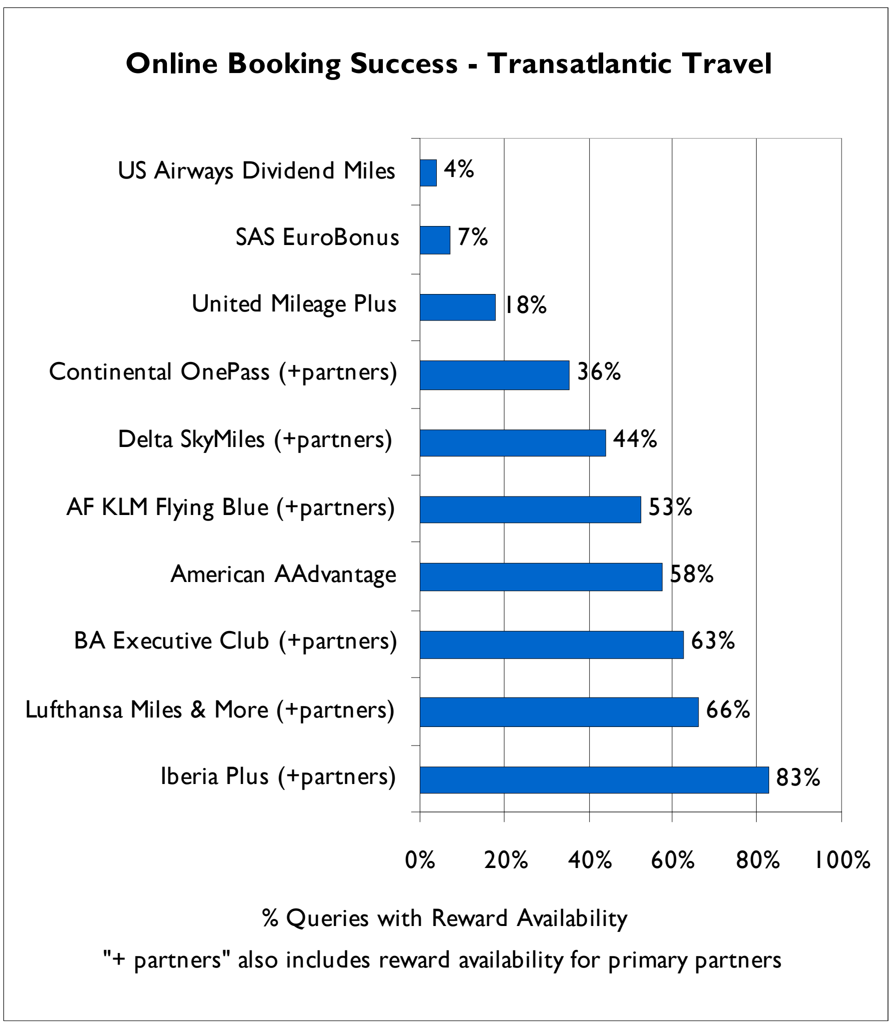
Providing more reward availability (and reducing mileage liability) should start with a simple fix. That's why this report begins with the elegant solution represented by Alaska Airlines. The carrier boosted the convenience of its rewards by converting to a one-way structure. The results are very encouraging with a big jump in reward travel coupled with the rarity of reduced liability. Delta Air Lines puts its "money where its miles are" with a Pay with Miles feature that allows select American Express cardholders to use all miles, like cash, to buy inventory controlled reward seats. Aeroplan takes this monetary method further with its income statement approach to loyalty programs. The company spends Canadian dollars to buy rewards from Air Canada and receives Canadian dollars by selling miles to to the airline. Aeroplan's success demonstrates a simple fact – running a frequent flier program like a business . . . is good business.

[1] "AMR Corporation Takes Significant Steps to Face Near-Term Challenges" AMR press release dated September 17, 2009.

Reward Availability is Not an Accident

There is no denying that some airlines face a real problem regarding reward availability. The graph on the following page depicts how each airline defines and delivers a key attribute of its brand identity to consumers. Reward availability is not an accident; it's a benefit that is consciously chosen by each airline. IdeaWorks analyzed reward availability for ten transatlantic carriers earlier this year. The Online Booking Success graph presents the data produced by the 6,400 online reward queries completed by IdeaWorks. The percentages reflect the number of times each of the queries produced reward seats on at least one outbound and one return flight on the largest transatlantic routes operated by the carriers included in the analysis.

Top scoring airlines, such as Iberia in Europe or American Airlines in the USA, made it far easier for frequent flier program members to find reward seats online. Others, such as US Airways and Scandinavian Airlines, made it practically impossible for consumers to receive the benefit of free transatlantic reward travel.



IdeaWorks made the booking queries at the websites of five major US-based airlines and five major Europe-based airlines during the latter half of January 2009. The same set of travel dates, which spanned from April through November 2009, were used for all queries. The queries were made for the largest passenger-carrying routes of each airline. The result provided a first-ever look into online reward availability differences among transatlantic airlines.

The graph provides a snapshot of the significant distinctions between frequent flier programs earlier in 2009. Consumers and the travel media too often accuse all airlines of not supplying enough reward seats. Clearly some airlines provide more reward seat availability than others. Partner networks might help in this regard; frequent flier programs can open their wallets and purchase reward seats from other airlines. In reality, this is an unattractive solution that creates a cash expense and allows another airline to provide the gift of travel to the program members. The best solution would keep customers and cash from leaving the company.

Alaska Airlines, One-Way Rewards, and Pickles

Alaska Airlines departed from industry tradition when it introduced one-way rewards in March 2007.[2] The change was announced as a customer-friendly enhancement for the carrier's 75th anniversary. "These new awards support our vision to make travel easier and to offer our customers more choices when using their miles," said Rick Rasmussen, Alaska Airlines' director of customer loyalty. In reality, it was a very savvy move that allowed Alaska to squeeze more redemption from the carrier's existing supply of reward seats.

A small sample of Laura Sorensen's 2009 batch of garlic and dill pickles using the Zientek family recipe.

One-way reward travel on Alaska in the Continental US and Canada starts at 12,500 miles, or 25,000 miles for roundtrip. Mileage Plan rewards for travel on Alaska and Horizon Airlines have been sliced in half for one-way travel. The structure does not apply to partner rewards.

How are pickles related to one-way rewards? While this report was being written, Laura Sorensen was preserving many jars of pickles. Take a close look at the two jars shown on this page. The jar on the left contains whole pickles that are not sliced; the other jar holds pickles that have been sliced. Laura's ever-helpful husband made the mistake of buying pickles that were too big during a visit to the farmer's market. The jar on the right reflects an enhancement in the pickle preserving process. Slicing pickles into small pieces increases the efficiency of pickle packing . . . and saved a poor husband from the scorn associated with yet another shopping mistake.

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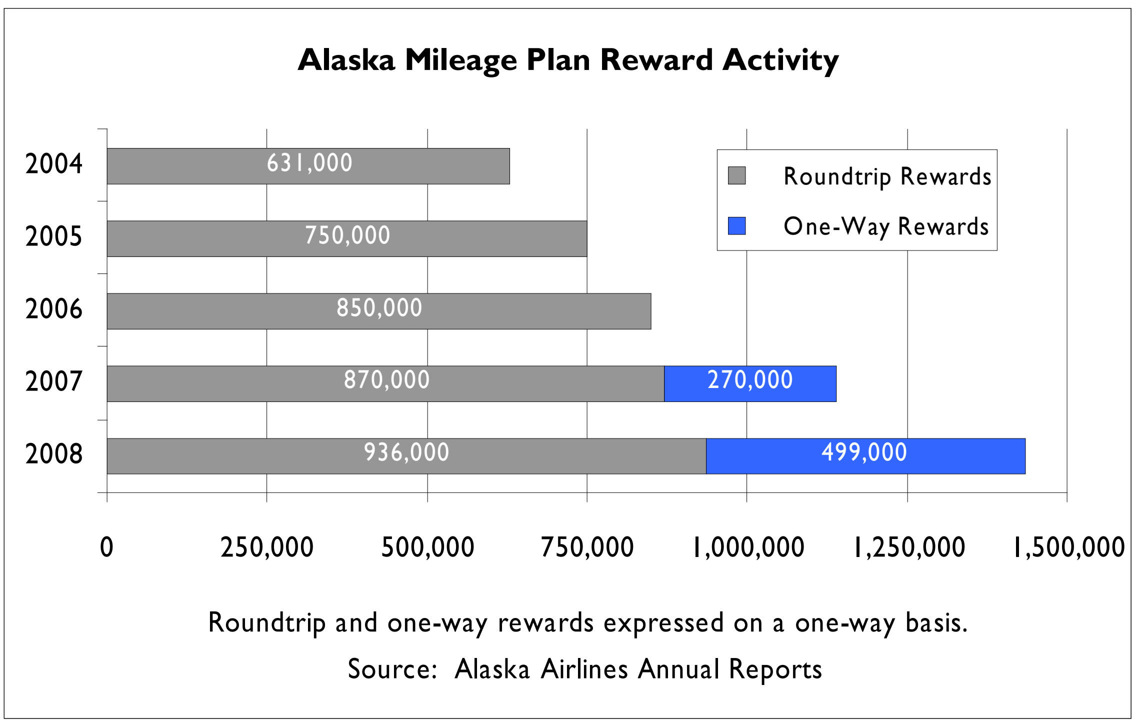
[2] "Alaska Airlines Mileage Plan Introduces One-Way Awards Systemwide" Alaska Airlines press release dated March 2, 2007.

Likewise, one-way rewards slice travel into smaller parts and provide greater travel flexibility. Travelers can book an outbound trip and keep their options open for the return. Perhaps a traveler visiting Phoenix for the winter hasn't firmed up a return date. The traveler can later choose an available reward flight or buy a one-way ticket and generate cash for the airline. Or the traveler might book multiple segments to complete a vacation. It really doesn't matter - - but what does matter are the positive results enjoyed by Alaska after it implemented this change.

The following graph displays how reward travel began to dramatically increase in 2007. Alaska disclosed in annual reports that its reward inventory profile remained the same; capacity controls were applied to 75 percent of reward travel during the 2004 through 2008 period. The increased activity is largely tied to more travelers using standard one-way and roundtrip rewards – not because members starting redeeming more miles for unrestricted rewards.



Reward trips for 2008 increased 39.5 percent from 2006 (the last full year before the change). While some of the increase can be attributed to the growth of airline, the combined ASMs (available seat miles) of Alaska and its Horizon Air subsidiary only grew 3.4 percent during the same period.[3] But beyond the reward travel increase, the change had an amazing impact on Mileage Plan's year-end balance of unused miles – it decreased in 2008.

[3] Alaska Air Group 2008 Annual Report

Alaska Mileage Plan – Mileage Balance Trend					
	2008	**2007**	**2006**	**2005**	**2004**
Mileage Balance at December 31	113 billion	114 billion	103 billion	95 billion	86 billion
Annual Change	- 0.9%	+ 10.7%	+ 8.4%	+ 10.5%	
Source: Alaska Air Group Annual Reports 2008 - 2006					

Mileage Plan posted a 0.9 percent decrease to the 2008 year-end mileage balance after years of consistent annual growth in the range of 8.4 to 10.7 percent. This miracle could be compared to the US government announcing a budget surplus and a reduction of the national debt. Alaska continued down the path of fiscal responsibility by implementing more measures in July 2008.[4] Mileage Plan raised its standard roundtrip reward from 20,000 to 25,000 miles, expanded the list of lower priced short-haul rewards, and changed to a 3-tier reward structure by introducing a new mid-level tier. It also started charging a $25 fee for each reward booked on a partner airline, which discourages the use of these rewards.

Alaska Airlines learned that by offering more flexibility and convenience, members will make more efficient use of existing reward inventory. Perhaps American Airlines noted this when it followed Alaska's lead and added one-way rewards in May 2009.[5] While other methods may have contributed to Alaska's year end mileage balance decrease, the launch of one-way rewards was clearly the leading factor for this achievement.

<u>Pay with Miles on Delta</u>

Pay with Miles frees the consumer from reward inventory restrictions. For example, SkyMiles members may exchange 10,000 miles for a $100 travel credit. Delta unveiled the benefit for American Express cardholders on February 27, 2008.[6] It allows members with a Gold, Platinum, or Reserve Delta SkyMiles Credit Card from American Express to spend miles to buy tickets at Delta.com. Similar to Alaska's $25 fee for partner rewards, Pay with Miles encourages redemption on Delta by restricting activity to select flights. On-screen prompts during the booking process designate Delta and Delta Connection itineraries; travel on partners such as Air France and KLM don't qualify for Pay with Miles.

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[4] "Alaska Airlines Announces Changes To Mileage Plan Program" Alaska Airlines press release dated July 24, 2008.
[5] "American Airlines Introduces a Whole New Approach to Frequent Flyer Award Travel With Launch of One-Way Flex Awards" American Airlines press release dated May 11, 2009.
[6] "Delta SkyMiles Program Makes It Easier Than Ever for Members to Use Their Frequent Flyer Miles" Delta Air Lines press release dated February 27, 2008.

The feature is similar to United's Mileage Plus Choices program that allows Mileage Plus cardholders to redeem points for tickets purchased at United.com. However, United's process is cumbersome and requires cardholders to request a refund after the purchase appears on a member's credit card statement. Delta provides a seamless experience by incorporating the offer into the booking process; members instantly apply miles to buy travel at Delta.com. United did recently score points with its members by introducing a new feature that allows all miles (even non credit card miles) to be redeemed online for hotel stays and car rentals.[7]

These programs rely on the revenue generated by co-branded credit cards to fund travel purchases. The airline reward benefit is consciously limited to co-branded cardholders, which awkwardly denies an attractive feature for elite travelers who don't carry the credit card. The economic model relies on accrual trends in which the majority of miles are accrued through partner-related activity, such as the miles sold to American Express and other partners.

The following chart provides a simple example of the accrual activity of a program member who takes six one-way flights per year, uses a co-branded card, and earns a few miles from hotel stays and car rentals. The analysis is not based upon any disclosures made by Delta and assumes a likely price of 1.2 cents for miles sold to partners. The analysis further assumes approximately 1/4 of miles are earned from flight activity; these miles do not generate partner revenue for the airline. 50,000 miles accrued during a two-year period, when divided by partner revenue of $456, generates revenue of $.0091 per mile for all of the member's mileage accrual.

Example of Revenue Generated by a SkyMiles Member	
Flight activity accrual	6,000 miles annually 6 one-way trips accruing 1,000 miles
Co-branded card accrual (established account without a sign-up bonus)	18,000 miles annually Average charge activity of $18,000 *
Program partner accrual (hotel stays and car rentals)	1,000 miles annually
Miles accrued in a 2-year period	50,000 (2 years @ 25,000 miles)
Co-branded and program partner revenue (co-branded and partner miles, 2-year period)	$456.00 ($0.012 per mile)
Pro-rated revenue for all accrued miles	$0.0091 (50,000 miles divided by $456)

Source: All assumptions are based upon IdeaWorks estimates unless otherwise noted.
** Annual airline card charge statistic disclosed by MasterCard at the FFP conference in Istanbul on March 11-12, 2008*

[7] "United's Mileage Plus members may now use their miles in more ways than ever before - from air to ground to pillow" press release dated September 29, 2009 at United.com.

With these figures in mind, let's examine how SkyMiles members might spend their balances under the Pay with Miles scheme. The example is based upon a $250 per person price for roundtrip travel between New York and Orlando. Let's assume our traveler initially tried to redeem 50,000 miles for two roundtrip rewards but could not find the seats. Fortunately for the member, Pay with Miles provides a better alternative because it covers the cost of taxes. Under the usual method, this itinerary would require the member to pay taxes of $21.20 per traveler in addition to the 25,000 miles redeemed for each standard reward.

Example of a Pay with Miles Booking	
New York – Orlando air fare example	$250 roundtrip per person
Taxes and fees (paid by airline in cash)	$21.20
Base fare	$228.80
Pay with Miles price for 2 persons	50,000 miles = $500 purchase

The key component of analyzing the economics of Pay with Miles is the "displacement assumption." Standard reward travel is based upon the premise that revenue management allocates excess inventory to the frequent flier program – at no cost to the airline. The theory is that the seats represent excess inventory and would remain unsold; capacity-controlled rewards don't displace a fare-paying passenger. Continental Airlines uses this language in its 2008 annual report to describe this assumption:

> ***"We believe displacement of revenue passengers is minimal given our ability to manage frequent flier inventory . . ."***

Clearly the Pay with Miles feature violates this premise, as do the anytime rewards typically offered at twice the mileage price associated with standard rewards. SkyMiles members may purchase any seat with Pay with Miles – not just the usual capacity-controlled inventory. Alaska Airlines discloses 25 percent of reward activity is not subject to capacity controls,[8] which is undoubtedly defined as the carrier's Choice and Full Flex rewards. This could be interpreted as an approximate displacement of revenue assumption for Alaska's frequent flier program.

For presentation purposes, the analysis assumes reward travelers will displace fare-paying travelers on 6 out of 10 occasions (60 percent displacement). Displacement factors, which are determined by revenue management, will vary due to each carrier's unique approach to reward inventory allocation.

[8] Alaska Air Group 2008 Annual Report

Financial Analysis of Pay with Miles – Using the Example	
Displacement assumption (Percent of reward travel that displaces fare-paying passengers)	60%
Implied cost to the airline (taxes, fees + 60% x base fare)	$158.48
Cost per redeemed mile ($158.48 cost divided by 25,000)	$0.0063 per mile
Revenue associated member's total accrual ($456 divided by 50,000)	$0.0091 per mile
Income from sale of miles to partners ($456 revenue less $158.48 x 2 cost)	$139.04
Margin on mileage sale (income divided by revenue)	30.5%
Source: All assumptions are based upon IdeaWorks estimates.	

The surprising outcome of the analysis is the resilient profit potential of Pay with Miles. Airline executives need to move past the old belief that every penny generated by a frequent flier program can be placed in the corporate treasury. The overabundance of mileage accrual and the scarcity of reward seats demands a re-thinking of the equation. Simply stated, frequent flier programs should be operated in the manner of a successful business. This requires an investment of resources to include cash expenditures for rewards.

Even after budgeting for reward costs, this model delivers extremely attractive margins. Of course, this margin will be slightly reduced by overhead expenses, but by any measure it demonstrates exceptional profit potential. Is there any wonder Aeroplan has enjoyed success as a stand-alone loyalty marketing entity? While Pay with Miles doesn't provide a total solution, it helps solve the reward availability problem for a program's co-branded cardholders.

Aeroplan Delivers Rewards as a Central Bank

Aeroplan was formed as a subsidiary of Air Canada in 2002 and became independent through an IPO in 2005 that achieved a market capitalization of CAD$2 billion.[9] It was founded in 1984 by Air Canada to manage the airline's frequent flier program. Aeroplan manages Air Canada's frequent flier program through an extensive contractual relationship. In addition, the company operates Nectar (a loyalty marketing program in the UK) and Air Miles Middle East.

[9] Investor Presentation dated November 2008 at GroupeAeroplan.com.

Aeroplan calls its stand-alone loyalty model the "central bank" (diagrammed below) which relies upon cash payments to reconcile accrual and reward activity. The model clearly works, as the company delivers attractive profits for investors. Groupe Aeroplan generated gross billings in excess of CAD$1.4 billion and adjusted EBITDA of CAD$317 million in 2008.[10] The company claims Aeroplan has enrolled 80 percent of affluent households in Canada.[11]

Earning Miles				
Member buys products or services and accrues Aeroplan miles	→	Accrual partners buy miles from Aeroplan	→	Miles deposited in member's account
Redeeming Miles				
Member redeems miles with Aeroplan	→	Aeroplan buys products or services from partners	→	Member enjoys rewards
Source: Investor Presentation dated November 2008 at GroupeAeroplan.com.				

Using cash to purchase reward travel is a market-based method that grabs the attention of the revenue management department. Reward travel is priced in miles and varies by flight and day. Behind the scenes, Air Canada is setting prices based upon the amount paid per mile by Aeroplan.

Air Canada disclosed in its 2008 annual report Aeroplan is "Air Canada's largest customer." The same would very likely be true of any major airline and its frequent flier program. This activity represented 57 percent of the amount spent by Aeroplan for rewards in 2008.[12] This relationship also provides Aeroplan access to other airlines through Air Canada's participation in the Star Alliance network. The airline purchases miles from Aeroplan for the accrual earned by its passengers. During 2008, Air Canada spent CAD$248 million on the purchase of miles from Aeroplan.[13] Air Canada has agreed to a minimum annual purchase of miles equal to 85 percent of average miles purchased during the prior 3-year period.

The central bank model works for Aeroplan because it sells accrual miles to partners (such as Air Canada) at a higher price than the price assigned to reward miles. Analysis was performed on the financial disclosures made for 2008. The following reveals the attractive margin that Aeroplan realizes on its mileage transactions in Canada:

[10] Groupe Aeroplan Annual Report 2008.
[11] Investor Presentation dated November 2008 at GroupeAeroplan.com.
[12] Goupe Aeroplan Annual Report 2008.
[13] Air Canada Annual Report 2008.

Financial Analysis of Aeroplan Canada – Using 2008 Results	
Miles issued +	84.1 billion
Gross billings +	CAD$1,025,184,000
Average billing per mile (calculated by IdeaWorks)	CAD$0.0122 (US$0.0112)
Reward cost +	CAD$567,599,000
Miles redeemed +	67 billion
Average reward cost per mile (calculated by IdeaWorks)	CAD$0.0085 (US$0.0078)
+ Disclosed in Groupe Aeroplan Annual Report 2008	*Conversion rate used: CAD$1 = US$0.92*

The average reward cost calculated by IdeaWorks of CAD$.0085 per mile is also reflected in the program's reward chart. For example, Aeroplan members may redeem 12,000 miles for a $100 Air Canada Vacations certificate, which equates a value of CAD$.0083 per mile.[14]

The Aeroplan program includes a wide range of partners beyond Air Canada such as American Express, hotel chains, car rental companies, and a robust selection of retailers and service providers. Aeroplan members may spend miles for air travel, hotel stays, car rentals, activities, and merchandise. While the financial results disclosed relate to all accrual and reward activities, Air Canada represents a significant portion of overall program activity.

Aeroplan is financially motivated to satisfy the needs of all stakeholders - - accrual and reward partners, program members, and investors. Air Canada is a satisfied "client" of Aeroplan as evidenced by the comments made by Calin Rovinesu, President and CEO:

> ***"We have already made it easier than ever to redeem reward miles by making 250,000 more seats available to Aeroplan this year, which serves the triple purpose of raising cash for Air Canada, winning applause from our customers and offering an advantage the competition can't match."***[15]

Aeroplan's central bank model uses cash transactions and contractual obligations to align the needs of the airline, partners, and program members. The company also included the needs of investors after its 2005 IPO. Revenue awareness allows frequent flier programs to apply monetary value to the services and features provided to consumers . . . and the airlines they are contracted to serve.

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[14] Aeroplan.com website reviewed October 2009.
[15] Comments made at the Air Canada Annual General Meeting Presentation, May 8, 2009.

Flexible and Cash-Based Rewards are the Future

Frequent flier programs become most effective when consumers can easily assign a value to the miles or points they accrue. The examples in this report provide a progression that starts with increased reward flexibility and ends with cash-based valuation. Alaska Airlines has maximized the availability of capacity-controlled rewards by providing travel benefits in smaller one-way pieces. Delta offers more flexibility by allowing its miles to be spent like cash at its website.

The benefit is restricted to SkyMiles credit cardholders which acknowledges the importance of the revenue contribution of American Express. The assignment of value allows frequent flier miles to compete with cash-paying customers to book capacity-controlled inventory. The Qantas Frequent Flyer program already allows members to spend points like cash to book any available seat. It should come as no surprise that Qantas has contemplated spinning off its program through a shares offering. Linking miles and points to currency value is akin to operating the program as a business venture.

Aeroplan represents the current evolution of loyalty marketing programs. The company uses market forces to blend the needs of travelers, its airline partner, and investors. Members use miles as a cash-backed currency to obtain rewards. Air Canada generates revenue from the rewards sold to Aeroplan and pays cash for the miles earned by its customers. Aeroplan has successfully defined its role as a retailer of frequent flier miles and a profitable place for investors. It would seem progressive management teams not only love the partner revenue, but also love the “business” of running a frequent flier program like a “business.”

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New Consulting Package for Airlines: IdeaWorks offers a one-price solution for an airline seeking to measure the financial performance of its frequent flier program. The two-phase project would provide a "tune-up" for the program to ensure peak operating performance in terms of mileage value and passenger revenues. Outcomes of the project would help management answer questions such as, "Is the program selecting the best candidates for the elite tiers?" and "What changes should be made to better align reward liability with accrual?"

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