The Impact of High Oil Prices on Frequent Flyer Programs

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Introduction

The International Air Transport Association (IATA) recently announced that it projects a loss of US$ 5.2 billion for the global airline industry in 2008 as a result of slowing economies and the increase in the price of oil. Despite the recent drop in oil prices, the average price per barrel is still US$40 more than what it was in 2007. As a result, IATA expects the total fuel bill in 2008 will increase by US $50 billion to a grand total of US$ 186 billion.

Adding insult to injury, a weakened US economy and reduced demand for premium traffic as a result of the credit crunch and volatility in the financial markets make for a perfect storm. Airlines who depend on premium traffic across the Atlantic and Pacific are particularly hurting.

More than thirty airlines have gone bankrupt so far in 2008, and the impact of the high oil price is felt by airlines across the board. Early victims included premium carriers such as Silverjet, Maxjet and EOS, as well as low cost carrier Oasis Hong Kong. More recently XL Airways, a UK based leisure carrier, and Zoom, a Canadian low-cost transatlantic carrier went bust. With increased fares, and less carriers to choose from, the consumers are feeling the pinch of the price of oil too.

Many of these consumers are members of large and comprehensive frequent flyer programs (FFPs). Generating huge amounts of revenues, these programs are considered by many to be the crown jewels of an otherwise unpredictably performing industry.

In this paper, we will explore the impact of a sustained increase in price of oil on the future of these programs.

In brief

- With fuel expected to rise to 36% of operating costs (IATA estimate), there will be a profound impact on how frequent flyer programs are run.
- In this paper, we will examine some of the possible consequences of the new operating environment.

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The Impact of High Oil Prices on Airlines

The industry profits have disappeared as fuel prices have gone through the roof. As a result, the airline industry has become more and more inventive in finding new ways to either reduce costs or generate new revenue streams.

Besides the use of traditional fuel surcharges, airlines have adopted a range of policies that will either save them money or drive incremental revenues.

Focusing heavily on the cost side, many airlines have decided to cut capacity – either through cancellation or postponement of new services or temporarily halting existing services. In the US alone, the six major carriers are expected to reduce overall capacity by up to 9% this year. Effectively, it is cheaper to ground the aircraft than to fly it. The resulting reduction in total seat capacity has been most pronounced in the United States.

In Europe, airlines are increasingly looking to replace short-haul service by high speed trains. Alternatively, some major carriers are substituting their full service brand carrier for low cost subsidiaries.

Airlines on both sides of the Atlantic are looking at consolidation as a means to drive economies of scale. The proposed merger between Delta Air Lines and Northwest Airlines would not only create the world's largest carrier in terms of traffic, but is also expected to create the world's largest FFP. The proposed merger was given the go-ahead by both parties' shareholders in September.

On-board services have been the subject of scrutiny as well – ranging from charging for non-alcoholic beverages on domestic flights to no longer providing baby bassinets.

Unbundling of existing services and offering additional services to drive ancillary revenues have been accelerated by the new pressures brought on by the high oil price. Emergency exit, or otherwise better seats are now for sale instead of being allocated purely based on customer demand or status in a frequent flyer program. Even checked luggage allowances, once a standard offering, now attracts a fee – American Airlines started charging $15 for the first checked bag – a move which may yield in excess of US$ 500 million according to analysts. Airlines across the board in North America have installed new fees for award issuance, miles re-deposits and various other program related activities.

Ancillary revenues have become centre piece of attention for the airlines, as it generates incremental revenues that will help offset high oil prices. They range from offering related services such as hotels and car hire on the website to selling seemingly unrelated products or services – such as gambling.

Coming off a wave of relatively good performance, airlines may have to stall on some of the proposed investments that were approved during better times. Areas impacted include fleet renewal, information technology and proposed cabin refurbishments. Using more fuel efficient aircraft and retiring older models will help to increase fuel efficiency. However not all airlines have sufficient funds available to purchase new aircraft and given the increases over the last six years (19% according to IATA), one may wonder what is still left on the table.

Customer satisfaction levels continue to drop in the US as a result of the new policies. Even before some of the new fees were announced, the airline industry, according to the University of Michigan's American Customer Satisfaction Index fell to its lowest satisfaction level since 2001.

The Impact on Frequent Flyer Programs

Frequent flyer programs are impacted by the current developments in a number of ways – both positive and negative.

1. **Perceived Value -** Frequent flyers may realize that after years of miles value erosion, the equivalent value of a 25,000 miles award ticket could now significantly increase as a result of higher fares. In combination with possibly less competitive offers from low cost carriers, an award ticket may seem as a more attractive option to travel. Of course, much will depend on the speed at which the price of oil moves. Airlines have in fact in the past made changes to their programs – and could increase award levels to reflect higher costs. (Even today, some airlines charges different amounts of miles for redemption travel on new aircraft such as the Airbus A380).
2. **Cost of a Mile -** If the oil price remains at a high level, airlines will look at the price at which miles are sold to partners. Current price levels may not truly reflect the future cost of carrying an award passenger when the miles are redeemed. Partners such as credit card companies may find themselves under increased pressure from airlines to pay more for a mile. This may be a bitter pill to swallow, especially for some of the credit card issuers who are facing more pressure on the interchange rates in some markets.
3. **Changes in Award Inventory Allocation –** Airlines have increasingly moved to a model whereby award inventory is effectively bought from revenue (yield) management. This model avoids confusion around the optimal level of seats to be allocated for award travel versus commercial revenue travel. As long as award travel can generate an equal amount to commercial travel, capacity can be allocated accordingly Now, if the price of a mile and/or the number of miles required for an award ticket remain stable, but the required dollar amount for a seat increases (as a result of an increased oil price), award travelers may find less availability awarded to them. Dynamic award pricing (the going bid price is converted into miles) is likely to be introduced in more programs. It allows FFPs to set award levels dynamically, matching revenues from partner miles revenues with the going price for a flight. With fares rising, the programs may increasingly encounter difficulty in buying sufficient award capacity given that the budget provisions are not linked to increased air fares or reduced capacity.
4. **Non-Air Rewards –** Higher average fares (and therefore greater possible dilution) and new accounting practices will drive FFPs to increasingly use non-air rewards. From an accounting point of view, airlines increasingly use the deferred revenue system for accruing for miles earned liability. It means that part of the revenue associated with selling a mile to a partner is set aside until the mile is actually redeemed. Once the mile is redeemed, the associated revenue (or remaining part thereof) is recognized on the balance sheet. Therefore, the faster a member redeems, the faster the (partial) revenue from that sale can be fully recognized. As a result, airlines may increasingly look at using non-air rewards for the frequent flyer program. This provides a fairly stable way of offering rewards in a reduced capacity environment. Members can redeem for a range of items, usually including vouchers and hard items. It also gives the airlines the opportunity to generate some incremental revenue by charging cash for at least part of the redemption.
5. **Spin-Offs -** As revenues suffer, more and more Boards will be looking at the possibility to partially or fully spin-off the frequent flyer program. While Qantas' plans to partially IPO its frequent flyer program have been deferred until early 2009 due to 'market volatility', other airlines, with cash positions far less advantageous as Qantas' may find it difficult to resist the

temptation to generate money fast through a full or partial spin-off. (In July 2008, Qantas announced it was considering a partial spin-off of its frequent flyer program – analysts at that time valued the program at between AU$ 2 billion and AU$ 2.5 billion depending on earnings and equity market conditions.

6. **Delayed System Migrations -** Proposed system changes will undergo further scrutiny from the airlines. Many airlines who started their programs in the 1990s were looking to replace the legacy systems with richer and more flexible solutions. In today's cost conscious environment, many projects will be at risk of being paused or cancelled given the tremendous focus on conserving cash. Even a robust ROI or business case may not be enough in these times to gain final approval. In this sense, cancellation of system changes is only once example of an area affected in the airlines by the current cost scrutiny.

7. **Reduction in Operating Costs -** Airlines will find ways to run the program cheaper. A reduction in marketing communications materials, such as statements, is one example. Self-servicing will continue to find its way around, both in the airport as well as remotely.

8. **Selling Benefits -** Airlines are increasingly monetizing benefits associated with elite status in a frequent flyer program by selling them to none frequent flyers. Special seating, lounge access are examples. It will be interesting to see who will find the best balance between maintaining an aura of exclusivity (and therefore an element of aspiration) and downright revenue generation through monetization of benefits. On the flipside, some airlines have exempted elite tier frequent flyers from newly imposed processing fees and charges (e.g. for check luggage).

9. **Redemption Capacity -** Redemption capacity may suffer as a result of network and frequency reductions. Traditional leisure destinations popular for award travel like Florida, Hawaii and Las Vegas have been hit most by capacity reductions. This could hurt the position of the frequent flyer programs in the long run. As the attractiveness and relevancy of the program's rewards diminish, the program partners may find it more difficult to justify their large budgets associated with buying miles for their customers. On an even more pessimistic note, some analysts predict that at least one of the US majors will fall if the price of oil would hit U$ 200. One can image the consequences it could have when the frequent flyer program of that airline goes under in the liquidation too.

10. **Mileage Incentives -** A reduced demand as a result of the weaker economy may lead some airline to offering additional mileage incentives. Good news for the frequent flyers, as it will give them myriad opportunities to earn extra miles.

11. **Additional Outsourcing -** With recruitment freezes in place, airlines management will increasingly look to outsource functions to providers who will be able to provide flexible and cost effective solutions.

Managing the Impact for FFPs

There is no way around it – the current operating climate is having a profound impact on airlines and their frequent flyer programs. In order for the programs to be able to continue to drive value for the airlines, a number of issues are paramount:

- **Drive transparency.** At times when perceived costs are scrutinized in detail, it pays to be able to articulate the value of a program. Collecting the right data and being able to evaluate the right metrics will allow the airline to identify the key value drivers and show the CFOs how much the program is delivering. Here it pays to look beyond the direct revenues generated by partners by examining more closely what kind of air revenue is generated by the members of the program (and compare that for example to non-members).

- **Cut Cost, Not Customers.** Programs will be subjected to the same cost cutting initiatives as other areas in the airline; the key here is to identify those areas that will lead to minimal customer impact. Embracing new, lower cost technology will drive cost down while maintaining customer satisfaction, already impacted by cuts in service. Getting the highest return on what's left of the marketing dollar will be the name of the game.

- **Recognize the Right Customer.** Understanding which customer is the greatest asset to the airline will help to make the right decision concerning that customer. Now more than ever, airlines need to be able to recognize and reward their best customers. Knowing your best customer goes far beyond rewarding based on frequency or miles flown.

- **Offer Flexibility.** Even if the airline is faced with no choice but to raise award levels, allow the member the flexibility to use the miles for other rewards. A la carte redemptions or value based redemptions will give greater access to seats while at the same time taking into account the interests of revenue management. Offering flexible rewards to members, potentially in combination with an enhanced offering for high value or top-tier members, will ensure the members will remain interested in the program. Of course, this relevancy and attractiveness is a vital component considering the large sums of money the partners are contributing to the programs. One could only imagine the detrimental impact on airlines when, for example, financial service suppliers start to move away from frequent flyer miles as a rewards incentive for its customers.

- **Outsourcing.** Airlines have a long history of outsourcing specialized tasks to external service suppliers. In today's climate, the flexibility and potential cost savings associated with outsourcing becomes even more relevant. Outsource partners will not only give airlines additional flexibility in scaling up - or down; quickly matching market demands, it will also allow them to take cost and assets out of its existing operations structure.

Carlson Marketing's 2007 Relationship Builder℠ research confirmed that membership in a frequent flyer program not only impacted the purchase decision, but those members who successfully redeemed reported a significant increase in willingness to forego offers from other airlines. In other words, know your customer, treat them right and they will stick with you. Targeted and relevant communications and offers to frequent flyers will result in the best return on marketing investment.