



Frequent Flyer Programs

*Panacea or Pandora's Box of the
Global Airline Industry?*

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Introduction

- **First Frequent Flyer Program (FFP) introduced in 1981 by American Airlines**
- **To date 160 FFPs are in existence with a combined member base of over 100 million**
- **FFPs are a sub-set of a larger class of related loyalty marketing approaches**
- **Marketeers consider these programs as a failure**
- **Economists however do not agree with this verdict**

Economic View of FFPs

- **Idea: Encourage repeat business by rewarding customers for their loyalty**
- **Definition of loyalty:**
 - *'the consumers tendency to continually use the same airline based on cumulative experience and because they are locked in'*
- **FFPs are designed to reduce the degree of substitutability between competing airlines**

Research Questions

- **What may be the true lock-in mechanisms of FFPs?**
- **What may be the potential costs and benefits of FFPs?**
- **What may be an ideal program structure?**

What may be the true lock-in mechanisms of FFPs?

- **Exogenous Switching Costs**

- Hess (2005) estimates the willingness to pay a premium of elite-status frequent fliers to be US\$ 125.

- **Derived Fringe Benefits**

- Principal-Agent Relationship
- Tax effects may make it possible that firms could derive a benefit from FFPs

What may be the potential costs and benefits of FFPs?

- **Costs**

- Operation Costs
 - > *Member Communication*
 - > *Contigent Liability*
- Reward Costs
 - > *Direct Costs*
 - > *Displacement Costs*
 - > *Opportunity Costs*

Benefits

- **Overt Benefits when the FFP is managed as a profit centre**
 - On-sales of Miles to partners (ie Banks)
 - Estimated global revenue is more than US\$ 10 billion p.a.
 - Problem: possible erosion of the loyalty effect.



Proposed Quantification Model

- **Wansik (2003)**

- Two-period model:

$$> \textit{Gain or Loss} = (T_a * P) - (T_b * P) - MV - A$$

- T_a = ticket sale after the implementation of an FFP
- P = price of a single category of tickets
- T_b = ticket sale before the implementation of an FFP
- MV = market value of redeemed miles
- A = administrative cost

- **Problem: Too simplistic**

What may be an ideal program structure?

- **Suzuki (2003):**
 - > Standard Scheme
 - > Non-mileage Scheme
 - > Discount Scheme
- **Standard scheme most attractive to high-mile travelers and Non-mileage scheme most attractive to low-mile travelers:**
 - Legacy carriers should use the standard schme
 - Low-cost carriers should use the Non-mileage scheme
- **Problem:** The majority of schemes are very poorly designed

Alliances

- **Trend since the late 1990's**
- **Heavily impacts the design of schemes**
- **Increases the earnings opportunity of miles**
- **Alliances may make sense from a network point of view (Lederman 2004)**

Conclusion



- Who really benefits from these schemes?
- Are they the panacea of the airline industry or Pandora's Box?

Thank you!

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