

The Economist (U.S. Edition)  
December 20, 2005

## **Funny money; Frequent-flyer miles**

*IdeaWorks contributed information to this article - - see italics.*

Who will cheer loudest when frequent-flyer miles celebrate their 25th birthday?

THE mania began in 1981, when American Airlines launched AAdvantage, the world's first mileage-based frequent-flyer programme, to encourage customer loyalty. Today more than 130 airlines issue miles, and according to Randy Petersen, the founder of InsideFlyer magazine, 163m people around the globe collect miles of some sort. Indeed, calculations by The Economist in January 2005 suggested that the total stock of unredeemed miles was worth more than all the dollar bills in circulation. The record for the biggest individual account is 25m miles (enough to fly from London to Sydney and back 250 times), reputedly belonging to a publishing executive who charged his firm's postage bill to his own credit card.

The biggest collectors of miles today are not frequent flyers but frequent buyers. More than half of all miles are earned on the ground, notably on credit cards linked to airlines' programmes or on telephone calls. Miles are doled out by hotels, car-rental firms, retailers, real-estate agents and mortgage brokers. In America, if you pay by credit card you can earn miles for hospital surgery, income-tax payments and funerals. Some airlines even award miles to pets that fly with their owner.

On most airlines, one mile is earned for every mile flown. But what is a mile worth? Airlines sell them to credit-card firms at a rate of between one and two cents a mile. Yet if you make the best use of your miles, such as flying business class across the Atlantic, the market value can be up to 10 cents per mile. In 2004, over 20m free tickets were issued, and on a typical flight 7-8% of passengers were travelling on such tickets. You can also use miles for hotel rooms, car rental, holidays, restaurants, CDs and magazines, but these account for a small fraction of miles spent.

As with any form of "money", frequent-flyer miles have bred crime, corruption and crafty scams. A Singapore Airlines employee in Australia was recently jailed for fraudulently awarding himself 17.6m miles. In 2002, two German politicians were forced to resign when it was discovered that they had broken the rules by using miles earned on official trips for personal tickets. In America, by contrast, miles earned by federal employees can now be used for personal trips. But sadly one of the best scams to earn lots of miles ended in 2003, when the American Treasury stopped accepting credit cards for online bond purchases.

Frequent-flyer programmes are no longer just a marketing gimmick; they have become a lucrative earner for airlines, through their sale of miles to partners, such as credit-card companies. When United Airlines filed for bankruptcy in 2002, it said that its frequent-flyer programme was the only part of its business that was making money. The economics is certainly attractive. Charging partners for each mile earned on a credit card, say, by a member of a frequent-flyer programme, brings in estimated annual revenue of more than \$10 billion for the industry worldwide. Better still, the airlines get this revenue upfront, while the miles are not redeemed until well into the future-if ever.

Moreover, although a ticket may be worth several hundred dollars to a passenger, the marginal cost to the airline of giving away empty seats is estimated at around \$25 for a roundtrip on an American domestic flight, to cover the cost of fuel, ticketing and food. If the airline had previously sold all 25,000 miles redeemed for that ticket to a credit-card firm, it could have earned up to \$400. Even allowing for some revenue loss from passengers who might otherwise have paid, the industry's total costs for giving away free seats are probably not much more than \$1 billion-a fraction of the \$10 billion revenue. No wonder sceptics argue that frequent-flyer miles now reward airlines more than passengers.

***Airlines have to include a contingent liability in their accounts, to cover the future cost of unredeemed miles, but they try to make this as small as possible. American airlines ignore all miles in individual accounts until they reach blocks of 25,000 miles (the minimum required for a domestic ticket). Then, for each 25,000-mile block of unredeemed miles, they enter a liability of only \$20-25. They also assume, on average, that one third of miles will never be redeemed. Taking all this into account, in 2004 the 14 biggest American airlines posted a total liability of only \$3.9 billion to allow for future frequent-flyer mileage redemptions, according to IdeaWorks, a consulting firm.***

Whatever the correct figure, the future financial liability of unredeemed miles cannot cause an airline to go bust, because the fine print of frequent-flyer rule books allows airlines to increase the number of miles required for a free flight, or to restrict seat availability. Both are a form of devaluation. With no independent central bank to protect the "currency", the value of frequent-flyer miles has already diminished: over the past decade most airlines have increased the number of miles needed for a free flight.

Just as passengers are addicted to earning miles, so airlines have become habituated to the profits from selling miles to partner firms. As a result, the stock of miles has soared. The snag is that the stock of seats available for awards is limited: the number of miles redeemed has barely changed over the past five years (see chart). Indeed, in relation to capacity, seat availability has fallen. In 1999, free tickets accounted for around 9% of total revenue passenger miles on both American Airlines and United. In 2004 the figure was only 7.5%.

With too many miles chasing too few seats, there are growing complaints from consumers who cannot book the flight they want, or have been forced to redeem twice

as many miles to get a seat. Most American airlines have a two-tier system: a limited number of seats are on offer at the basic rate of 25,000 miles for a domestic ticket; but if you pay up to double this, you can buy any available seat. Once again, this is a form of devaluation.

According to a survey on Webflyer.com, the average success rate in getting a free ticket varies from 71% on US Airways to 54% at British Airways and only 37% on Northwest. Members of US Airways' frequent-flyer programme succeeded in getting upgrades 76% of the time, on British Airways only 23% (see chart). British Airways' scheme is generally stingier than those of its American counterparts. Not only are upgrades much harder to get, but discounted tickets earn only 25% of the miles flown (compared with 100% on most American carriers) and do not count towards earning elite status. On the other hand, a British Airways gold card is a much-coveted prize of the frequent traveller, allowing free access into luxurious first-class lounges around the world. British Airways likes to see its Executive Club as a true loyalty programme rather than just an upmarket trading-stamp scheme.

It is one thing for frequent-flyer miles to be devalued, but what is the risk they might become worthless? Never before have so many airlines been in such trouble. American airlines have lost around \$40 billion over the past five years, and three of country's four biggest carriers (United, Delta and Northwest) are currently operating under Chapter 11 bankruptcy protection. In the past, when a big airline went out of business, parts of it were acquired by rival airlines, which honoured its frequent-flyer miles. When TWA went bust in 2001 its loyalty programme was absorbed by American. But smaller airlines have fared less well. In the cases of Midway, Braniff, Ansett Australia and National, members lost all their miles when the airlines folded. If one of the big American airlines went under today, none of the other giants is currently strong enough to take it over.

What to do? AwardGuard, a company that insured frequent-flyer miles, stopped accepting new customers in 2003, because of the increased risk of claims. But American Express has just launched an insurance policy for miles in the United States.

Both history and recent financial troubles suggest that frequent-flyer miles will not improve with age. If you can't use all your miles on flights now, you could try to sell them. The fine print of every programme prohibits the sale or barter of miles, but there is a black market of brokers, such as Award Traveller, which will buy your miles at a discount (by paying you to redeem them for a ticket for one of their customers). However, if the buyer is caught with your award ticket, it will be confiscated and your frequent-flyer account permanently frozen. Some members who have sold their miles on eBay have also had their miles revoked.

Another option is to transfer miles to a sounder airline. Points.com brokers miles among various programmes, but its rates of exchange involve losses of up to 90% of the value of miles. The Diners Club Rewards programme can also be used to swap some airlines' miles (again with a sizeable loss). For instance, 10,000 United miles can be switched into 5,000 BA miles.

If current losses persist, might some airlines try to raise money by selling off their frequent-flyer programmes? In 2005, Air Canada sold 12.5% of its loyalty scheme, Aeroplan, into a separate income trust. This raised C\$250m, putting a total valuation of C\$2 billion (\$1.6 billion) on the scheme. United's Mileage Plus has eight times as many members as Aeroplan. On the other hand, United's estimated revenue from sales of miles to partner companies is perhaps only three to four times larger. This suggests a valuation of United's mileage scheme of \$5 billion-10 billion.

That would come in handy, but in the long run, airlines that flogged off their loyalty programmes would risk killing the goose that lays the golden (or perhaps platinum?) eggs.