



Issued: May 18, 2005
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United Airlines Shutdown Would Impact 45 Million Mileage Plus Members and 145 Partner Brands Industry Analysis from IdeaWorks

Potential strike by employee groups would affect United's frequent flier program, which now generates 5% of annual operating revenues for the airline.

IdeaWorks recently completed analysis on the impact an employee strike would have on the United Airlines Mileage Plus frequent flier program. Employees appear ready to walk off the job over growing contract and pension disputes that exist between labor groups and company management.

Substantial media attention has focused on the travel disruption that would be caused by a partial or full shutdown of United Airlines. This event would also affect United's fourth-largest business segment - - its United Loyalty Services subsidiary which is the operator of the Mileage Plus program. This Industry Analysis reviews how a strike would affect the marketing partners and 45 million members of Mileage Plus.

The Success of Mileage Plus

By any measure, United Loyalty Services ("ULS") and its Mileage Plus frequent flier program are very successful. United changed its corporate structure in 2002 by transferring responsibility for the operation of Mileage Plus to the wholly-owned United Loyalty Services subsidiary.¹ ULS also operates in e-commerce, travel clubs and media assets areas.

United divides its operations into five reporting segments: 1) North America, 2) Atlantic, 3) Pacific, 4) Latin America and 5) ULS. The largest of these is North America, which reported 2004 operating revenues in excess of \$10.5 billion.² ULS was ranked fourth (and ahead of Latin America) with \$822 million in revenues for 2004. Airline operations to Central and South America were placed fifth and generated \$406 million during the same year.

In total, ULS represented 5% of United's 2004 operating revenues; ULS revenues have grown by nearly 17% since 2002. Most tellingly, ULS was the only reporting segment with positive earnings for the last four years since 2001. During 2004 ULS generated positive earnings of \$302 million (defined as "earnings before special items, gain on sale of investments and reorganization items").³

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Frequent flier program revenues are largely generated through the sale of miles to other entities such as hotel chains, car rental companies, retailers and credit card issuing banks. IdeaWorks believes most frequent flier programs realize over 65% of their revenues from the sale of miles to banks issuing co-branded credit cards. . . and for some programs, the percentage is likely to be far higher. Applying this statistic to the 2004 revenues of ULS generates an estimated \$534 million contribution from United's co-branded credit card products. Any discussion about partner activity must begin with the program's primary partner - - the co-branded credit card issuing bank.

Bank One is a Key Partner

ULS and its relationship with credit card issuer First USA (an affiliate of Bank One and Chase) is of critical importance to United and contributed to the survival of the airline. Bank One provided DIP (Debtor in Possession) financing of \$300 million to United shortly after United filed for bankruptcy. This financing was contingent upon the continuation of the Mileage Plus Visa credit card. A financial adviser to United made the following statement in court documents:

“ . . . Pursuant to the First USA Agreement, First USA buys Mileage Plus miles from ULS that it then transfers to cardholders' Mileage Plus accounts when purchases are made on the First USA/United credit cards. The First USA Agreement provides a significant source of revenue to United. Because of the presence of this valuable and important contract and Bank One's desire to keep it in effect, Bank One was willing to provide a larger initial DIP loan than the other lenders . . . ”⁴

In effect, Bank One made pre-payments to ULS for the purchase of miles generated by the Mileage Plus Visa card relationship. But more importantly, the success of United's frequent flier program provided the collateral required to help save the airline. As demonstrated by consistently positive earnings, ULS/Mileage Plus has become United's only profitable reporting segment.

This is an important distinction for program partners and members. It conveys the importance that Mileage Plus has to United's management, creditors and investors. Any disruption to operations would impact the passenger revenues of the carrier. However, revenues generated by partner activities such as the sale of miles to Bank One, hotel chains, car rental companies and retailer partners would likely represent United's sole source of revenue in the event of a strike-caused shutdown of the airline.

The Partners of Mileage Plus

Mileage Plus and American AAdvantage share the distinction of being the largest and most sophisticated frequent flier programs. United, and its competitor American Airlines, each claim to have more than 45 million members⁵. Mileage Plus offers extensive partner reach into every category, such as hotels, car rentals and retailers.

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The following is a listing of the partner brands found at the Mileage Plus web site:⁶

Star Alliance Airlines – 14 Partners

Air Canada • Air New Zealand • ANA • Asiana • Austrian Airlines Group • bmi
LOT Polish Airlines • Lufthansa • SAS • Singapore • Spanair • Thai • US Airways •
Varig

Other Airline Partners – 6 Partners

Aeromar • Air China • Aloha • BWIA West Indies Airways • Cayman Airways • Emirates

Hotel Partners – 57 Brands

AmeriSuites • Best Western • Candlewood Suites • Clarion • Comfort Inn
Comfort Suites • Conrad • Country Inns & Suites by Carlson • Courtyard by Marriott
Crowne Plaza • Doubletree • Econo Lodge • Embassy Suites Hotels
Fairfield Inn • Four Points Hotels • Hampton Inn • Hilton • Hilton Garden Inn
Holiday Inn • Holiday Inn Express • Homewood Suites • Hotel Indigo
Hyatt Hotels & Resorts • InterContinental Hotels • Mainstay Suites
Marriott Hotels, Resorts & Suites • New Otani Hotels • Omni Hotels • Park Hyatt Hotels
Park Inn • Park Plaza Hotels & Resorts • Preferred Hotels & Resorts Worldwide
Prime Hotels & Resorts • Quality Inns, Hotels and Suites • Radisson Hotels & Resorts
Regent International Hotels • Renaissance Hotels, Resorts & Suites • Residence Inn
Rodeway Inn Hotels • Scandic • Shangri-La Hotels & Resorts
Sheraton Hotels & Resorts • Sleep Inn • SpringHill Suites • St. Regis Hotels & Resorts
Staybridge Suites • Summerfield Suites • Summit Hotels & Resorts
The Luxury Collection • TownePlace Suites • Traders Hotels • W Hotels
Wellesley Inns & Suites • Westin Hotels & Resorts • World Hotels
Wyndham Hotels & Resorts

Car Rental Partners – 8 Partners

Alamo Rent A Car • Avis • Budget Rent a Car • Dollar Rent A Car • Hertz • National
Sixt Rent a Car • Thrifty Car Rental

Communication Partners – 4 Partners

Sprint • Nextel • Network Solutions • T-Mobile Hotspot

Financial Service Partners – 30 Partners Globally

Ameritrade • Awards for Mortgage & Real Estate • Bank One Home Loans • Diners Club
E-LOAN • Equifax • E*TRADE Financial • Fidelity • H&R Block • LendingTree
Mileage Plus Visa • PMP Relocation Services • Credit Cards – offered in 17 countries

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Dining, Retail and Groceries – 26 Partners

AirMiles for Moving • Butterfield Blooms • Dominick's • Flowers USA • FTD.com
Genuardi's • Gift Sense • Give Miles • Great Expectations
Hartwick & Grove Wine Merchants • iGourmet.com
Mileage Plus Online Mall – over 80 online merchants • Mileage Plus Vehicle Miles
Neiman Marcus • NetFlix • Organic Bouquet • Pak'n Save • Pavilions • Safeway
Sony Connect • Sony Style • Teleflora's Flower Club • United Cruises.com
United Vacations • Vons • Wine.com

United has connected its Mileage Plus program with 145 brands across the globe. The list of partners includes leading corporations such as: Ameritrade, Avis, Hertz, Hilton, InterContinental Hotels, Lufthansa, Marriott, Nextel, Safeway, Sprint, Starwood and US Airways. Each of these partners have placed significant reliance upon the loyalty marketing power of Mileage Plus and the competitive advantages provided by frequent flier participation.

The Impact on Mileage Plus Partners

The shutdown of the airline as a result of labor unrest would send ripples through the categories most aligned with frequent flier programs such as hotel and car rental companies. The impact of a catastrophic event was anticipated by the carrier's co-branded credit card partner in a disclosure made by Bank One in its 2002 annual report:⁷

“ . . . If United Airlines is unsuccessful, and in the worst scenario is liquidated, Card Services' net income would be negatively impacted by the dissolution of the marketing agreement, loss of fee and interest income and increased marketing expense to encourage customers to continue card usage. Management expects the amount could be as high as several hundred million dollars. . . ”

Bank One - - as an investor and partner - - felt compelled to disclose this risk to investors and the financial community. While Bank One's worst-case scenario may provide an extreme example, the effect on other partners could be just as significant. The impact of a strike would have these tangible and intangible outcomes:

- **Up to 177,000 potential customers lost daily.** The strike would cause an immediate disruption in the travel industry. While some travelers would switch brands - - many would simply remain home and avoid unessential travel. Based upon 2004 results, United carries more than 177,000 passengers on an average day.⁸
- **At least 4,600 reward travelers disrupted daily.** Based upon 2004 reward redemptions, IdeaWorks estimates over 4,600 passengers travel each day using Mileage Plus reward tickets.⁹ Actual activity would likely decrease prior to a strike as members avoid reward travel during a period of possible work stoppage.

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- **Reduced loyalty advantage.** Partners rely upon Mileage Plus to create a competitive advantage over companies that don't participate in the program. Members are likely to switch to other programs concurrent with flying another airline such as American or Frontier.
- **Negative perception by members.** Strikes create painful experiences for customers, employees, management and investors, a drama that would be on full display in the media. Mileage Plus members are likely to resent the inability to accrue miles in their favorite program through flight activity on United. Elite members would dislike the loss of benefits after switching to other carriers. For partners, it's a case of guilt-by-association - - the relationship with United may remind customers of the inconvenience caused by the strike.

The overall impact upon partners would largely be determined by the severity of a shutdown and the likelihood of a financial meltdown of the airline. A long strike would handicap the ability for Mileage Plus to remain an effective marketing tool when the work stoppage ends and flights resume.

The Impact Upon Mileage Plus Members

Investors, creditors, suppliers, union leaders, employees, management and politicians would actively watch the behavior of consumers. The shutdown of United would create immediate chaos in the airline industry. Somehow, United would need to accommodate an estimated 177,000 passengers each day. Actual numbers would likely be lower, as reservations drop in anticipation of a work stoppage. However, thousands of passengers would be squeezed onto United's remaining flights and the flights of its partners and competitors.

A work stoppage would test the limits of United's participation in the Star Alliance. Presumably, as a close-knit partnership, the bulk of passenger accommodation would fall to these 14 airlines: Air Canada, Air New Zealand, ANA, Asiana, Austrian Airlines Group, bmi, LOT Polish Airlines, Lufthansa, SAS, Singapore, Spanair, Thai, US Airways and Varig.

Unfortunately, the Star Alliance network provides little coverage for United Airlines in the western United States and the Midwest. Undoubtedly, United would be required to establish agreements with major competitors such as American and Frontier to accommodate passengers - - and this would likely include arrangements to fly reward travelers. All of this activity would occur at the expense of United Airlines.

Reliance on e-ticketing would probably United to staff its airport counters to provide accommodation assistance; passengers can't simply walk to another airline in an industry where printed tickets have largely disappeared.

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Members would likely react to a strike through the following behaviors:

- **Switching to other brands.** Members would be required to switch their loyalty to competing brands such as American and Frontier. Permanence of these brand changes would be influenced by the quality of assistance provided by United during the stoppage and the duration of a shutdown. Competing airlines would likely try to poach United's elite members through targeted offers.
- **Increased reliance on partner rewards.** Partner reward activity would increase dramatically, and could approach run-on-the-bank levels as members seek safe places to spend their account balances. Increased redemption activity has probably already occurred on the Star Alliance carriers. However, these alternatives are far less attractive if the strike occurs during the peak summer travel season - - when many of these carriers already have little remaining reward availability.
- **Decreased Mileage Plus activity.** Members would worry over the fate of United Airlines and their Mileage Plus account balances. This would likely result in decreased accrual of miles through partner activities, to include the credit card. Similar to competing airlines, other co-branded credit card issuers would likely try to poach Mileage Plus Visa cardholders through targeted offers.

United's elite travelers - - those with Premier, Premier Executive and 1K status - - would be the most angry component of the Mileage Plus membership base. United would likely work to sooth and preserve these relationships with extra customer service and bonus offers. For United to recover after a shutdown, it must woo its elite members back with an abundance of perks and personal attention.

Strategy Suggestions for Partners

What should a partner do when a major airline may experience a work stoppage and shutdown? The simple answer is "plan, communicate and act."

United does not appear to be leading by example in the communication aspect of its customer relationships. While news of a pending strike swirls in the media, the company's web site pays scant attention to the issue. The web site does not provide a link for customers to read the company's position or to help prepare travelers for a strike. United's April 22, 2005 press release provides details on United's pension difficulties but fails to mention that labor groups are threatening a work stoppage.

Rather than ignore the possibility of a strike, partners should consider the following actions in preparation for a shutdown:

- **Review the promotion schedule.** Partners should tread carefully when launching promotions in the near term. Mileage bonus offers that coincide with periods of labor strife or the shutdown of an airline should be avoided.

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- **Create alternatives for consumers.** Companies with multiple partner relationships have a fortunate advantage by not relying upon any one single frequent flier program. Partners should consider adding more choices for consumers to accrue frequent flier mileage through other program relationships.
- **Recognize elite travelers.** All of United's passengers will experience pain during a shutdown. However, the pain will be acute for the elite members of Mileage Plus. Very likely, these very frequent fliers are valuable customers for partners too. Partners should consider programs that provide extra recognition for elite members such as upgrades or other perks, as the loyalty of these prized customers will be up-for-grabs during a strike.
- **Don't burn bridges with United.** Market forces and investors will ultimately determine the fate of United Airlines. As a major carrier, United has tremendous resources and staying power and will likely survive an employee strike. Partners should demonstrate their loyalty by supporting United and Mileage Plus during an incredibly challenging period for management. Companies usually remember who their true friends were during a crisis.
- **Consider creative responses.** Partners may even consider selling non-airline rewards to Mileage Plus as a method to maintain reward alternatives during a shutdown. While cash may be in short supply for United, partners could suggest in-kind payment through mileage credits tied to bonus offers.

The airline industry is experiencing tremendous change, and the pace of this change will quicken during 2005. Consumers seem to have an insatiable demand for cheap air travel. However, investors have a finite supply of money and can't be relied upon to continue subsidizing bargain-priced tickets. Clearly an oversupply of legacy airline capacity exists in the United States. The troubles experienced by the major airlines will not end any time soon. Companies that rely on frequent flier partnerships should consider these issues when designing their marketing strategies and invest resources in loyalty marketing programs that are the most likely to thrive in today's economy.

About IdeaWorks: IdeaWorks was founded in 1996 as a consulting organization building brands through innovation in product, partnership and marketing and, building profits through financial improvement and restructuring. Its international client list includes the hotel, airline, marine, railroad, consumer products and health care sectors. IdeaWorks specializes in brand development, customer service improvement, customer research, competitive analysis, creating partner-marketing strategies, cost reduction programs and business restructuring. IdeaWorks brings value as a consultant by researching the expectations of the customer, learning from the wisdom of the client organization and applying innovative ideas to create solutions for clients and consumers. Learn more by visiting: IdeaWorksCompany.com

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Sources used in this Industry Analysis: Please refer to the Endnotes for a description of sources.

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Endnotes:

¹ 2003 United Airlines annual report, Segment Information section.

² All 2004 statistics from the 2004 United Airlines annual report, Segment Information section.

³ 2003 and 2004 United Airlines annual reports, Segment Information section.

⁴ Statement made by Todd R. Snyder, Rothschild Inc., United's Petition to Obtain Postpetition Financing, December 8, 2002.

⁵ For United: 2004 Annual Report. For American: Advantage web site at OrderAAMiles.com.

⁶ Snapshot of partner listing taken on May 16, 2005 at United.com.

⁷ Bank One Corp., Financial Review portion of the 2002 Annual Report, Page 47.

⁸ U.S. Department of Transportation, Form 41, T-1 or T-3 data for United Airlines.

⁹ Reward travel of 1.7 million reported by United in the 2004 Annual Report and divided by 365 days.