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## **Frequent Flier Miles Gain Value But Redemption Remains a Consumer Complaint**

*Mileage Value Index for jumps in 2005, reward issues continue to plague consumers and United Airlines offers an alternative to credit card miles.*

The IdeaWorks Company has analyzed the value of one of the world's most unique currencies - - the frequent flier mile. Airline bankruptcies, rising fuel prices and low fare competition have impacted frequent flier program members in the United States and throughout the world. Frequent flier programs do not exist in a vacuum and have been affected by the extreme turbulence afflicting the airline industry. These conditions have created a confusing environment for program members and marketing partners. By some measures, the value of a frequent flier mile seems to be increasing, and yet other measures suggest a troubled mileage marketplace.

The Mileage Value Index computed by the IdeaWorks Company describes fluctuations in mileage values for the most recent 12 years of the 25-year history of the major U.S. programs. The buying power of frequent flier miles, as measured by the number of miles required to buy a typical reward ticket for U.S. domestic travel, may have hit bottom during 2004. Frequent flier miles became more valuable during 2005 purely due to the airline industry's ability to increase average ticket prices; the mileage value increase was not due to a reduction in the number of miles required for a free ticket.

Frequent flier program members have seen the value of their miles decline since 1994 through multiple pricing and program changes:

- In 1994, when the prevailing U.S. reward level was 20,000 miles, the typical frequent flier mile would purchase **2.2 cents** of reward travel.
- During 1995 most airlines raised their domestic U.S. reward level to 25,000 miles and the value of a frequent flier mile dropped by 20% to **1.8 cents**.
- Since 2001, falling domestic air fares have brought the value of a frequent flier mile down to **1.4 cents** in 2004 - - its lowest level since 1994.

Frequent flier program members can take some comfort in the increased buying power of frequent flier miles, which rose to **1.6 cents** in 2005. The increase was driven by the 12.7% jump in the average fares used by IdeaWorks to define a typical reward ticket.

**Frequent Flier Rewards and Average Fares**

IdeaWorks researched frequent flier reward levels and average air fares in key U.S. markets to calculate a Mileage Value Index that measures the buying power of frequent flier miles for a 12-year period from 1994 through 2005:

<b>Table 1: Mileage Value Index Calculated by IdeaWorks</b>											
<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
\$0.022	\$0.018	\$0.018	\$0.019	\$0.019	\$0.020	\$0.022	\$0.017	\$0.016	\$0.017	\$0.014	\$0.016

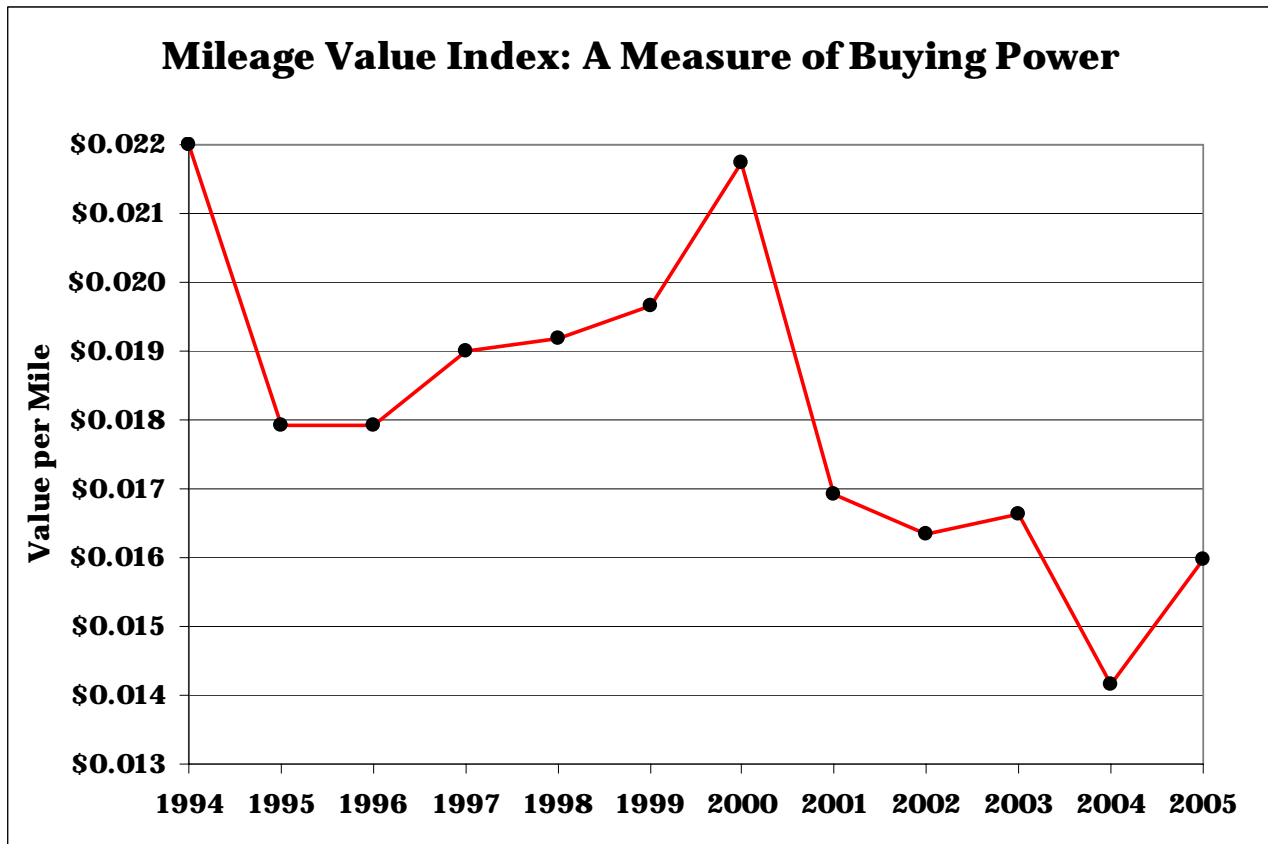
IdeaWorks began this analysis by creating a market sample to represent the value of a typical frequent flier reward ticket. The nine U.S. markets listed in Table 2 are noted for their high passenger volume and have also been referenced in the travel media as top frequent flier reward choices:

<b>Table 2: Key Frequent Flier Reward Markets</b>
Atlanta - New York
Boston - Los Angeles
Chicago - Los Angeles
Chicago - New York
Los Angeles - New York
Los Angeles - Washington DC
Miami - New York
New York - Orlando
New York - San Francisco

Average air fares were assigned to each market based upon data available from the U.S. Department of Transportation and the Air Transport Association (see note on page 9). Passenger volumes for each market were used to assign a weighted value to each air fare. The result created an average weighted air fare for each year from 1994 to 2005.

The influence of the “Big Five Airlines” (a name applied for this analysis to American, Continental, Delta, Northwest and United) on frequent flier programs looms large in the travel industry due to the significant size and presence of these airlines. Their dominance has effectively established the 25,000 mile reward as the de-facto standard domestic reward level. The domestic travel reward easily dwarfs all other reward choices in terms of member popularity.

The “Mileage Value Index” graph below displays the buying power of a frequent flier mile (from Table 1), which is calculated by dividing the weighted air fare by the standard reward level for each year of the 1994 through 2005 analysis period:



### **Reward Levels Impact Mileage Values**

For many frequent flier program members, 1995 was made significant by the dramatic increase in the number of miles required for reward travel in the continental United States. During 1995 the standard reward level for most airlines increased from 20,000 miles to 25,000 miles - - a level which still dominates frequent flier reward travel today.

Among the larger airlines, Alaska remains unique for its 20,000 mile reward level, while Frontier clearly breaks ranks with all other airlines with its 15,000 mile domestic travel reward. The 15,000 mile level has remained a constant since Frontier’s EarlyReturns program was unveiled in 2001. Southwest Airlines and AirTran appear to also offer exceptional value with a free coach ticket after eight roundtrip flights. By comparison, earning a comparable ticket on American Airlines could require 25 roundtrips at the minimum mileage accrual of 500 miles per one way trip.

The dramatic drop in the Mileage Value Index from 1994 to 1995 can be attributed to the increase of the standard domestic reward level to 25,000 miles. The gradual increase from 1996 to 2000 reflects the relative health of the airline industry and its ability to increase average air fares. The value of reward travel, as reflected by average air fares for the market sample, entered a period of deep descent from 2000 to 2004.

The Big Five Airlines have maintained the price of reward travel at 25,000 miles - - even while the value of air travel has dropped substantially. This has resulted in a decline in the value and buying power of the frequent flier miles earned by program members. The Big Five Airlines would be required to drop their standard reward level to 18,000 miles to equal the 2.2 cent mileage value offered to members back in 1994.

### **Conflicting Messages on Mileage Value**

The increase calculated by IdeaWorks is at odds with the widespread portrayal in the media of the declining value of miles due to growing consumer frustration over a perceived lack of reward seat availability. The headline in the April 26, 2006 business section of the International Herald Tribune is fairly typical, “**Will success doom frequent-flier miles?**” The following quote from the article nicely sums up the problem facing the major programs:

*“Frequent-flier miles are now suffering through their own inflationary spiral. With all the miles now floating around and with planes almost full, it's become impossible to claim rewards on a lot of routes.”*

Consumers appear to simultaneously love and hate the frequent flier programs offered by major airlines. However, more frequent flier program members enjoyed free travel during 2005 with reward travel surpassing the 2004 redemption levels, as reported in the 10-K SEC filings of Alaska Airlines, America West, Continental Airlines, Delta Air Lines, Northwest Airlines, Southwest Airlines and United Airlines. Reward travel activity for American Airlines remained unchanged, and dropped at US Airways during 2005.

Even as consumers complain in the media about frequent flier programs, they bid up the value of a mile above the level calculated by IdeaWorks. Recent online auction activity at eBay.com to benefit a children's charity generated an average price of **2.6 cents** per frequent flier mile. Bidders chose from 25 auction items featuring miles from five major U.S. airlines. While it's a small sample, the auction did generate substantial activity with over 5,000 bids made by frequent flier program members. Keep in mind that charity auctions can somewhat inflate the value of the items auctioned.

Other indicators in the mileage marketplace suggest consumers are becoming less responsive to the benefits promised by traditional frequent flier programs. Airline credit cards once commanded annual fees in the range of \$65 to \$95. Now many of these programs are apparently facing difficulties getting enough applications and are waiving annual fees for one or two years and offering thousands of bonus miles.

For example, consumers can choose a Delta SkyMiles American Express credit card with no fee for the first year and 15,000 bonus miles. Not to be outdone, United Airlines just launched its new Visa credit card with no first year fee and a 17,500 bonus.

Competing travel reward credit cards offered by major banks have also hampered the ability of airlines to keep cardholders and maintain their annual fee structures. The Chase Flexible Rewards Visa Signature represents a typical bank travel card. It doesn't charge annual fees and allows consumers to earn points that can be exchanged for a ticket on any airline purchased by the bank for the consumer.

The Chase program does require cardholders to book 21 days in advance, stay over a Saturday night, and pay a \$14.95 ticketing fee. But the bank doesn't restrict travel with blackout dates and will spend up to \$400 to purchase a ticket for domestic U.S. travel. These benefits, when combined with no annual fee, have prompted many consumers to switch from airline miles to bank points for their credit cards.

### **United Airlines Rolls Out an Alternative to Miles**

On May 1 United and Chase launched the Mileage Plus Choices credit card as a product that "goes beyond miles with enhanced redemption options."<sup>1</sup> In a likely nod to consumer dissatisfaction over mileage devaluation, the card introduced a new loyalty currency called "Choices" that bypasses the need for members to rely upon traditional reward availability.

The Choices currency represents a hybrid between traditional airline miles and the points offered by bank travel credit cards. The concept is very similar to that introduced by Air New Zealand when it replaced its mileage program with Airpoints Dollars in late 2004. Air New Zealand travelers now earn Airpoints Dollars that can be spent like cash for the purchase of tickets on every seat and every flight.

The Choices program launched by United Airlines essentially allows cardholders to earn miles having special redemption privileges. The Choices currency adds to a cardholder's traditional mileage balance - - or can be redeemed for a special list of rewards. \$1,000 in charge activity can represent 1,000 Mileage Plus miles or 1,000 Choices. The cardholder's 1,000 Choices could be applied as \$10.00 toward the purchase of United tickets, or \$8.00 toward hotel accommodations or car rentals at [United.com](http://United.com).

The Choices currency allows Mileage Plus members the freedom to purchase “Any available seat, any United flight, anytime” at United.com. However, freedom does come at a price - - Choices redeemed for airline tickets are effectively valued at **1 cent** per mile and those redeemed for hotel accommodations and car rentals are valued at **8/10 of a cent (\$.008)** per mile.

United’s introduction of the Choices currency represents a major product innovation and a milestone in the ongoing development of frequent flier programs. It also may represent an admission of weakness - - miles alone are no longer attractive enough to hold consumer interest for airline credit cards. United and Chase were compelled to offer an extravagant mix of bonus benefits, fee waivers and a new dollar-based currency in their need to attract cardholders. The consumer truly benefits from this competition as the 17,500 Choices bonus reflects an unprecedented \$175.00 gift of virtually unrestricted air travel from United and Chase.

Ongoing Choices participation, after the generous 17,500 bonus, may provide a lower level of return for consumers than existing bank travel cards. The Chase Flexible Rewards Visa Signature card referenced earlier in this report provides up to \$400 in travel value for \$25,000 in consumer charges. United’s Mileage Plus Choices credit card would require \$40,000 in consumer charges to generate a \$400 purchased travel benefit. The bank travel card does have restrictions such as a Saturday night, but it also doesn’t charge an annual fee.

United’s Choices currency, while offering the attractive benefit of easier reward redemption, may deliver less cash value than bank travel cards and traditional airline rewards because of the one cent per mile valuation (1 mile = 1 Choice = 1 cent).

### **The Power of Frequent Flier Programs**

IdeaWorks predicts the launch of United’s Choices currency represents the first of many changes that will be made to the frequent flier programs offered by major airlines. Airlines with large credit card portfolios, such as Delta and American, will likely enhance and improve upon United’s new Choices initiative. Allowing cardholders to convert their charge volume into the purchase of tickets online is a very appealing offer. This benefit will likely be matched by United’s competitors and may someday apply to all miles earned by members of the major programs.

The reward mechanism may change, but the concept of rewarding customers for their loyalty will likely continue because it delivers results. Research conducted at the Graduate School of Business at the University of Chicago (in conjunction with the China Europe International Business School) on the topic of reward motivation<sup>2</sup> demonstrates the power of currency-based systems to motivate consumer behavior.

Humans are encouraged at an early age to maximize point accrual; more points scored on a school exam are rewarded with parental praise. As adults, money is a primary motivation to perform work even though the money itself is of no value - - it's the merchandise and experiences that money purchases that should provide the actual satisfaction.

Perhaps consumers are simply addicted to the behavior of mileage accrual. This may explain why members express dissatisfaction with airline reward availability and yet continue to participate in frequent flier programs. The University of Chicago research demonstrated consumer behavior could be manipulated through the introduction of a points-based currency as a mechanism to earn rewards.

The study found research subjects would go through extra effort, and even make unattractive choices, to pursue greater point accumulation. In one case, research subjects were divided into two groups. The first group (the control group) was asked to choose a particular banking relationship and payout. The second group was asked to consider the same banking relationships but were awarded points for their choices. It was explained the awarded points could be redeemed for the same payout.

Under both scenarios the banking relationship and eventual rewards were identical, the only difference being the inclusion of a points-based currency for the second group. The ability to earn points, rather than a direct reward, affected the response rate by more than 150%. The same behavioral trend was noted in all of the cases associated with the research. The University of Chicago research also indicates that accrual and reward ratios can be manipulated to improve desired results.

Mileage accrual behaviors may explain why consumers continue to participate in frequent flier programs. This may suggest major airlines can simply continue to offer miles and ignore consumer complaints about reward redemption. However, the programs offered by the major airlines do not exist in a vacuum and competitors are only too willing to poach their members through better offers. Clearly, frequent flier programs represent a critical marketing tool for major airlines and their competitors.

### **Conclusions and Observations**

The water has become clouded by disturbances in the airline industry. The impact of airline bankruptcies, rising fuel prices and low fare competition continues to reverberate through the industry, frequent flier programs and partner relationships. Attempts by IdeaWorks to place a value on frequent flier miles by analyzing reward buying power provides a compelling measurement. The decline of mileage value since 2000 appears to parallel consumer dissatisfaction with frequent flier programs. Financially impaired airlines, while eager to generate profits from the miles sold to their program partners, can hardly afford to set aside valuable seats for free travel. Or can they?

United Airlines appears to have found a method to provide Mileage Plus cardholders with new reward opportunities that bypass traditional mileage redemption. This announcement follows recent moves by major airlines to boost existing mileage-based reward charts with new options involving hotel accommodations, car rentals, dining, airport club membership and online auctions. It appears the major airlines are gradually recognizing the limits of the traditional 25,000 mile domestic reward.

The redemption problem may have bottomed out during 2004. Alaska Airlines, America West, Continental Airlines, Delta Air Lines, Northwest Airlines, Southwest Airlines and United Airlines all report carrying more frequent flier reward travelers in 2005 than in 2004. This may suggest airlines recognized the severity of the availability problem and allocated more seats for reward travel. Or, 2005 might be an aberration and reward redemption might decrease during 2006.

The major airlines have many reasons to fully support their frequent flier programs. Research indicates frequent flier programs can successfully alter consumer behavior and airline income statements demonstrate these programs are highly profitable. United reported its Mileage Plus program contributed over \$800 million<sup>3</sup> to the airline during 2005. These factors suggest frequent flier programs are simply too important to the success of major airlines to allow mileage values to continue their drop.

IdeaWorks believes the major airlines are responding to market forces that call for greater attention to the needs of frequent flier program members. The competitive issues facing the frequent flier programs offered by major airlines have increased. All of the largest low fare airlines in the United States now offer frequent flier benefits and generally provide a greater reward payout. The frequent guest programs offered by hotel chains have become a formidable force and generally offer reward credit cards and an attractive array of program partners. Bank travel cards also represent an attractive reward alternative for a consumer's charge activity.

What is the value of a frequent flier mile in this challenging environment? The valuation computed by IdeaWorks indicates it's **1.6 cents**. A small sample of online auction activity suggests consumers are willing to pay **2.6 cents** per mile. United's recent launch of its Choices currency generates a value of **1.0 cent** per mile for cardholders redeeming their bonus to buy air travel. Perhaps value can also be affected by consumer perception regarding the ease of converting miles into a tangible reward such as airline tickets.

Regardless of any attempt to assign a value, the prevailing wisdom appears to be true - - there are simply too many miles chasing too few seats.

**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. Learn more at [www.IdeaWorksCompany.com](http://www.IdeaWorksCompany.com).

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**Sources for Mileage Value Analysis and Footnotes:** Information describing frequent flier reward levels is from the web site operated by each airline program. Air fares from 1996 through 2005 are from the 3<sup>rd</sup> quarter Consumer Air Fare Report published by the USDOT Office of Aviation Analysis. Air fares for 1994 and 1995 were calculated by applying the Annual Passenger Prices data (published by the Air Transport Association) to 1996 USDOT Consumer Air Fare Report results.

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<sup>1</sup> “United Reinvents Airline Loyalty Programs; Partners with Chase to Launch Mileage Plus Choices” May 1, 2006 press release, [United.com](http://United.com).

<sup>2</sup> Hsee, C. K., Yu, F., Zhang, J. & Zhang Y. (2003) Medium Maximization. *Journal of Consumer Research*. 30, 1-14.

<sup>3</sup> UAL Corporation (United Airlines) 2005 SEC Form 10-K filing.