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No-Annual-Fee Credit Cards in the Airline Industry Industry Analysis from IdeaWorks

Co-branded card offers from American, Delta and United are not easily found and are not promoted alongside their fee-based credit cards.

The IdeaWorks Company has reviewed the no-annual-fee credit cards associated with the frequent flyer programs of 18 U.S. based airlines. The airlines included in the survey are: AirTran, Alaska, Aloha, America West, American, ATA, Continental, Delta, Frontier, Hawaiian, Independence Air, jetBlue, Midwest, Northwest, Southwest, Spirit, United and US Airways. As a group, these airlines represent over 96% of the revenue passenger miles flown by U.S. based airlines.

All of the original co-branded credit cards introduced by the major airlines assessed annual fees to cardholders. While the rest of the credit card industry switched to no-annual-fee programs, the major airlines were unique in their continued ability to charge annual fees. However, the ever-competitive airline industry is finally acknowledging the pressures of the credit card marketplace with 3 major airlines now offering no-annual-fee cards to meet the growing demands of fee-adverse consumers.

“Airlines typically have held back from offering free credit cards to their customers,” said IdeaWorks president Jay Sorensen. “But cracks in the wall are beginning to show with the appearance of no-annual-fee offers from a growing number of airlines.”

The no-annual-fee credit cards offered by American, Delta, Frontier, Midwest and United are described on page 4 of this industry analysis.

Overview of Co-Branded Credit Cards

Co-branded credit cards allow frequent flyer program members to earn extra miles from the charge activity associated with card use. These credit cards are currently offered by all major airlines with a growing number of new entrant and low-cost carriers now offering the cards to their frequent flyer program members. However, 3 of the airlines in the survey don't offer mileage credit cards: Independence Air, jetBlue and Spirit. Competitive pressure within the airline industry suggests these 3 airlines may soon include mileage-earning credit cards as a feature of their frequent flyer programs. ATA recently joined the ranks of airlines offering co-branded cards just 2 weeks prior to the issuance of this report.

Annual fees have traditionally been a component of the co-branded credit card products developed by major airlines and their bank partners. These fees typically are \$40 to \$65 per year for regular credit cards with higher fees assessed for premium cards offering more features. The growing presence of co-branded credit cards in other industries has placed competitive pressure on the fee-based credit card strategy.

Consumers can now opt for no-annual-fee credit cards and earn awards in a wide array of industries such as retail, petroleum, entertainment and lodging. For example, no-annual-fee cards are now offered by 8 of the 16 frequent guest programs associated with the largest U.S. based hotel companies. Petroleum is another popular category with 8 gas-rebate cards offered by major petroleum companies. “Me too” cards that provide free airline travel are now offered by major credit card banks such as Bank One, Capitol One, Chase, MBNA and US Bank.

How Co-Branded Credit Cards Work

Co-branded credit cards bring together an issuing bank and an award sponsor, such as an airline, hotel chain or retail group. Issuing banks, such as MBNA, Juniper and American Express, are responsible for all credit and transaction activities associated with the credit cards. It's the banks that issue the plastic cards, determine consumer creditworthiness, mail out monthly statements and provide customer service. The role of the award sponsor is somewhat limited; the airline is responsible for getting card applications into the hands of consumers and for delivering the awards associated with the co-branded card.

Fees paid by merchants accepting credit cards provide the financial power for co-branded cards. Anytime a card is accepted for payment of merchandise and services, the merchant pays a small percentage, typically around 1.5%, as a processing fee. The issuing bank allows the award partner to receive a significant portion, usually around 70%, of the merchant processing fee. Negotiations over the amount paid to the award partner are a primary component of co-branded credit card relationships.

Banks make money by issuing credit cards to creditworthy consumers. It's no surprise frequent flyer program members are usually very affluent and are very safe credit risks. Banks realize a small share of the merchant processing fee but usually receive all of the revenues associated with interest charges, late payment and other account-related fees, balance transfer and cash advance fees, and any annual fees.

Airlines make money by charging the issuing bank for each mile contributed to the cardholder's frequent flyer account. The industry average is approximately one penny per mile. The quality and size of an airline's frequent flyer membership portfolio is an important factor in rate negotiations.

The economics of co-branded credit card programs can be illustrated by applying them to a major carrier such as American and a smaller national carrier such as Frontier.

American Airlines likely commands a significant premium because it offers access to over 45 million AAdvantage members and a worldwide flight network. If only 3% of American's members hold an AAdvantage credit card, and make monthly charges of \$1,000, American would receive \$162 million from the bank each year for the purchase of frequent flyer miles (at a penny per mile) posted to cardholder accounts. American does not provide detailed information about its co-branded credit card in its Form 10-K, but actual results are likely to be well in excess of \$200 million annually.

Frontier Airlines is on the smaller side of the size spectrum with just over a million members in its EarlyReturns frequent flyer program. But even at its small size, its member portfolio was attractive to issuing banks. The benefits of the program to Frontier have been impressive. Frontier's most recent annual report reveals it received an advance payment of \$10 million as a component of its co-branded credit card relationship with Juniper Bank. Frontier also benefited in other ways, and attributed an over 70% increase in frequent flyer membership to its new co-branded credit card program during its most recent fiscal year.

Mileage-earning credit cards and their companion frequent flyer programs have become important product distribution methods for the airlines. The sale of frequent flyer miles to banks and other program partners such as hotel chains and car rental companies generate millions of dollars at rates that can be more profitable than the direct sale of tickets to consumers.

During a recent visit to an online travel website, roundtrip travel between Chicago and Los Angeles was available from a major airline for **\$187** roundtrip. The same trip could be booked using a frequent flyer award requiring 25,000 miles. Theoretically, the award ticket could be earned through \$25,000 of charge activity on an airline mileage credit card. If the issuing bank pays a penny for each mile posted to the cardholder's frequent flyer account . . . those pennies add up to **\$250**. Using these assumptions, it's easy to understand why the frequent flyer programs operated by the major airlines are sometimes considered to be one of the few remaining profit centers in the industry.

The Arrival of No-Annual-Fee Mileage Credit Cards

It's in the best interest of the airlines and the issuing banks to maintain this lucrative level of financial activity. The major airlines have been testing various combinations of product benefits to maintain market share in the face of competing card offers from inside and outside the airline industry. American, Delta and United are the only major airlines that make no-annual-fee credit cards available to all frequent flyer program members. However, the cards are only available upon request - - and are not promoted at the airline web sites. Frontier and Midwest have moved past this hidden-promotion phase and now include no-annual-fee credit cards as a regular choice on their web sites.

The 5 airlines offering no-annual-fee credit cards also offer versions that charge annual fees. The distinctions between the two versions are the number of miles earned by members for charge activity.

Traditional fee-based mileage credit cards earn 1 mile for every \$1 of charge activity. The airlines and their issuing bank partners have reduced the mileage payout to accommodate the loss of annual fee revenue. As a result, the no-annual-fee credit cards offered by the 5 airlines reward cardholders with 1 mile for every **\$2** of charge activity (equating ½ mile per dollar charged).

“The no-annual-fee credit cards offered by the major airlines are difficult to find,” said IdeaWorks president Jay Sorensen. “Frontier and Midwest readily promote the no-annual-fee cards at their web sites. The American, Delta and United offers are a bit more elusive and are not mentioned on the airline web sites, but are available to consumers who call the telephone application line and request the cards by name. It appears these cards are reluctantly offered by these airlines to compete with other cards.”

The following provides an overview of the no-annual-fee credit cards to include “where to apply” information:

American AAdvantage Bronze MasterCard

Mileage offer: 1 mile for each \$2 of net charge activity
Standard bonus offer: 2,500 bonus miles after first use of the card
To apply: Call 800-359-4444 (issued by Citi)
Web site: Information is not available at the airline web site

Delta SkyMiles Options Card from American Express

Mileage offer: 1/2 mile for each \$1 of net charge activity
Standard bonus offer: 1,000 bonus miles after first use of the card
To apply: Call 800-223-2670
Web site: Information is not available at the airline web site

Frontier Airlines Platinum MasterCard

Mileage offer: 1 mile for each \$2 of net charge activity
Standard bonus offer: 2,500 bonus miles after first use of the card
To apply: Call 866-750-6024 (issued by Juniper Bank)
Web site: Visit www.FrontierAirlines.com to apply

Midwest Airlines Platinum MasterCard

Mileage offer: 1 mile for each \$2 of net charge activity
Standard bonus offer: 2,500 bonus miles after first use of the card
To apply: Call 866-750-6024 (issued by Juniper Bank)
Web site: Visit www.MidwestAirlines.com to apply

United Airlines MileagePlus No Annual Fee Visa

Mileage offer: 1 mile for each \$2 of net charge activity
Standard bonus offer: None
To apply: Call 866-422-6566 (issued by Bank One)
Web site: Information is not available at the airline web site

Airlines, to include those not listed above, may occasionally make special offers to frequent flyer program members for no-annual-fee credit cards via direct mail. These offers may include special features, such as a higher mileage bonus, after first use of the card.

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.

Sources for the No-Annual-Fee Mileage Credit Card Analysis: Unless indicated otherwise, all data is from a review of airline web sites and calls placed to issuing bank call centers during August 2004. U.S. airline industry statistical information is from a variety of sources such as the Air Transport Association web site and the financial reports issued by individual airlines.

Disclosure: IdeaWorks makes every effort to ensure the quality of the information available in this report. Before relying on the information, readers should obtain any appropriate professional advice relevant to their particular circumstances. IdeaWorks does not have a client relationship with the companies included in this analysis. IdeaWorks cannot guarantee, and assumes no legal liability or responsibility for the accuracy, currency or completeness of the information.

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