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Miles ahead: How to improve airline customer-loyalty programs

Without a new approach, airline loyalty programs risk alienating many customers.

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Since American Airlines created the industry's first successful[1] customer-loyalty program, in 1981, almost every carrier has followed suit. These programs are hugely important: they encourage customers to fly an airline that otherwise might not be their best choice for a trip. And over time, airlines have learned that frequent-flier miles from such programs are a valuable, aspirational currency they can sell to third parties.

The result has been a boom in the number of miles—which has not, however, been balanced by a similar increase in the number of seats that can be redeemed for them. We estimate that more than 30 trillion frequent-flier miles are currently sitting unspent in accounts. That was enough to let almost every airline passenger in the world redeem miles for a free one-way flight in 2017—if miles could be redeemed for trips without restrictions.

In fact, outstanding balances of miles are becoming much harder to redeem, so programs created to make customers more loyal actually risk alienating them. In this article, we'll show how airlines have begun to rethink the way they handle redemptions and suggest some ideas on how they could reengage customers by broadening redemptions further.

Successful airline loyalty programs generate lots of miles

Airline customers like miles. Research shows that for certain business travelers, earning them may be the most important decision factor of all.[2] At any rate, many business travelers see collecting miles as a perk of the job. Stories abound of them going out of their way to fly with this or that carrier to earn enough miles to reach its next status tier or to redeem their miles for a dream vacation.

The ability to save up miles for such trips is the reason many customers enroll in customer-loyalty programs in the first place. Eighty percent of all miles are redeemed for flights. (In many programs, they can also be redeemed for hotel stays, car rentals, and consumer products.) In a classic program, 20 round-trip economy-class flights from Europe to North America, at a total cost of around $20,000, can earn a passenger enough miles to redeem a first-class ticket that costs $10,000—a payback of 50 percent!

As we have already noted, airlines realize that selling miles can not only make their passengers more loyal but also generate lucrative income streams in its own right. Airlines are therefore selling more miles to third parties: in 2015, for example, American sold 58 percent of all its miles to them,[3] and in 2016 more than one-third of Australia's credit-card spending earned Qantas miles.[4] Bloomberg has suggested that some airlines might make more money in this way than from the core business of selling tickets.[5]

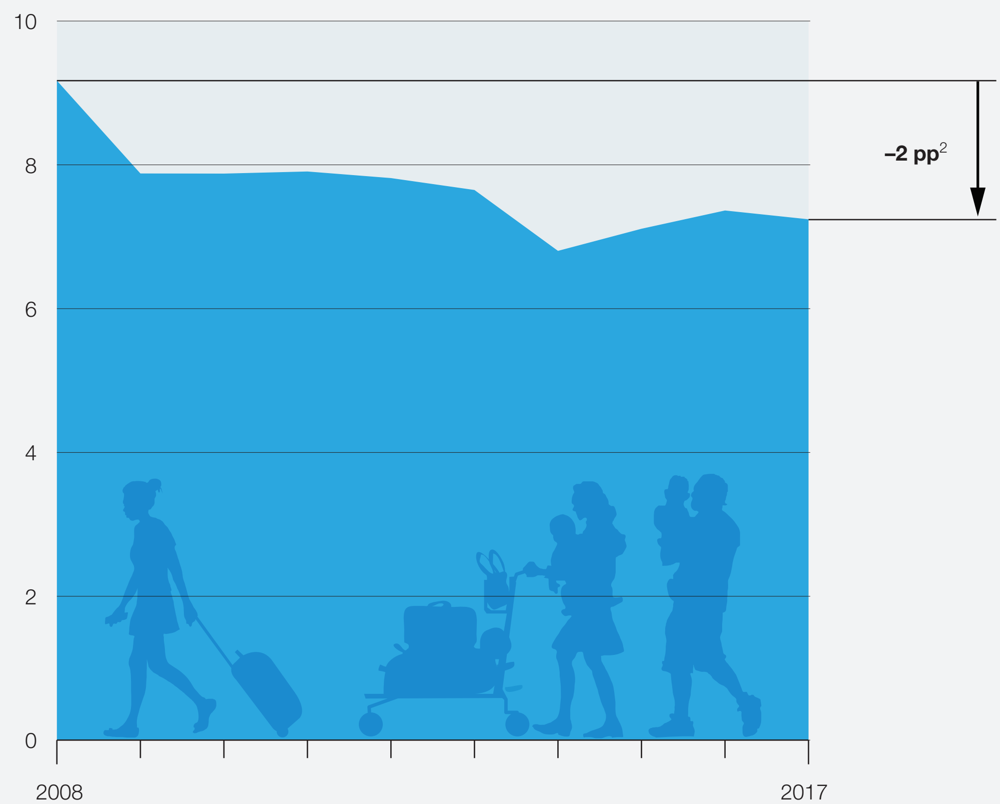
There are fewer options to redeem miles

Among US legacy carriers, the share of travel obtained with miles has been falling for the past ten years (Exhibit 1).[6] As the sheer number of miles outstanding increases, carriers have clamped down on the availability of redemptions, which make much less money for them than paying passengers do. For many carriers, a typical mile may have an internal cost of around one-half cent.[7] Although internal valuations differ, some airlines may recognize as revenue just $500 dollars for a London–New York business-class return redemption flight that costs 100,000 miles. The typical ticket price is $6,000 or more.

Redemptions are good value for airlines if no paying customer is available for a seat that would otherwise fly empty. To use industry lingo, carriers try to avoid "displacement." This approach worked well when redemptions were relatively simple to manage: passengers got seats that would otherwise probably have remained empty—as many did during and just after the financial crisis, when the level of business travel plunged. But as the number of miles soars, balancing them with redemptions becomes much harder. In our experience, 20 percent of redemptions end up on flights that take off full.[8] Airlines could probably have sold those seats for real money.

Exhibit 1 **During the past ten years, the share of award flights has declined.**

Award flights as share of revenue passenger miles,[1] %



1 Weighted average.
2 Percentage points.

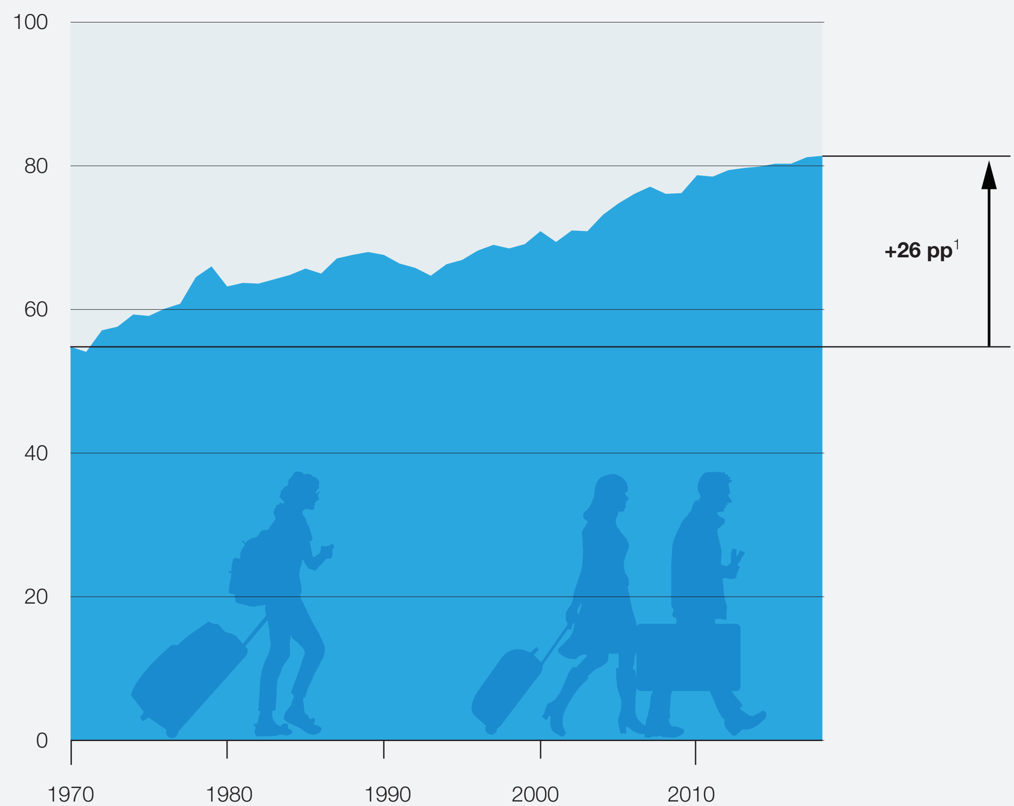
Source: US SEC filings (10-K forms) of US legacy carriers 2008–17

This problem is all the worse because flights are now generally fuller than they used to be: the average load factor across all airlines has increased from around 55 percent in 1970 to more than 81 percent today (Exhibit 2). Improved pricing and inventory-control systems fill up flights by exploiting powerful computers and advanced analytics. That explains why some carriers have made redemptions harder to get—for example, by introducing additional fees, tightening stopover rules, and restricting redemptions through partner programs. Almost every airline has gradually increased the number of miles needed to redeem a seat. For all these reasons, their worth to customers is falling, as the regular valuations on two major frequent-traveler blogs show (Exhibit 3).[9]

While it is difficult to get like-for-like data on the availability of redemptions, research suggests that availability has declined over time (Exhibit 4).[10]

Exhibit 2 **Airlines' average load factor has increased from around 55 percent in 1970 to more than 81 percent today.**

Passenger load factor, %



[1] Percentage points.
Source: ICAO

Exhibit 3 **Two major frequent-traveler blogs show that the valuation of miles is falling.**

Valuation of miles 2014–17, US cents average[1]

[1] Set of 5 carriers.

Source: Brian Kelly, "Points valuations," year-end values, 2014–17, The Points Guy; Gary Leff, "How much are miles really worth?," 2014–17, View from the Wing

Loyalty programs must innovate for value

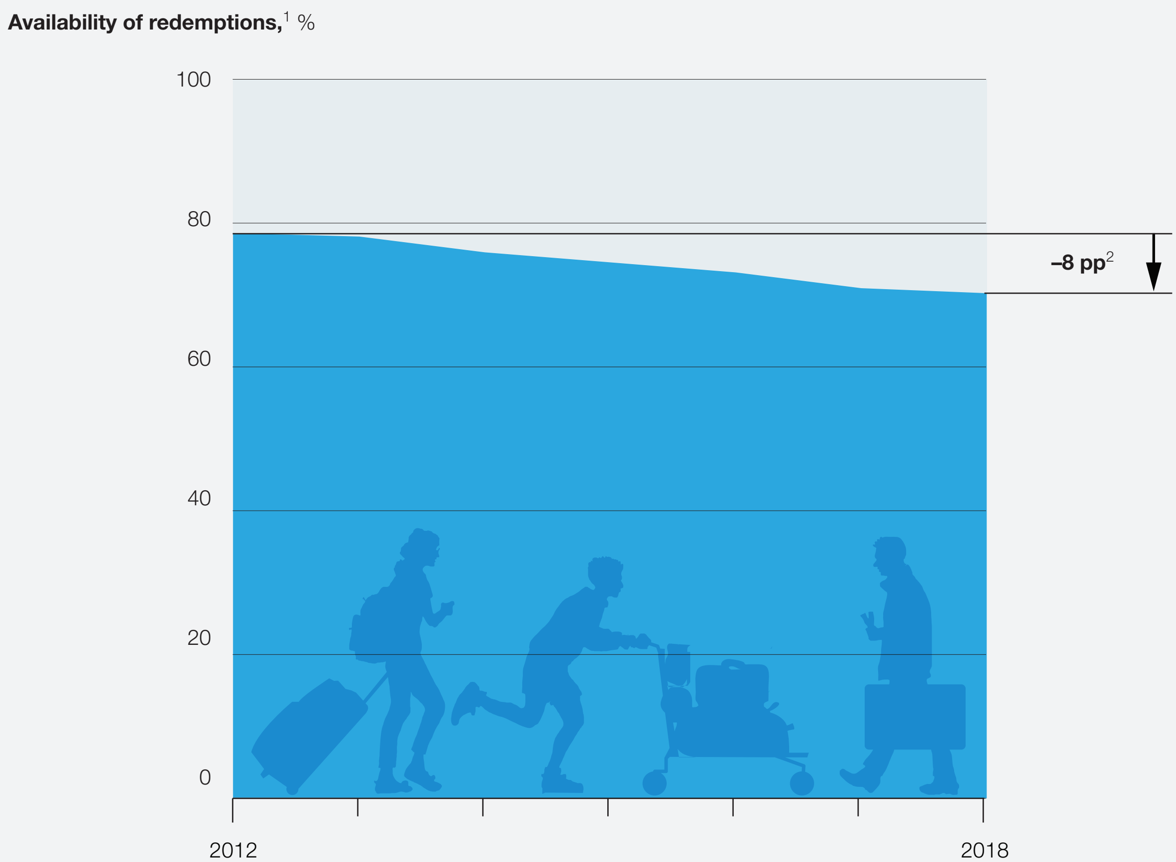
Airlines have begun to address the problem. Most begin by changing accruals. Classic airline loyalty programs based the number of miles customers received on the distance they flew: someone with a cheap economy-class ticket would get the same number of miles as a late-booking corporate traveler who paid a good deal more. Airlines are now rightly moving away from this miles-flown approach and toward awarding points more closely matching the price of a ticket.

But to make customers more engaged and satisfied, airlines should also rethink *redemptions*. Although many airlines have started down this route, more innovation is needed to ensure that their loyalty programs regain the customers' affections. We have a few ideas.

1. Go beyond airline seats

Redemptions can be great value for customers, since airlines are willing to accept a low price for seats that would otherwise go unsold. To use economists' lingo,

Exhibit 4 **Over time, the availability of seats for redemption has declined.**



[1] Set of 25 carriers.
[2] Percentage points.
Source: McKinsey analysis

there is a large gap between the perceived value of a seat and the marginal cost to deliver it. Airlines need to find redemption categories that have distressed inventory and a similar gap.

- Hotels are an ideal source of distressed inventory: when they have empty rooms, they will accept a price close to the marginal cost, so long as the actual price paid is opaque to the consumer. Opening up redemptions for miles is an ideal solution. Some airlines already have relationships to redeem miles for hotel rooms, but the number of miles needed is high, since the airline typically pays something close to a standard rate. Airlines should work with hotels or hotel intermediaries to give passengers access to great rates by focusing on distressed inventory.

- Luxury-goods firms, especially newer ones looking to enter the market, can be appropriate partners, since they have very high margins and want to maintain price integrity.

- Concert tickets and restaurants are excellent choices. For most concerts, certain dates and times are less popular than others. Once a concert ends, the ticket is worthless, so any undersold event meets our definition of distressed inventory. Similarly, at off-peak times, restaurant owners will accept promotional bookings at prices close to the marginal cost (the Groupon model). Airlines should build partnerships that give them access to these distressed opportunities.

- Finally, digital innovations make real-time promotions a possibility. Say that a customer passes a coffee shop at an airport. She might get an offer for the instant redemption of 200 points for a cappuccino. Fulfilment would take place through a quick scan of a code on the airline's mobile app. Even if the airline gave the coffee shop only $1 for the coffee itself, the shop would be pleased to get an additional customer and an opportunity for cross-selling.

Airlines should also look internally. They have many opportunities to provide redemptions at a low (or even no) cost across the business—and to please customers to boot.

- Onboard, some airlines have started to offer a menu of redemption choices—for example, a glass of champagne for 500 points or Wi-Fi access for 1,000 points.

- At the airport, airlines can offer instant redemptions, as well—for example, speed-boarding priority for 500 points, confirmed immediately through the mobile app. Some airlines have started to allow redemptions for lounge access; smarter carriers are even pricing it lower at off-peak times.

- Last-minute upgrades through miles are a true win–win. At check-in, airlines know for certain if a flight has empty seats, so that redemptions pose no risk of displacing paying passengers. Airlines can therefore offer immediate cabin upgrades for miles, perhaps at a discount to the number typically required for upgrades. More airlines should offer miles upgrades in their online check-in flow, at kiosks, and on the mobile app. Check-in staff could prompt passengers: "I can upgrade today's flight to business class at a discount, for only 20,000 miles instead of the regular 30,000." Emirates is a leading example of a company that already takes this approach.

2. Encourage late-booking redemptions

With bookings four or more months out, an airline's efforts to avoid displacement are hit-and-miss, so it will choose to err on the side of caution by holding back inventory. But in the last week before departure, the airline has a much better idea which flights won't be full. Such close-in bookings represent a great opportunity to offer redemptions. The opportunity comes with two challenges, however.

First, most passengers redeem points for vacations and therefore want more than a week's notice. Airlines can find innovative solutions that work both for them and their customers—for instance, redemptions that can be reallocated: fewer miles would be required if you accept being moved to a different flight one day on either side of the current booking, with notification one week out from departure. Airlines might even offer "multidestination" redemptions; you would know you were going on vacation but not exactly where until a week before departure. Hotels already offer similar innovations, such as srprs.me.[11]

The second challenge of close-in bookings is dilution: allowing customers to redeem miles for a seat they would have been willing to buy with cash. Close-in redemption bookings could be attractive for business travelers, especially owners of small and midsize companies. Certain airlines now actually charge more for these close-in redemptions to discourage them. In our view, airlines should require fewer miles for such bookings. The risk of dilution is lower than the risk of the displacement resulting from early redemptions. To reduce the possibility of dilution, airlines can add "fences"—for example, redemptions for a relatively low number of miles would be available only if two people traveled together or remained at a destination for more than a week.

3. Move to dynamic redemptions

Most carriers now publish long redemption-value tables that few customers read and fewer understand. More should move away from fixed tables and toward dynamic pricing for redemption seats. By varying how many miles passengers must redeem for a route, airlines can direct them to less full flights, with a lower risk of displacement: a redemption seat for a certain flight might cost 25,000 miles on Tuesday, say, but 35,000 on Friday. Some carriers now use a basic version of this approach: saver awards for a lower number of miles and premium awards for a higher number of miles but with better availability.[12] A dynamic version would be even better. Note that this would be different from the "pay with miles" option some carriers have implemented already—an approach that risks showing customers the sky-high numbers of miles needed for redemptions and could therefore damage customer loyalty.

4. Rethink how to price and manage redemption seats internally

Airlines should also change the way they manage redemptions internally. Classically, when an airline's revenue-management team decides which flights are eligible for redemptions, it applies the same logic it uses to manage revenue tickets. This creates tension: the rewards-program managers clamor for additional redemption inventory, while the revenue team wants to avoid displacement and therefore proceeds with caution.

Revenue-management teams should realize that customers not only have different levels of price sensitivity but also behave in different ways for redemptions, on the one hand, and paid flights, on the other. Revenue teams today generally use the same fences for loyalty and for pricing, such as advance-purchase restrictions, higher fares for one-way travel, and more restricted inventory for direct (as opposed to connecting) flights. These fences separate business from leisure passengers in money-based pricing. We think it would be worth examining whether they really make a significant difference in loyalty redemptions, which relatively few business passengers use. All of the fences have real issues: blocking redemptions on direct flights while encouraging them on connecting flights, for example, makes customers less satisfied and raises costs.

A better way to allocate redemption seats would be to open the full inventory to the rewards program, but at variable pricing. In modern revenue-management systems, the "bid price" is the expected revenue from the last seat on a plane. By allowing the rewards program to "buy" seats internally at the bid price, a rewards program pushes customers toward less full flights. The rewards managers can decide whether the circumstances warrant taking a loss on a seat by allowing it to be redeemed if the miles are worth less than the bid price. Analytics that help companies to understand the total value of each customer can support this approach.

5. Take a more customer-value view of redemptions

Building on the previous point, a rewards program is well placed to reveal the total value of customers and thus how much to invest in them. Innovative programs are starting to offer more valuable customers higher levels of available redemptions. At present, airlines usually implement this idea in a simple way, taking into consideration only a customer's status tier in the loyalty program. More sophisticated airlines are moving to a better view of total customer value. Passengers who earn 100,000 miles a year through a credit card, for example, may receive high levels of availability even if they remain in the loyalty program's base tier.[13]

Airlines can also offer some redemptions at a loss to promote their loyalty programs. One carrier ran "redemption special" flights: all seats to a holiday destination were slated for passengers redeeming miles.[14]

6. Become more relaxed about redemptions on partner airlines

Airlines pay each other real money for redemptions. Many therefore restrict them on partner airlines and encourage them on their own flights. Some airlines have been deliberately slow to build online interfaces showing a partner carrier's full inventory, so passengers must reach the call center to get it. Even then, many carriers don't volunteer options on partner airlines without a specific request.

A good compromise would be a website showing the availability of redemptions on partner airlines only if the passenger's airline had no options. In any case, airlines should loosen their policies. The money they pay partner airlines is a fraction of the value their members receive by redeeming flights. It is better for the health of the program—and the company—to encourage all redemptions. United is a good example of an enlightened carrier in this respect: it shows (online) all partner redemptions. Emirates has taken this idea a step further by introducing a redemption-only partner in easyJet.

7. Shift the mind-set from 'breakage is good' to 'breakage is bad'

Some 15 to 30 percent of all airline miles end up unspent and thus expire. This "breakage" is booked directly as profit to the airline. Historically, airlines have welcomed breakage. More advanced carriers are shifting their views. Expired miles represent a lost opportunity to engage customers. Carriers are starting to lengthen their expiration policies, to remove expirations totally for higher-value customers, and to introduce micro-redemption ranges to encourage more frequent activity.

8. Rethink miles

Finally, if miles-based rewards programs irritate customers, airlines should rethink the whole issue of miles. Airline loyalty programs kludge two different things: miles that passengers can redeem for flights, on the one hand, and status levels that confer benefits during flights, on the other. Anecdotally, many travelers, especially higher-value business ones, care more about the perks from the top tier (which different airlines variously call gold, diamond, black, platinum, and so forth) than about collecting hard-to-redeem miles.

Why not focus on building a great status program with multiple tiers? For example, "fly five times with us and get priority check-in," "build up 20 status points and you can enjoy priority boarding," "get to 100 points and you can access our lounges," "for each additional 50 points, we will give you an upgrade if space is available."

An airline could even let its passengers choose their benefits—allowing them, in effect, to design their own rewards programs. Other industries provide inspiration. The Global Hotel Alliance (GHA) Discovery program, for instance, gives higher-tier customers "local experience awards" with benefits such as free camel rides in the desert, boat cruises, spa treatments, Segway tours, day tours, and tastings[15] rather than points. The grocer Waitrose has no points program[16] but offers shoppers who belong to its myWaitrose loyalty program free coffee and access to special discounts and magazines.

At first thought, this approach may seem to jeopardize the lucrative revenue streams from third parties buying miles. But airlines could still innovate by selling higher-tier memberships and status benefits to their credit-card partners.

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Customer-loyalty programs risk becoming victims of their own expansion. Airlines must act now to ensure that a profit driver doesn't become a profit destroyer. ■

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[1] The first miles-based program, created by Texas International Airlines in 1979, had barely begun when the airline merged with Continental Airlines in 1982.

[2] "Air travel more accessible in 2017, according to latest air travelers in America report," *Airlines for America*, February 20, 2018, airlines.org.

[3] American Airlines' Securities and Exchange Commission 10-K filing, February 24, 2016, americanairlines.gcs-web.com.

[4] Angus Whitley, "Qantas frequent flyer program turning into airline's biggest money spinner," *Sydney Morning Herald*, May 12, 2017, smh.com.au.

[5] Justin Bachman, "Airlines make more money selling miles than seats," *Bloomberg*, March 31, 2017.

[6] US legacy carriers' Securities and Exchange Commission 10-K filings, 2008–17, weighted average of US legacy carriers.

[7] Public announcements of the internal rate are rare. But Lufthansa put its internal valuation of a mile at about 0.4 cents in 2012. *Lufthansa Annual Report 2012*, p. 147, investor-relations.lufthansagroup.com.

[8] Defined as flights that depart with 95 percent of their seats filled.

[9] Brian Kelly, "Points valuations," year-end values, 2014–17, The Points Guy; Gary Leff, "How much are miles really worth?," 2014–17, View from the Wing.

[10] McKinsey analysis based on public data on economy-class availability. The study does not account for seasonality.

[11] Liz Boulter, "Destination unknown: The new way to book a mystery holiday," *Guardian*, July 31, 2017, theguardian.com.

[12] While saver awards can typically also be booked using partner airlines' miles, premium awards are usually restricted to members of an airline's own program.

[13] With very few exceptions, only flying (not credit-card spending) earns miles for status.

[14] "Redeem Asia Miles' first-ever chartered flights!" Cathay Pacific, asiamiles.com.

[15] "Discovery: A loyalty programme like no other," Discovery, discoveryloyalty.com.

[16] "Enjoy more, starting today," Waitrose, waitrose.com.

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