The Future of Revenue Management and Frequent Flyer Programmes:

How the rock stars of the airline industry are finally starting to sing in tune

LOYALTY PROGRAMMES and Revenue Management (RM) have arguably been the most widely adopted business practices that trace their origins back to the airline industry. Frequent flyer programs (FFPs) have set the gold standard for loyalty programs in general, and airline RM techniques have been applied successfully in myriad industries. But despite their rock star status, the relationship between the two has at times been frosty – and fraught with a certain level of suspicion. If the FFP is a stadium-filling rock star, then perhaps RM would be best characterized as the established and respectable philharmonic orchestra, that views its younger and more brazen counterpart with equal parts disdain and admiration. But looking ahead, new developments in RM could turn the tables – and may lead to a closer integration between the two – ultimately impacting the design and management of loyalty programs in the future.

Summary

- Even after 35 years, loyalty programmes are still growth areas.
- Optimal structuring – should the programme be held in or outside the airline.
- Debate still remains over what is the true cost of an award ticket.
- Smart operators will ensure the right members will have access to the most desirable type of awards.

2018 in review

Whilst RM was the quiet achiever in the background as usual, loyalty programmes did grab the headlines on a few occasions. But overall, 2018 witnessed the continuation of three recurring themes for FFPs. Firstly, although programmes have been around for more than 35 years, there seems to be no limit to their growth. Even in what arguably is the most mature loyalty market, the United States, the main airline programmes demonstrate robust growth.

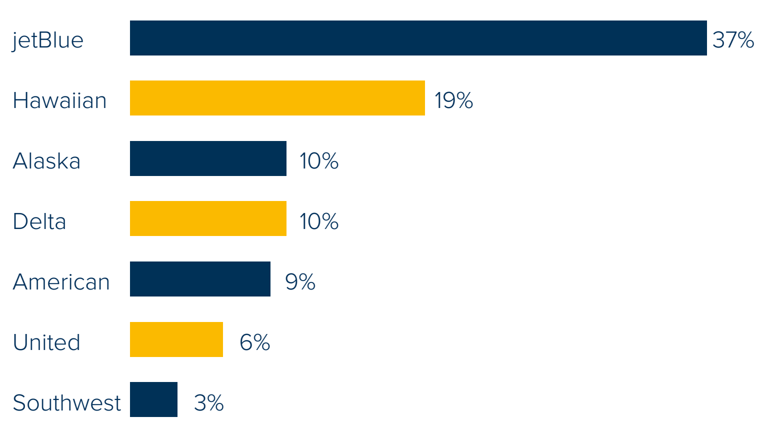
Growth itself can come from multiple sources. Qantas Loyalty, for example, operating in the limited market which is Australia, has set itself a goal of contributing AUD 500 million in Earnings Before Interest and Tax (EBIT) by 2022 – in part by focusing on new businesses adjacent to its core loyalty business (it predicts that its core business will still continue to grow at a compound annual growth rate of 5 per cent). Another remarkable statistic comes from Air New Zealand: it announced that in 2018 it had enrolled its 3 millionth member in its Airpoints program – quite an achievement for an airline with a home market of only 4.8 million inhabitants. And in the United States, although the absolute percentage of Revenue Passenger Miles (RPMs) travelled on award tickets has dropped for some carries, the total number of awards issued (covering both air and non-air awards) generally shows an upward trend, signalling at least a partial shift in redemption categories. Using the latest available data, United for example reported that in 2017 approximately 85% of the total miles redeemed were used for flights on United (including class-of-service upgrades), with the balance being redeemed for United Club memberships, car and hotel rewards, merchandise and flights on other air carriers.

The second theme, which should not come as a surprise to anyone, is the enormous financial power the programmes wield. In the US, up until the third quarter of 2018, the loyalty programmes are in many cases responsible for more than half of the total EBIT generated by an airline. The AAdvantage programme for example accounted for 66% of American's total EBIT; United's MileagePlus program accounted for 51%.

In the United States, where interchange has been unaffected by regulators, airlines have been able to renegotiate new agreements driving up yields per mile sold. In other markets, most notably Australia and the European Union, program operators are forced to find new sources of revenues to plug holes left by downward pressure on yields and volumes as a result of interchange reform. In some markets like the United Kingdom, some co-branded credit cards became effectively unsustainable as a result of interchange reforms (MBNA for example announced the end of its MBNA Virgin Atlantic card, and its MBNA American Airlines card, blaming the move on European Union interchange caps limiting the amount credit card companies can charge merchants to process a transaction to 0.3 per cent). But regardless of these geographical differences, it is clear the FFPs are pushing above their weight from a financial perspective. Generally, airlines are keeping their cards close their chest with regards to the financial performance of their FFPs – it is likely however that investors will push for more segmental reporting, potentially arguing that FFPs are in fact meeting quantitative thresholds under IFRS accounting rules requiring them be reported as a separate segment.

YEAR-ON-YEAR TOTAL LOYALTY PROGRAMME REVENUE GROWTH*

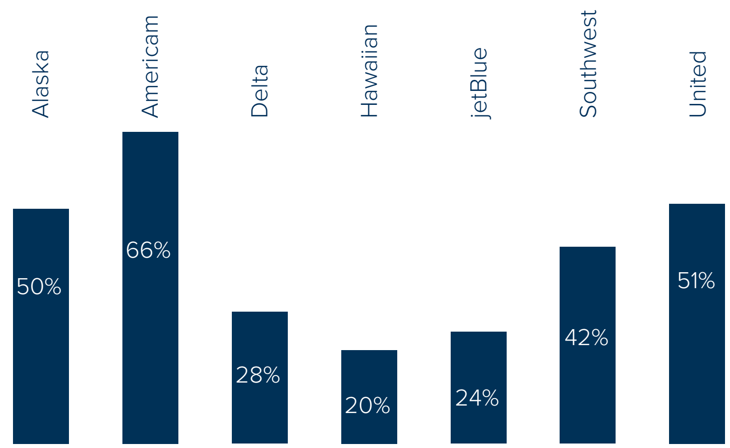
SOURCE: STIFEL, ON POINT LOYALTY



*Note: *Comparison period 3Q17-3Q18*

SHARE OF LOYALTY PROGRAMME CONTRIBUTION TO OVERALL AIRLINE EBIT*

SOURCE: STIFEL, ON POINT LOYALTY

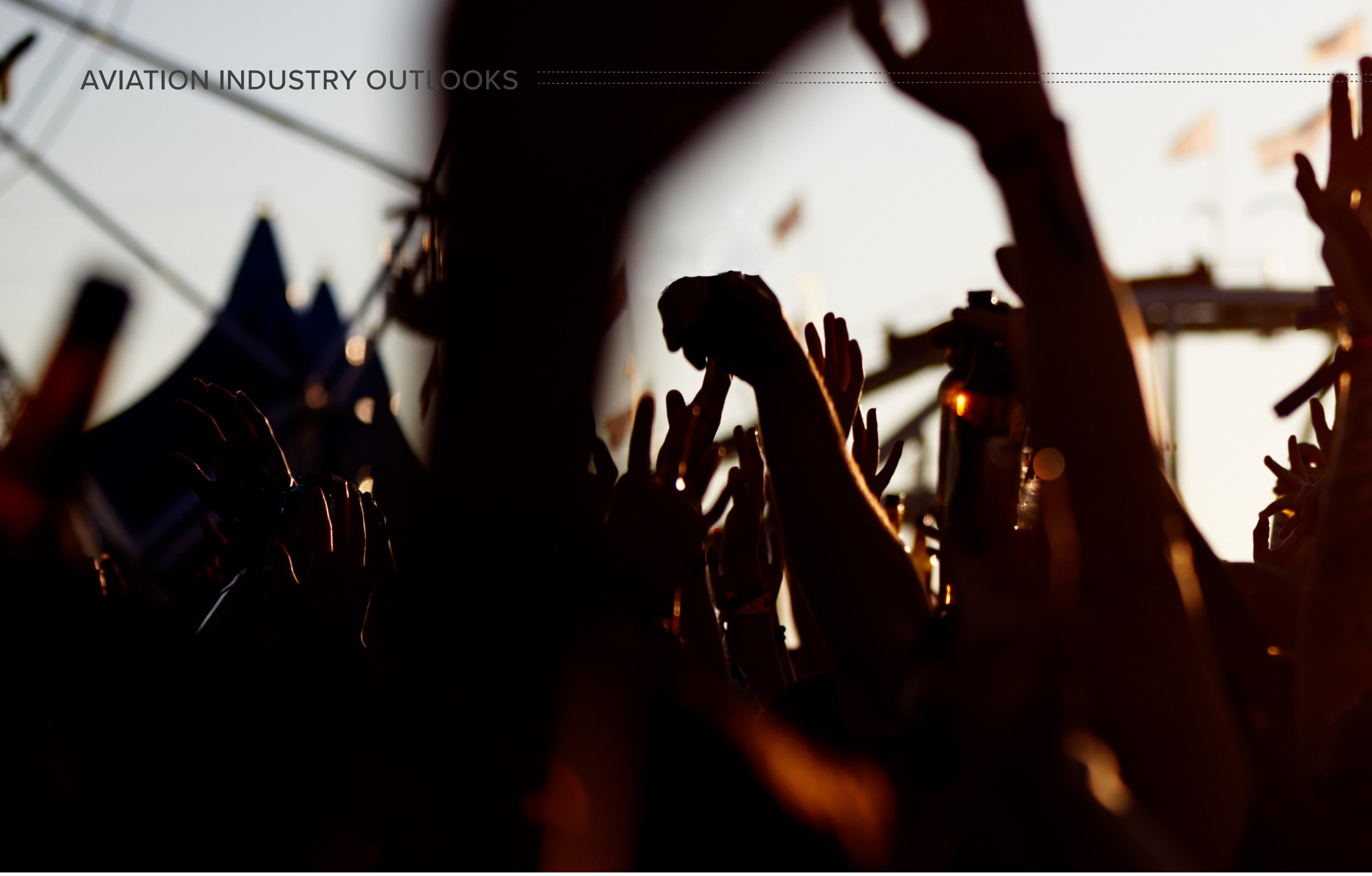


*Note: *Period Year-to-Date 3Q17*

The third trend – and perhaps the most headline-grabbing - is the ongoing search to find the optimal structure for the FFP which could be summed up as placing it in- or outside the airline (although hybrid solutions also exist). In 2018, Air Canada and Aimia (the holding company of Aeroplan) conducted prolonged negotiations and ultimately agreed on a commercial agreement that would bring Aeroplan back into Air Canada. In South America, both LATAM and GOL saw a window and announced their respective intents to delist their loyalty programmes which were partially floated on the Sao Paulo stock exchange several years ago. The judges are still out on what the optimal solution is – with a damned if you-damned if you don't dilemma seemingly unfolding. It will be interesting to see how 2019 will shape up for the FFP market from two perspectives. Firstly, two private equity (PE) investors are coming to the end of what their normal holding period would be, namely Affinity Equity Partners in the case of Velocity (Virgin Australia), and Advent International in the case of Lifemiles (Avianca). A successful secondary market transaction would be a boost for the model, providing comfort to investors and potential spin-off candidates alike. The second question is how LATAM and GOL will fare with their proposed delisting of their respective FFPs. Whilst the Chilean partners in the LATAM marriage were probably never so enamored with the concept of the spun-off loyalty program, it remarks a surprising reversal of strategy for GOL.

The old interplay between Revenue Management and FFPs

Despite their rock star status outside of the airline industry, the relationship between RM and FFPs themselves started off as a bit of a tepid affair. Route managers and flight analysts, tasked with optimizing revenue on their assigned flights, had little incentive to accept award passengers other than to support low-load flights. Certainly, in the beginning, no financial value was attached to award travel. And in a way, the programmes themselves prolonged this positioning as their exclusive reliance on distressed inventory meant that the cost side of the miles could be downplayed to very marginal proportions. It laid the foundation of what would ultimately become one of the most lucrative parts of the business, selling miles to outside partners at a yield which was significantly greater than the associated cost, resulting in formidable profit margins. The early days of the RM-FFP relationship could be described as the separate phase, where both departments typically functioned more or less in isolation. But as the programmes grew in popularity, and the sale of miles to external partners took off, program managers started to realize that merely relying on the goodwill of RM to throw them left-over inventory would not be sustainable in the long-run. Adding additional pressure on the existing set-up was the fact that passenger load factors started to rise across the board. At this point, RM and FFP departments started to engage in what would ultimately evolve into internal agreements governing the allocation of award seats by RM above and beyond the traditional distressed inventory. Different airlines chose different solutions, some assigned a fixed number of seats per route or aircraft type, whereas others opted to include awards in the RM nesting system. As an inevitable consequence, there now was a real cost associated with award travel as seats used for redemptions could have been sold to commercial passengers. This laid the foundation for a debate which has



arguably never been fully solved. It centred around the question: what is the true cost of an award ticket? Although both parties quickly came to agree on the main drivers of the cost, namely displacement and dilution, it turned out to be much harder to quantify the effect of both drivers. Displacement refers to the opportunity cost that an airline incurs when a passenger is occupying a seat using an award ticket that could have been sold to a fare-paying passenger. Dilution on the other hand refers to the situation whereby a passenger elects to use an award ticket instead of purchasing a regular ticket. Dilution especially turned out to be a bit of an elusive concept, as it is highly dependent on assumptions which could only be partially corroborated by customer research. At the end of the day, airlines would typically arrive at commonly supported notion of the cost and revisit it as and when material changes occurred.

Evolutions in FFPs and RM

Before we look at how new developments will impact the future interplay between RM and FFPs, it is worthwhile to make a quick trip back in time. The origins of airline revenue management can be traced back to the mid-1960s when American Airlines implemented its semi-automated business research environment (SABRE). The introduction of super-saver discount fares in 1977, and the US deregulation of airline prices and schedules in 1979 further catapulted RM to prominence. FFPs were introduced a few years later in an effort to create a competitive advantage. Both concepts witnessed a significant evolution over the decades that came after their initial introduction. In its early days, RM was characterised by a singular focus on optimizing yields and loads on a particular flight. By assigning capacity to pre-defined booking classes, revenue managers sought to optimise the total revenue generated. Much of the allocation was done on the assumption of defined market segments that would display specific price sensitivities. Discounted fares were offered to attract more price-sensitive travellers, in lower booking classes that were closed as and when they would encroach on inventory that was expected to be sold at higher fares. To

protect the higher fares from leakage, and curb potential down-selling, fare fences were used including advance purchase and minimum stay requirements. With the adoption of hub-and-spoke systems in the 1990s, RM evolved and started to look the revenue contribution across the whole itinerary instead of looking at individual flight segments, as it was clearly undesirable for lack of availability of a feeder flight to block revenue coming in on a longer, and potentially more profitable, connecting flight (so-called "origin-destination" systems were introduced at that time). In the 2000s, the traditional RM concepts started being re-evaluated on the back of industry and consumer developments. Like never before, the internet enabled price transparency, shifting significant power to increasingly informed consumers. At the same time, increased competition as a result of ongoing liberalization of markets and the rapid rise of low-cost carriers, traditional RM fare fencing practices became less effective. But also, the notion of cleanly delineated customer segments became less and less viable. Consumers, as it turned out, tended to offer a far more mixed consumption pattern, alternating between full service and low-cost carriers. Airlines themselves also started blurring the lines with the introduction of low-cost subsidiaries, sometimes replacing or supplementing the existing legacy product. The current frontier for RM can be summed up as moving beyond myopic view of the market to a comprehensive assessment. In some cases, traditional RM techniques can be combined or supplemented with new machine-learning practices. Given the importance of ancillary revenues, RM is also tasked to consider how to maximise revenues beyond the base fare and account for these in the RM process. Bundling products or services according to a specific customer segment will be key.

Similar to the progress witnessed in RM, airline loyalty management also underwent a significant transformation from its inception around the same time. Within the context of Revenue Management, a number of changes bear particular relevance. They are predominantly related to the purchasing power of the FFP, resulting from selling miles to partners. New accounting rules also no longer allowed downplaying the value of miles to marginal costs, instead relying on fair value. Perhaps the most interesting concept from a RM point of view is how loyalty programmes evolved in the way they evaluate the value of customers (members).

On the back of the developments in RM and FFPs, we can observe three major trends unfolding. The first development is a resetting of the discussion between RM and FFPs. Traditional concepts like displacement and dilution will become less prevalent as the yield gap between commercial traffic and reward traffic continues to narrow. With newer award pricing policies, including the increasingly popular cash and miles concept, the notion of displacement costs will be less relevant (as the de facto revenue is equal to the commercial fare). According to British Airways, the Pay with Avios product, which allows customers to use their Avios to discount commercial tickets, has grown and now accounts for 30 per cent of total Avios redeemed. As the industry is moving towards new distribution models (for example IATA's New Distribution Capabilities initiative), RM will find itself tasked to optimize beyond the traditional accept-or-reject decisions and must consider a broader basket of goods to optimize. With the availability of enhanced data and artificial intelligence, it is logical it would use a multi-step process to set availability and pricing. The FFP, with its myriad sources of data, is well-placed to generate more insights into individual customer behavior. The second shift that can be observed in the industry is the increasing adoption of RM tactics by FFPs – in a way the two disciplines are converging. In some ways, FFPs have leapfrogged traditional RM approaches by using customer insights in the accept-reject decision for award travel. FFPs today assess the member's request for an award seat not merely on the bid-price of the flight, but also by considering the member's total contribution to the airline, including spend on associated credit cards, or a member's propensity to purchase ancillary goods. Historically, RM's application of FFP insights has been limited – many airlines for example offer guaranteed seats to members of the top tiers in the program on sold-out flights. Lufthansa for examples guarantees the availability of a seat on a fully booked flight to its top-tier members. At the same time, we see that award capacity is more deliberately managed then before. An increasing number of airlines is limiting access to First Class awards. Redemptions for Air France's La Première product are only available to elite members of the Flying Blue program, blocking both base members and partner airlines members. Similarly, Swiss only offers redemptions in its First Class product to members who hold Senator or HON Circle status in the Miles & More program. Conversely, airlines are increasingly offering additional access to classic award availability for members of its own elite tiers. British Airways for example states that its Executive Club Gold members get access to additional economy reward seats at the standard price. In the context of the future of RM, it is interesting to note that FFPs have already successfully embraced dynamic pricing principles for award travel – and consumers seem to generally accept the notion of varying levels of availability and award pricing.

The third and perhaps the one that will require a bit more time to develop, is the increasing ability to recognize and reward customer without the help of a loyalty program. Undoubtedly, RM will be able to make decisions by using a variety of sources to use the right insights. In this setting, it is no longer dependent on the loyalty program to act as a lens, or recognition tool.

With new techniques, RM will be able to recognize customers directly and at least in theory provide very specific and targeted rewards. Clunky tiers, that generally do a poor job at recognizing true member value, could become a thing of the past if it was not for the psychological appeal they exert on members. They could be replaced by personalized recognition systems, rendering the exact right service to each member, maximizing the level of utility provided. As a result, it would not be necessary anymore to capture the program structure in arcane program rules as each member will be offered benefits and awards specifically tailored him or her.

The new challenge

As the industry keeps moving closer to practically full planes (passenger load factor reached a 28-year high in August of 2018 with 85.3 per cent - a figure which has not been achieved since at least 1990), RM will increasingly turn its attention to other sources of incremental revenues. Undoubtedly, new RM techniques and capabilities, especially when coupled with the ability to market bundles of services through more distribution channels, will create significant opportunities for airlines. Inevitably, the conversation between FFPs and RM will change in tone. Instead of looking at the displacement and dilution costs of award travel, RM will need to consider the total commercial value represented by members traveling on miles or any other form of loyalty currency. Smart operators will not relegate their programmes into cash-back style loyalty programmes (fixing the value of a mile to monetary amount) – but instead preserve the attractiveness of the FFP by ensuring that the right members will have access to the most desirable type of awards. The FFP is well placed to support RM with its rich data offering, and toolkit of perks. Although RM might theoretically be able to bake in any discount into personalised pricing, it would be misguided to discount the FFP given is unparalleled ability to generate revenues from third-party sources (and in the foreseeable future these partnerships would still require a form of currency). As long as the FFP holds the keys to highly-valued award inventory, a win-win partnership will yield the best results for both parties for the long-term. AL

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THE LOYALTY PROGRAMME'S ROLE: RECOGNISE CONSUMERS

SOURCE: IATA, ON POINT LOYALTY