THE TRUE OPPORTUNITY COST

CALCULATING THE COST PER MILE

CASE STUDY

ONPOINT LOYALTY

ABOUT US

On Point Loyalty is a global consulting and investment firm focused exclusively on the airline loyalty space.

We partner with leading airlines, technology providers, financial institutions and investors to shape and realize their airline loyalty vision.

With tailormade solutions, ranging from strategy consultancy to outsourced operating models, we help our clients to define the future – and create a competitive edge.

Our suite of Financial Planning & Analysis tools puts insights at the fingertips of program managers.

AT A GLANCE

A major international airline realized that its existing cost per mile was limiting the future growth potential of its frequent flyer program – and started to question the foundation of the existing number.

Working with On Point Loyalty, an approach was developed to re-assess the true cost per mile.

On Point Loyalty defined both the required inputs as well as a revised model, delivering a more empirical approach for the analysis.

With a validated view on the cost per mile, the airline can now set out on its future growth course with confidence.

BACKGROUND

Airline loyalty programs offer a remarkably simple business model. Miles are earned across a range of partners, and when the member has a sufficient balance, a redemption can be done.

The cost per mile redeemed, in this context, can be considered as the equivalent of the cost of goods sold in any other business. It will be clear therefore that the cost per mile is a critical component to the ongoing success of the loyalty program.

Whilst its importance may be self-evident, arriving at the right cost per mile is actually a more complex matter.

Establishing the correct cost per mile requires a careful calibration of assumptions into the model

Redemptions generally fall into one of two categories: air travel and non-air awards. For the latter, it is straightforward to establish the cost per mile redeemed as the program will typically know the costs involved in procuring an item or service. Think for example of a car rental, a hotel stay or merchandise – for each of the categories the program will know exactly the cost involved in providing the member with the selected award.

For air travel however, the situation is less straightforward. The reason for this is two-fold. Firstly, FFPs traditionally have been given favorable access to seats as the FFP operates as part of the same company or group. This access translated into a very low, or marginal cost, associated with award travel, as airlines and their FFPs traditionally relied on distressed inventory for award seats. Secondly, even when airlines and FFPs progressively started to adopt intra-company pricing agreements, the basis on which to cost out the miles is not clear cut.

Establishing the correct cost per mile requires a careful calibration of assumptions into a model, using a combination of operational data and predictions based on customer research.

THE APPROACH

The process of constructing the cost per mile for air redemptions ensures a clear view on the underlying drivers

Generally speaking, On Point Loyalty deploys project teams that are assembled specifically around the requirements of a client mandate. With our global roster of FFP experts, representing a wide range of disciplines, we are in a position to deliver the right mix of know-how and experience to our clients for each assignment. Delivery usually takes place through a combination of on-site meetings and presentations, complemented with offsite research work. Occasionally, we are in a position to link existing clients, enabling them to exchange ideas and approaches, ensuring the maximum possible knowledge transfer.

The airline brought On Point Loyalty on board to determine the best approach to calculate the cost per mile.

Beyond the initial review, we started laying the foundation for what would ultimately become cost per mile model. The cost per mile is typically driven by a variety of factors, including three principal drivers (see Figure 1). The first driver is the displacement factor, which sets out to predict the extent to which award passengers will be displacing revenue-paying passengers. On Point Loyalty recommended a proven approach to determine the level of displacement.

The second driver is the dilution factor, which is used to predict the extent to which the member is using an award ticket instead of buying a commercial ticket on the same airline. Working together with a cross-sectional team from the airline, On Point Loyalty developed a model which predicted the right level of dilution.

The third factor is variable costs, which can be described as the marginal cost of carrying an additional passenger.

The process of constructing the cost per mile for air redemptions ensured a clear view on the underlying drivers. This offered management a greater ability to steer the cost. Through extensive modeling, On Point Loyalty was able to demonstrate what they were, providing management with the tools and insights to set the parameters at an optimal level.

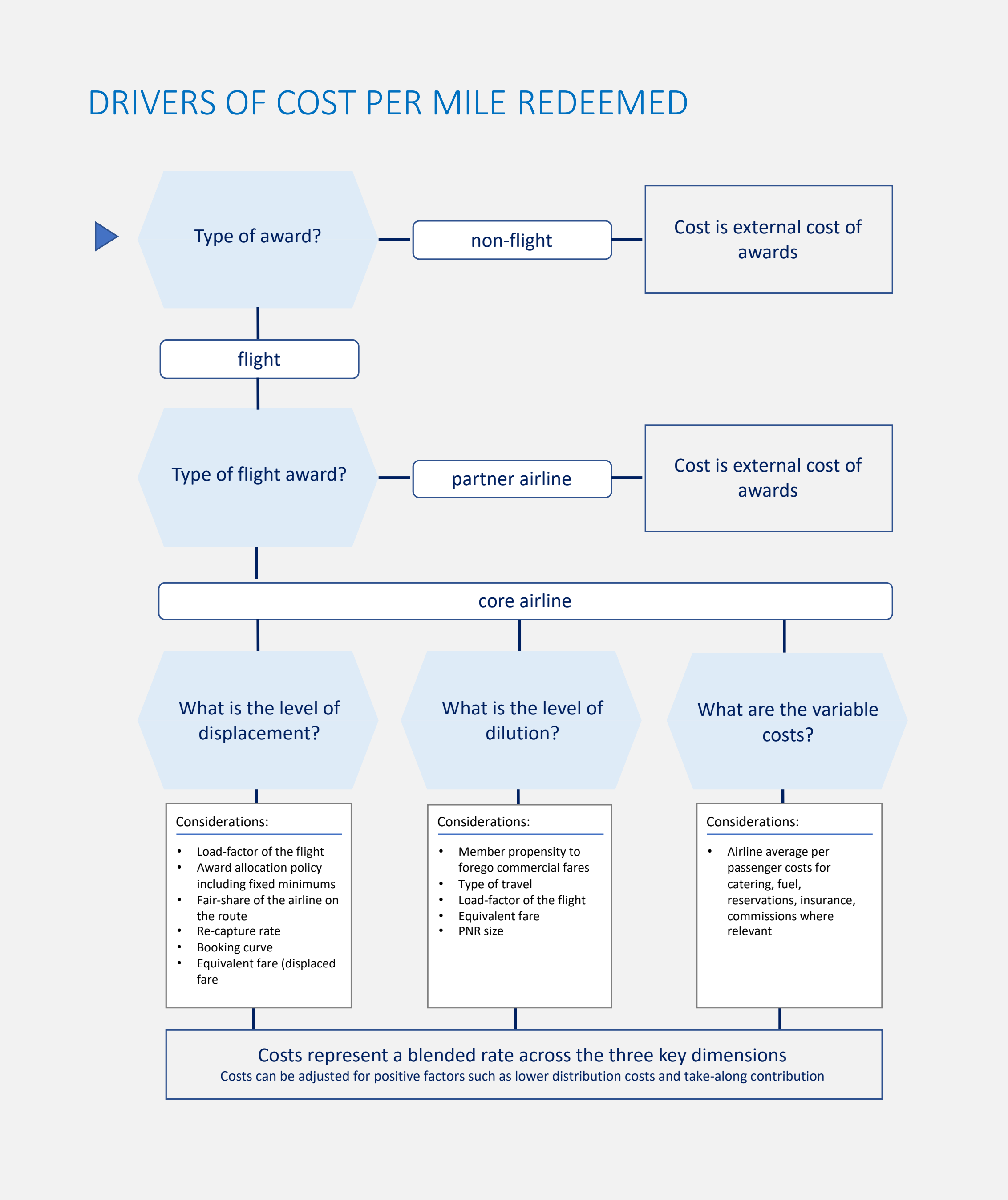

Figure 1 - Overview of typical drivers of the cost per mile

RESULTS

Grow with confidence Knowing the right cost per mile number ensures that the business can make informed decisions around the pricing of miles to partners. It safeguards the required spread (difference between the selling price per mile and the cost) and allows for an optimal balance of selling volumes against yields.

Optimize the award allocation The deconstruction of the cost per mile, through the segmentation of the underlying drivers, also provides more levers to control and steer the cost per mile as the redemption portfolio increases in size and complexity. As potentially each award category or product carries a differentiated cost, even for air awards, programs are now able to steer access to awards by taking a revenue management-like approach to the allocation policy.

Develop a P&L for the program Having a clear and agreed cost per mile on the airline side opens the door to an at arm's length agreement between the FFP and the airline. This in turn allows the FFP to be run as a standalone business unit with its own income statement. This level of transparency can unlock greater accountability, and visibility on the true current and future performance of the FFP segment.

Knowing the right cost per mile number ensures that the business can make informed decisions around the pricing of miles to partners

About the authors

Evert de Boer is Managing Partner and is based in the Singapore office of On Point Loyalty. You may contact him at evert.deboer@onpointloyalty.com.

Xiao Yao Chin is Vice President, Strategy and is based in the Kuala Lumpur office of On Point Loyalty. You may contact her at xiaoyao.chin@onpointloyalty.com.

For further contact:
If you would like to discuss this case study further, please contact one of the authors.

To find the latest On Point Loyalty content, please visit www.onpointloyalty.com. Here you can also find more information about our suite of Financial Planning & Analysis tools for loyalty programs, as well as our range of training programs for loyalty professionals.

ONPOINT
LOYALTY