INSIDE TRACK - What it really means to be loyal - MARKETING - Reward schemes can be lucrative for ...

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INSIDE TRACK - What it really means to be loyal - MARKETING - Reward schemes can be lucrative for airlines, but for retailers benefits are much harder to achieve, says Richard Tomkins.

So you thought airlines made their profits selling tickets? In a good year, maybe. But even in a great year, a surprisingly high proportion of their income comes from a seldom-mentioned sideline: selling frequent flier points to credit card companies, hotels, retailers and other merchants for use in their customer loyalty programmes.

Each year, the big US airlines earn hundreds of millions of dollars of revenue from this source. In 2000, says Paul Brown, an associate principal of McKinsey's global travel and logistics practice, sales of frequent flier points by the top five US airlines totalled $2bn (£1.3bn) and accounted for no less than 40 per cent of their combined operating profits.

As Mr Brown points out, here lies the big distinction between loyalty programmes offered by airlines and those offered by other companies: for airlines, they are a source of profit, while for other companies, they are a cost. Airlines redeeming frequent flier points are just filling seats that would otherwise go unsold, whereas most other merchants operating loyalty schemes must reward customers with gifts that cost money - either goods from their own shelves or items such as frequent flier miles that have to be bought from other vendors.

The distinction explains why loyalty programmes have proved more durable within the airline industry than outside it. While many big retailers have experimented with loyalty cards, Britain's Safeway and Asda supermarket chains are among those that have abandoned them and many others remain unconvinced that the benefits outweigh the costs.

Even so, another retail loyalty card scheme is due to be rolled out in Britain later this year when four big merchants - J. Sainsbury, Debenhams, BP and Barclaycard - transfer their individual schemes to a new programme called Nectar, run by a company called Loyalty Management UK. It is expected to be Britain's biggest loyalty programme so far, capturing 50 per cent of the country's households.

It is easy to understand why loyalty cards have a mixed record among retailers. The costs are daunting. They include not just the cost of providing the customers' rewards but also the cost of operating the programme - issuing the cards, providing a call centre, running the database, sending out mailings and so on. Safeway says its scheme was costing £60m a year when it ended in 2000.

To succeed, such schemes must increase sales by more than enough to outweigh the costs. The trouble is, many members of these schemes are free-riders, taking the rewards without spending any more. "Since the free-riders get more without giving anything in return, the incremental sales from programme members who do spend more must cover the cost of the programme not only for themselves but also for the free-riders," says Susan Whalley, a principal in McKinsey's London office.

To take an example: suppose a retailer gives its programme members a 1 per cent rebate on sales. If the store's profit margin after variable costs is 30 per cent, its programme members will have to spend 3.4 per cent more just to cover the cost of the rebate. But if half the programme's members are free-riders, the rest must spend 6.8 per cent more to cover the cost of the rewards - even without taking into account the cost of operating the programme.

Realistically, sales gains of this order are hard to achieve, not least because the rewards on offer are so lacklustre. A 1 per cent rebate on a £500 annual shopping bill translates into grocery vouchers worth just £5 a year - hardly a sum to set shoppers' pulses racing, still less to prompt a change in their shopping habits.

Not surprisingly, when Britain's competition commission investigated the supermarket industry in 2000, it found little evidence that loyalty cards influenced people's store choice. The main factors cited were the ability to do the week's shopping under one roof (43 per cent), prices (18 per cent) and distance from home (16 per cent).

When customers were asked what services and facilities they most valued, only 5 per cent mentioned loyalty cards. More important were good customer service (22 per cent), toilets (18 per cent), a coffee shop (12 per cent), low prices (9 per cent), help with bag packing (6 per cent) and a pharmacy (6 per cent).

One often-cited justification for loyalty cards is that the information gleaned on people's shopping habits allows retailers to build relationships with customers and provide more attractive product ranges in their stores. While this may be true, it implies large data processing costs; and the gamble the retailer takes is that the money would not be better spent on improving customer service or on cutting prices.

Safeway, for example, says it experienced a surge in sales and market share after it dropped its loyalty card, partly because it re-invested the £60m-a-year cost on mouth-watering price promotions and partly because, under a new chief executive, it tackled operational problems, such as poor stock availability, that had weakened its competitive position.

"The lesson that came over to us very strongly is that if your basic drivers of loyalty are weak, a loyalty card isn't going to compensate for that," says Kevin Hawkins, Safeway's communications director. "And the converse is also true: that if you are firing on all cylinders on the things that drive loyalty, and you are pleasing your customers with your basic offer, what do you need a loyalty card for?"

In its favour, the Nectar programme does appear to offer a more advantageous cost/benefit ratio to retailers than some of the traditional schemes. Spreading the operating costs over a number of retailers means the cost to each is lower and the rewards are more attractive because consumers can pool the retailers' points to earn gifts of higher value than mere £5 grocery vouchers: Loyalty Management is planning to buy in rewards such as package holidays, restaurant meals and trips to theme parks.

Keith Mills, Loyalty Management's chairman, says the least understood aspect of the scheme is that most forms of marketing - price cuts, advertising campaigns, promotions, even single-retailer loyalty card schemes - can be replicated very quickly by competitors. "But replicating a big alliance of companies in a coalition programme like this is extremely difficult to do and what all of these companies believe they will get out of it is a really significant competitive advantage."

Still, not even Mr Mills expects to revolutionise a nation's shopping habits. Based on his experience of these schemes in other countries, he says: "They clearly don't affect the behaviour of a lot of customers but they affect the behaviour of enough customers to provide a substantial return on investment for the companies involved."

According to Richard Hyman, chairman of Verdict Research, a retail consultancy, loyalty cards are something of a misnomer. They may make a difference at the margin "but they don't foster loyalty; they repay loyalty - and there's a subtle difference between the two", he says. Significantly, the three UK food retailers scoring highest in Verdict's loyalty surveys are Waitrose, Asda and Morrisons, none of which has a loyalty card scheme.

"Loyalty is an increasingly elusive concept in retail," says Ms Whalley. "Competition is driving an increasing desire for value for money and hence a desire for shopping around."

As someone once said: if you want loyalty, get a dog. Failing that, the next best thing may be low prices, helpful staff, a coffee shop - and a nice, clean customer toilet.