

Modeling of Customer Non-Financial Valuation: Empirical Study on Loyalty Reward Program

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Abstract

The goal of relational program is to retain customers who are profitable to the organization. Reward point is a form of customer loyalty widely used by many industries, including airline industry. Airline loyalty program, notorious as Frequent Flyer Program (FFP), is the most sophisticated marketing strategic used by airline industries nowadays to maximize their profit and to satisfy their loyal customers. However most airlines have very little understanding of their FFP members yet have a little knowledge about their most valuable customers. Most airlines have inaccurately determined their customer values by only considering business worth of nominal profit generated by FFP members. The value of customers beyond purchasing behavior has not been commonly captured yet. This non-financial value serves as a driver in retaining customers, hence becomes one of crucial factors in preserving the profitability of the organization. For this reason, this paper is the beginning of a study that aims to determine the customer' non-financial valuations to the organization as well as develop a model of the non-financial values. The relationships between relational benefit, relationship quality, and relationship marketing outcomes will be analyzed in this study. The effect of loyalty reward on the non-financial worth of FFP members to the airline is explored. Scope of loyalty reward program to be studied is a non-paid and accumulated reward program in the context of FFP offered by airline in Indonesia.

Keywords: Frequent Flyer Program, Loyalty, Relationship Benefit, Non-Financial Valuation

1. Introduction

In the context of customer equity, consumers generate values to the organization by means of financial and non-financial contributions. Based on the Customer Lifetime Value (CLV) approach, financial value to the organization is typically defined by business worth of nominal profit generated by customer. However, traditional model of CLV only captures the financial value of the customer to the organization (Reinartz & Kumar, 2000). The value of customers beyond purchasing behavior has not been commonly captured yet. As a matter of a fact, customers also give value to the organization through non-monetary means, such as helping the firm to attract other customers, retain some current customers, and also provide guidance to the firms. This beyond purchasing behavior has not been considered in determining customer value yet could mislead organization in losing valuable customers (Bolton et al., 2004).

Recognizing customer' values are crucial for the organization to sustain its profitability in terms of economic benefits and intangible supports generated by the customers (Hogan et al., 2003). In order to retain customers who are profitable to organization, company develop a relational program. A relational program is tool for organization to retain customers who are profitable and to build customer loyalty. This concept has been implemented in many business areas including airline industry. Initiating by American Airlines with its frequent flyer program (FFP) known as "AAdvantage" in 1981, FFPs become the largest membership of loyalty program with more than 120 million members enrolled in one or more of the 200 FFPs globally (McCaughey & Behrens, 2011). FFP awards generally reward loyal (and frequent) customers in the form of "loyalty currency" which can be used for free & upgrade flights, shop products, and other services. Having considered as a part of payment systems, frequent flyer miles represent one of the world's most popular currencies (Dreze & Nunes, 2004).

The primary goal of the FFP is to retain a base of committed customers who are most likely to contribute to the profitability of an airline. However most airlines have very little understanding of their FFP members yet have a little knowledge about their most valuable customers (O'Connel, 2009). This program has even been associated with the difficulty and restriction of the redemption policies. There were almost 17 trillion unredeemed frequent-flyer miles making only around 28% of frequent flyer points being redeemed than earned (Greenberg, 2008 in Ho et al., 2009). This fact leads to the question whether FFP is indeed beneficial for the members as well as to the issuer considering high cost involved in managing this program. Airline requires better understanding in customer needs and preferences and taking them into consideration to develop customer loyalty in the long periods of time (Weber, 2005).

While FFPs have attracted a great deal of attention in the transportation and marketing literatures, there has been no study on the effect of frequent flyer program on the non-financial value given by the members to the airline. As far as the context of this non-financial customer behavior to organization, to our knowledge, the first and only research on the effect of loyalty reward on the non-financial value, called "relational worth", of customer to organization (B-to-C exchanges) has been ever conducted is study by Melancon et al. (2011). Their study was carried out in a specific geographic area (USA) and on a specific type of relational programs, such as a professional sport team (paid and non-accumulated type of rewards) and experimental study (a fictional hotel reward). Consequently, the effect of loyalty reward toward the non-financial value of airline frequent flyers, in term of non-paid and accumulated type of rewards, has never been understood yet. For this reason, this paper is intended to analyze the effect of loyalty reward on the non-financial worth of the members to the airline. Scope of the study covers analyzing of a non-paid and accumulated reward program in the context of FFP offered by airline in Indonesia. Research is referred to FFP of an established airline in Indonesia. The analysis could not be examined to loyalty program on the other Indonesian carriers due to insignificant number of members (Globalflight, 2013). The study proposes a model of the relationship of FFP with the marketing outcomes, how FFP develops the expected relationship outcomes, and what is the

contribution of social benefits on FFP outcomes. This study becomes unique by analyzing the FFP program to determine the non-financial value of FFP members of an established airline by a direct access. Research with access to actual FFP data from an airline is still uncommon (McCaughey & Behrens, 2011).

This result contributes to the knowledge of aviation loyalty reward program by improving the effectiveness of the program from the aspect of enhancement the lifetime value of the members. It reveals a correlation of the non-monetary value of the members with reward benefits. The result contributes to the industry in increasing the lifetime value of its customer to sustain long-term relationship benefit of the firm as well as of the customers.

In the first part of the study, the review of literature on previous study or research is conducted. Based on the review, the conceptual framework is proposed. In the third part, work plans, research process and analysis are discussed.

2. Literature Review

Loyalty Reward Program (LRP)

A loyalty program is a marketing program to attract customer by offering rewards to encourage loyal behavior. The key-roles of this program are “loyalty” as the primary goal of loyalty program, and “reward” as the key instrument for attaining it (Yuheng, 2011). The basic concept of LRP is to enhance the profitability of customer relationship for long-term business relationship as a form of equity (Yuheng, 2011). Reward has proven strongly in affecting customers’ making decision and also their behavior changes as well (Gomez et al., 2006). A loyalty program weakens price competition by offering incentives for repeat purchase, leading to less price-sensitive brand switches (Kim et al., 2001) and also the partnership-like activities from the customers for the benefit of organization (Bowen & Shoemaker, 2003).

Dowling & Uncles (1997) classified a loyalty reward program onto a two-dimensional of loyalty programs: type of reward (direct versus indirect rewards) and timing of reward (immediate versus delayed rewards). Direct rewards, which directly support the value proposition of a given product or service, are intended to keep customer loyal on the product or service (Yuheng, 2011). Delayed rewards, which are provided at a later date from the point of sale, are more effective in shaping customer loyal behavior for retaining customer (Zhang et al., 2010).

Frequent Flyer Program (FFP)

As defined by Yi & Jeon (2003), FFP is classified as “a direct reward” with “delayed” time of reward. FFP is noted as a direct reward because it does directly support the value proposition of a given service. Airline awards FFP’ reward related to its core business (free ticket, upgrading, lounge, priority boarding, etc). As a loyalty program, FFP induced effect of loyalty from customers because FFP has the strongest influence on selecting an airline (Prousaloglou K & Koppelman F., 1995). Moreover, numerous studies on FFP have confirmed that FFP is positively significant in retaining loyal customer & attracting for new customer (Dowling & Uncles, 1997; Dowling et al., 2002; Long & Schiffman, 2000; Chin, 2002; Hsu & Wen, 2003; Suzuki, 2003; Weber, 2005).

It has been estimated that cost for retaining customer is only one fifth of cost for attracting new customer (Reichheld, 1996). Therefore, company would like to perform more business operations for customers in order to keep existing customers and build up long-term customer relationship. A successful loyalty program increases value-proposition of the product, retains loyalty and hence preserves the profitability from the customers (Kumar & Petersen, 2005). Loyalty reward program can be significantly costly for the organization despite the fact that loyal customers are not always generating profit to the firm in non-contractual settings (Reinartz & Kumar, 2000). Airline business is classified as a non-contractual setting as the time at which a customer ended the relationship with the

airline is unknown. FFP is costly to the airline, requiring about \$3 to \$20 per member per year for managing the program and involving about \$2M-\$12M to start up the program (O'Connell, 2009).

Relational Benefit

A relational benefit is perceived benefit - other than the core service itself - obtained by customers as a result of having a long-term relationship with the organization (Hennig-Thorou et al., 2002). Hence, these benefits are significant for both consumers and organization as well. Relational benefits include tangible and intangible outcomes such as: loyalty, positive word-of-mouth, relationship continuance, as well as customer satisfaction (Gwinner et al., 1998). Economic benefit includes price discounts, frequency discount, volume discount, price reduction, and special rates (Gwinner et al., 1998; Berry, 1995). The major benefits of FFP's members are free tickets and upgrading (Ya-Han Hsieh, 2007). Social benefits have been considered to involve feelings of familiarity, personal recognition, friendship, personalized & customized services, bond, social treatments, and high status relative to the average consumer (Berry, 1995; Phillips, 2007) and special treatments to customers, such as participating on exclusive events, better service, and friendship-like relationship (Berry, 1995; Gwinner et al., 1998). Customers feel engagement to the organization through affective commitment and enhance the value of transactional behavior (Price & Arnould, 1999; Rust et al., 2000).

In the context of relational program in aviation industry, airlines award their frequent flyers with economic benefits in the form of monetary rewards such as award and upgrade tickets as well as non economic benefits. Based on previous researches, FFP' members are identified expecting intangible values and services, such as: booking priority and booking guarantee, lounge facility extra luggage, and also priority baggage handling (Weber, 2005).

The fact that only about 28% of mileage being redeemed has been associated with the the reward redemption issues. Based on the cognitive evaluation theory, the condition of reward policy influences the behavior of customers. Previous studies found that controlling policy is affected by the reward type or and timing (Rothschild & Gaidis, 1981). Flexible reward policy increases customer commitment whereas strict reward policy is believed will weaken the effect of customer affective commitment while increase continuance commitment to the organization. Based on the this concept, this study is proposed that controlling reward policy of FFP has negative relationship with affective commitment of the members but positive relationship with continuance commitment.

Relationship Quality

Relationship program with tangible reward, such as frequent flyer programs, created customer trust in which leading to increasing customer commitment and loyalty (De Wulf & Odekerken-Schroder, 2003). However, study on different context found inconsistent result when the same structure of relationship amongst reward-trust-commitment-loyalty of frequent flyer program was not observed for direct mail and preferential or special treatments.

Relationship quality consists of multivariate constructs that represent the overall strength of a relationship and the extent to which it meets the needs and expectations of organization and consumers (Smith, 1998). The expectation and interaction of organization with its customers has been identified as the main factors contributing to the development of relationship quality. In the context of service industry, relationship quality can be regarded as the nature of relationships between organization and consumers whom are rely on the organization because its employees' integrity; consumers feel confidence because the past historical performance has been consistently satisfactory (Crosby et al., 1990). Existing literatures consider various conceptualizations on relationship quality but amongst the most common constructs encompass customer satisfaction, trust, and commitment to the relationship (Crosby et al., 1990; Morgan & Hunt, 1994; Hennig-Thorau, 2002). A three-component model of commitment (Allen & Meyer, 1990) illustrates that consumers are motivated to maintain a relationship with an organization through three approached of commitments, hereafter, as affective (desire-based),

normative (obligation-based) and continuance (cost-based) commitments. In this study, the relationships of customer commitments and satisfaction of FFP members in generating intangible outcomes are analyzed.

The benefits received from special treatments such as economic savings or customized services are expected to positively influence customer satisfaction with the service provider (Hennig-Thorau, 2002). According to Hennig-Thorau & Klee (1997), satisfaction is related to the realization of customer social needs which then leads to emotional bond of the customer to the service provider. Therefore, either social benefits or economic benefits are expected to influence customer satisfaction

Customer Involvement

Involvement is defined as an engagement with the product (the relation program). Behavioral learning theory suggests that involvement varies depending on the relationship between the individual relevances and benefits or reward offered. Low-involvement consumers are likely to be motivated by reward related issues than are high-involvement consumers (Rothschild & Gaidis, 1981; Dowling & Uncles, 1997). Under low-involvement, the reward and not the product can become the primary reward, while for high-involvement the product not the reward is the primary reward. Low-involvement consumers focus on reward program types, while high-involvement customers more concerned with the congruency between reward and the product being consumed (Yi & Jeon, 2003). Therefore, lower involvement consumers will show more distinct interaction of relational benefit and policy on customer relationship commitment than that of higher involvement customer.

In this study, level of tier is used as a proxy for involvement to assess if there are interactions amongst reward type, reward policy and involvement

Relational Worth

The true value of a customer to service industry is not only generated by economic benefits but also social interactions, such as word of mouth, imitation (adoption) and other social effects which can generate significant future profits for the firm (Hogan et al, 2003). Other previous study also indicated indirect effect of social behaviors in determining the profitability of an organization (Zeithaml, 2000). The other study in the context of aviation enterprises (Kalda, 2008) explained the relationship of financial and social outcomes of loyalty reward program and their impact to the business performance. She found that financial and social advantages of loyalty program significantly relates to airline profits.

Relational worth is defined as desirable social behavior of customer toward the organization (Melancon et al., 2011). This customer stewardship-like behavior is important to organization because customers voluntarily contribute in performing organization's responsibilities (Phillips, 2007). These voluntary-partnership activities by customer to organization include spreading word-of-mouth (WOM), giving business referrals, providing positive references & publicity to parties outside the organization, and providing information and feedback to the organization as well (Bowen & Shoemaker, 2003). The outcomes include decreasing the propensity to leave the relationship with the organization, reducing customer uncertainty, increasing acquiescence, increasing cooperation to organization, and increasing the belief that conflict will be functional (Morgan & Hunt, 1994). Stewardship behavior in the context of employees-organization is measured by willingness to accept personal challenges if they serve the long-term interest of the organization, willingness to accept personal challenges if they serve the long-term interest of the teamwork, willingness to help others to see the balance their responsibilities to the organization and to those outside organizations, and willingness to use leadership role appropriately to raise important issues (Kuppelwieser, 2011). Melancon et al. (2011) developed the constructs of relational worth based on customer relational behaviors that have not yet captured by traditional customer value models. Those dimensions of relational worth for business-to-customer context comprise as five-constructs, including WOM, immunity, openness, acquiescence, and honesty.

Effect of Relationship Quality to Relational Worth

The following table summarizes the research roadmap of relationship between customer commitment and satisfaction to relational worth drawn from past academic works.

Table 1: Study Roadmap on the Effect of Relationship Quality to Relational Worth

Relationship Quality	Relational Worth	Previous Studies	Result from previous study
Affective Commitment	Word-of-Mouth	Hennig-Thurau et al. (2002), Bendapudi & Berry (1997), Mowdays et al. (1982), Bowen & Shoemaker (2003), Finn (2005), Fullerton (2003), Harrison-Walker (2001)	+
	Immunity	Allen & Meyer (1990), Fullerton (2003), Jaros (1995), Phillips (2007), Bolton et al. (2000), Bendapudi & Berry (1997) Gruen et al. (2000)	+ Nil
	Openness	Mowdays et al. (1982), Bowen & Shoemaker (2003), Hirschman (1970)	+
	Acquiescence	Morgan & Hunt (1994), Ivens (2004), Heidi & John (1992), Bendapudi & Berry (1997)	+
	Honesty	Vankehove et al. (2003), Gruen et al (2000), Meyer et al. (2002)	-
Normative Commitment	Word-of-Mouth	Phillips (2007) Meyer & Allen (1991) Gruen et al. (2000)	- Nil +
	Immunity	Bansal et al. (2004), Phillips (2007) Gruen et al. (2000) Randall (1990), Meyer et al (2002)	- Nil +
	Openness	Phillips (2007) Meyer & Allen (1991) Gruen et al. (2000)	- Nil +
	Acquiescence	Phillips (2007) Meyer & Allen (1991) Gruen et al. (2000)	- Nil +
	Honesty	Phillips (2007), Gruen et al. (2000), Meyer et al (2002)	-
Continuance Commitment	Word-of-Mouth	Fullerton (2003), Bendapudi & Berry (1997) Harison & Walker (2001), Gruen et al (2000) Meyer et al. (2002), Phillips (2007)	- Nil +
	Immunity	Phillips (2007), Fullerton (2003), Meyer et al (2002) Gruen et al. (2000) Bansal et al. (2004), Bendapudi & Berry (1997)	+ Nil -
	Openness	Phillips (2007) Gruen et al. (2000) Bendapudi & Berry (1997)	+ Nil -
	Acquiescence	Gruen et al. (2000) Phillips (2007)	Nil -
	Honesty	Meyer et al (2002) Joshi & Arnold (1997), Phillips (2007), Geykens et al. (1996)	Nil +
Satisfaction	Word-of-Mouth	Reichheld & Sasser (1990), Anderson (1998), Caruana (2002), Imran Saeed (2011)	+
	Immunity	Morgan & Hunt (1994), Ekinici et al. (2008), Caruana (2002), Anvari (2011)	+
	Openness	Morgan & Hunt (1994), Ping R. (1993), Reza et al (2011)	+
	Acquiescence Honesty	Morgan & Hunt (1994) Reza et al (2011)	+ -

Based on the above review and referring to previous study by Melancon et al. (2011), the hypothesized relationships are proposed for this study as below.

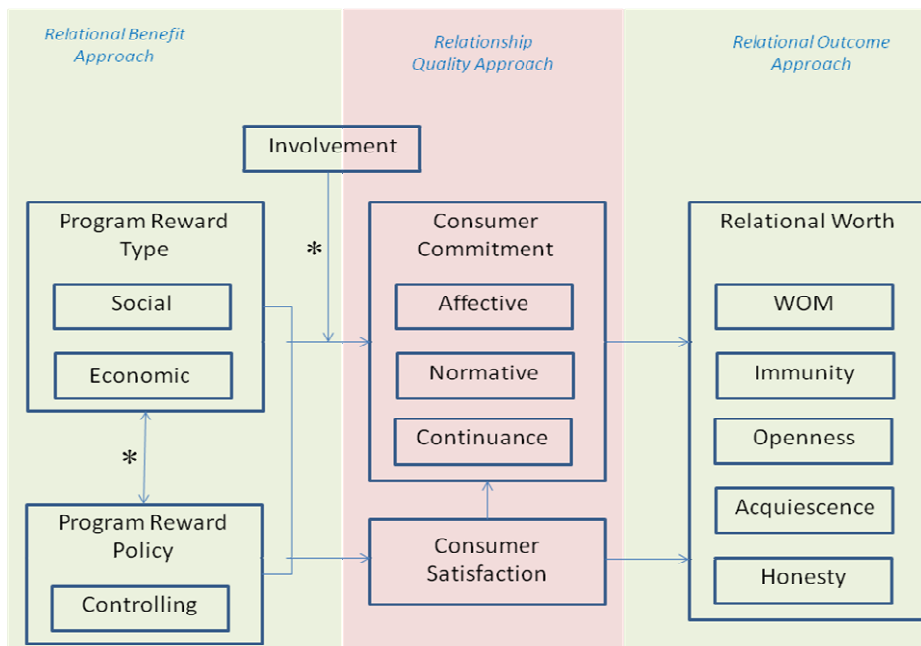
Table 2: Hypothesized Relationship

Hyphotesis	Relationship To Be Tested	Hypothesized Direction
H1	Social Rewards → Affective Commitment	+
H2	Economic Rewards → Affective Commitment	-
H3	Social Rewards → Continuance Commitment	-
H4	Economic Rewards → Continuance Commitment	+
H5	Social Rewards → Satisfaction	+
H6	Economic Rewards → Satisfaction	+
H7	Controlling Reward Policy → Affective Commitment	-
H8	Controlling Reward Policy → Continuance Commitment	+
H9	Social Reward * Controlling Policy → Affective Commitment	-
H10	Social Reward * Controlling Policy → Continuance Commitment	+
H11	Economic Reward * Controlling Policy → Affective Commitment	-
H12	Economic Reward * Controlling Policy → Continuance Commitment	+
H13a	Social Reward * Controlling Policy * Involvement → Affective Commitment	-
H13b	Social Reward * Controlling Policy * Involvement → Continuance Commitment	+
H13c	Economic Reward * Controlling Policy * Involvement → Affective Commitment	-
H13d	Economic Reward * Controlling Policy * Involvement → Continuance Commitment	+
H14	Satisfaction → Affective Commitment	+
H15	Satisfaction → Normative Commitment	+
H16	Satisfaction → Continuance Commitment	+
H17	Affective Commitment → Relational Worth	+
H18	Normative Commitment → Relational Worth	+
H19	Continuance Commitment → Relational Worth	-
H20	Satisfaction → Relational Worth	+

Note (*): interaction between the constructs

Derived from on the above approaches, the model of relational values of FFP members to the airline is developed as below:

Figure 1: Conceptual model of Relational Worth



Note (*): interaction between the constructs

3. Methods

Location and Time

The study is conducted on a FFP' membership of an Indonesian airline. The model of the relationship relational benefits and relational worth for FFP will be empirically tested with conducting a survey. The survey is conducted on July-September 2013.

Data Source

The research involves primary data as well as secondary data. Primary data on the relational benefit, relationship quality and relational outcomes are obtained from survey questioners, while data related to the customer profiles and financial transactions obtained from internal database of the airline.

Data Collection

For analyzing the financial value derived from current customers, the data will be collected through compiling from Garuda Indonesia's internal GFF and Revenue Management database. The data are collected through cross-sectional survey on the FFP members by distributing questioner through online survey.

Sampling Technique

The sampling technique is a combination of stratified and systematic random sampling. Stratified sampling is determined based on the tier level then the individuals are chosen based on systematic random sampling.

The sampling element is loyalty member. Population is the FFP members of the airline. Sampling element: Registered FFP members in 2012 (594,320 members). Sampling Unit is individual registered FFP members. Sampling Frame is list of FFP members. Referring to Hair et al. (2010), the minimum SEM sample size suggested for the models with large number of constructs, some with lower communalities, and/or having fewer than three measured items, is minimum is 500. With assumed response rate 10%, the sample size is 5,000.

Variables

In term of modeling the relationship benefits and relational worth for FFP, the variables comprise of exogenous and endogenous latent variables.

Table 3: Exogen Latent Variables of Model Relational Worth

No	Exogenous Latent Variable	Operational Definition	Measurement	Item#	Scale	Method
1	Social Reward Benefit	priority boarding, priority reservation, lounge access, baggage handling	Modification of Hennig-Thurau et al. (2002)	4	Ordinal	Likert 1-6
2	Economic Reward benefit	financial incentives by mileage redemption: free ticket & upgrading ticket the condition (controlling or flexible) in which the reward is offered or redeemed	Modification of Hennig-Thurau et al. (2002)	3	Ordinal	Likert 1-6
3	Controlling		Melancon et al. (2011)	3	Ordinal	Likert 1-6
4	Involvement	The engagement with the product	Modification of Zaichkowsky (1985) Yi & Jeon (2003)	3	Ordinal	Likert 1-6

The following are endogenous latent variables

Table 4: Endogen Latent Variables of Model Relational Worth

No	Endogen Latent Variable	Operational Definition	Measurement	Item#	Scale	Method
1	Affective Commitment	Member' commitment because of emotional bonds with the airline	Allen & Meyer (1991)	3	Ordinal	Likert 1-6
2	Normative Commitment	Member' commitment because of obligation feeling with the airline	Allen & Meyer (1991)	4	Ordinal	Likert 1-6
3	Continuance Commitment	Member' commitment due to switching cost	Allen & Meyer (1991)	2	Ordinal	Likert 1-6
4	Satisfaction	Consumer' emotional to the perceived difference between performance appraisal & expectations	Oliver (1980)	3	Ordinal	Likert 1-6
5	WOM	A willingness to spread positive word-of-mouth	Modification of Anderson (1998)	3	Ordinal	Likert 1-6
6	Openness	A willingness to provide information to the airline	Bendapudi & Berry (1997), Hirschman (1970)	3	Ordinal	Likert 1-6
7	Acquiescence	A willingness to adapt to necessary changes related to the airline	Ivens (2004), Wilson (1995)	3	Ordinal	Likert 1-6
8	Immunity	A tendency to remain loyal to the airline	Bolton (2000)	3	Ordinal	Likert 1-6
9	Honesty	A willingness not taking advantage of the airline in any manner	Joshi & Arnold (1997)	3	Ordinal	Likert 1-6

Structural Equation Modeling (SEM)

SEM analysis aims to test and statistical models in the form of causal models. SEM analysis is based on the analysis Confirmatory Factor Analysis (CFA), a method that combines the correlation analysis, regression analysis, traffic analysis and factor analysis. While the software used in the SEM analysis was LISREL 8.5.1.

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