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Price or Privilege? Customer Perception on Loyalty Programs

*Asnan Furinto**

The main purpose of the research is to understand how customers perceive loyalty programs. The author argues that types of loyalty programs could be classified into two: price based and privilege based. This research models that customer perceptions on loyalty programs, differ between these two types, and is contingent upon the relationship between customers and firm. Using settings of airline domestic passengers and bank customers in Indonesia, the research provides evidence that price based rewards are perceived to provide higher utility perception in contractual relationships compared to non contractual relationships. However, this research failed to provide empirical support that privilege based rewards are perceived to provide higher utility perception in non contractual relationship compared to contractual relationship. Firms are therefore, encouraged to incorporate affective elements into their loyalty programs, on top of monetary elements, in order for the loyalty programs to be better perceived by their customers.

Keywords: Loyalty programs, price based rewards, privilege based rewards, affective commitment, customer perception.

Tujuan utama penelitian adalah untuk mempelajari persepsi pelanggan terhadap program loyalitas. Peneliti mengelompokkan program loyalitas ke dalam dua kategori yaitu yang berbasis harga dan yang berbasis hak istimewa. Model penelitian memasukkan variabel jenis relasi antara pelanggan dan perusahaan sebagai variabel moderator antara kedua kategori program dengan persepsi pelanggan. Konteks yang digunakan adalah industri penerbangan domestik dan perbankan di Indonesia, dan hasilnya menunjukkan bahwa program loyalitas berbasis harga dipersepsikan memiliki tingkat utilitas yang lebih tinggi pada jenis relasi kontraktual dibandingkan non kontraktual. Namun begitu, penelitian tidak dapat menunjukkan dukungan empirik bahwa program loyalitas berbasis hak istimewa akan dipersepsikan memiliki tingkat utilitas yang lebih baik pada jenis relasi non kontraktual dibandingkan kontraktual. Implikasi dari penelitian ini adalah perusahaan dianjurkan untuk selalu berusaha memasukkan elemen afektif kedalam program loyalitasnya, dan tidak hanya mengandalkan elemen ekonomis agar program tersebut dipersepsikan dengan lebih baik oleh para pelanggannya.

Kata kunci: program loyalitas, penghargaan berbasis harga, penghargaan berbasis hak istimewa, komitmen afektif, persepsi pelanggan

Introduction

One of the most popular strategies developed by firms to retain their customers is the implementation of loyalty programs. A loyalty program is a marketing action of a firm that is designed to provide reward incentives for profitable customers who are deemed to be loyal to the focal firm (Youjae and Jeon 2003), providing more satisfaction and values to certain customers (Bolton, Kannan and Bramlett 2000), retaining customers by creating high switching costs and building a base of customers who make repeat purchases, pay premium prices and

make referrals to other customers (O'Brien and Jones 1995).

Some researchers have attempted to introduce typologies of loyalty programs (Dowling and Uncles 1997). The current research puts forward a new typology of designing loyalty programs. It is posited that all loyalty programs can be categorized as either price based rewards or privilege based rewards.

Loyalty programs should be designed in such a way that they would be perceived posi-

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tively by the customers, and create attitudinally loyal customers

Assessing how types (price based rewards or privilege based rewards) of loyalty program designs interact with relationship modes in affecting customers utility perceptions of the programs, has been unsatisfactory to date, despite many attempts. Therefore, the current research strives to close the gap in marketing literature by focusing on the *ex ante* of loyalty program design instead of *ex post*. Given the high costs and risks involved in implementing and administering loyalty programs, this research intends to investigate the imperatives for firms to plan meticulously before launching loyalty programs for their customers, and to carefully design the types of programs being considered prior to actual implementation.

The main purpose of the current research is to fill the void in marketing literature on loyalty programs by generating a theory of *ex ante* competitive loyalty program design. Pursuant to the main purpose, this research will attempt to (1) empirically show the main effects of program types (price based or privilege based rewards) on customers' utility perceptions and (2) investigate the interactions between types of loyalty program and relationship modes on customers' utility perceptions.

Literature Review

Customer loyalty programs have attracted widespread attention from marketing researchers (Kivetz and Simonson 2003). The focus of this research has been directed toward investigating how these programs contribute to customer perception.

Further, it is generally accepted that short and long term oriented customers differ in factors that determine their future exchanges (Garbarino and Johnson 1999). Customers with transaction orientation rely on satisfaction, whereas customers with relational exchange orientation rely more on trust and commitment. Firms must be able to approach these different types of customers with the appropriate marketing activities.

Recent work has shown that hedonic benefits evoke promotional emotions of cheerfulness and excitement, whereas utilitarian ben-

efits evoke preventive emotions of confidence and security (Chitturi, Raghunathan and Mahajan 2008). These emotions would eventually lead to post consumption satisfaction, word of mouth referrals and repurchase intentions.

Price based rewards in this research are analogous to utilitarian benefits and hedonic based rewards are analogous to hedonic benefits. Post consumption emotions correspond to loyalty program utility perceptions, as both constructs measure the customer's assessment towards different sets of stimuli, namely product benefits and types of loyalty programs respectively.

Privilege Based Rewards

Loyalty programs designed with special treatment rewards are, mainly to provide comfort and peace of mind to loyal customers. Customers develop feelings of reduced anxiety, increased trust and confidence in the firm (Gwinner, Gremler and Bitner 1998). For example, loyalty programs of a restaurant which provides certain strategic tables only for its selected customers will provide the selected customers with feelings of assurance and reduced anxiety that they surely will get a table anytime they patronize the restaurant, a benefit which could not be obtained by other, non selected customers.

Privilege based rewards, to a certain extent, are analogous with hedonic benefits. They both refer to aesthetics, experiential and enjoyment related benefits of offerings. In the context of consumer goods such as cars, availability of sun-roofs and luxurious interiors is an example of hedonic benefits. Special treatment rewards trigger promotion emotions of cheerfulness and excitement in customers' minds.

Price Based Rewards

Loyalty program designs which contain types of price based rewards are mainly aimed at providing economic advantage to selected numbers of firms' customers. These customers could easily calculate their better "profit and loss statement" compared to other on-selected customers. The rewards could be in the forms of real cash, bonus points, vouchers and others, but despite the various forms, customers

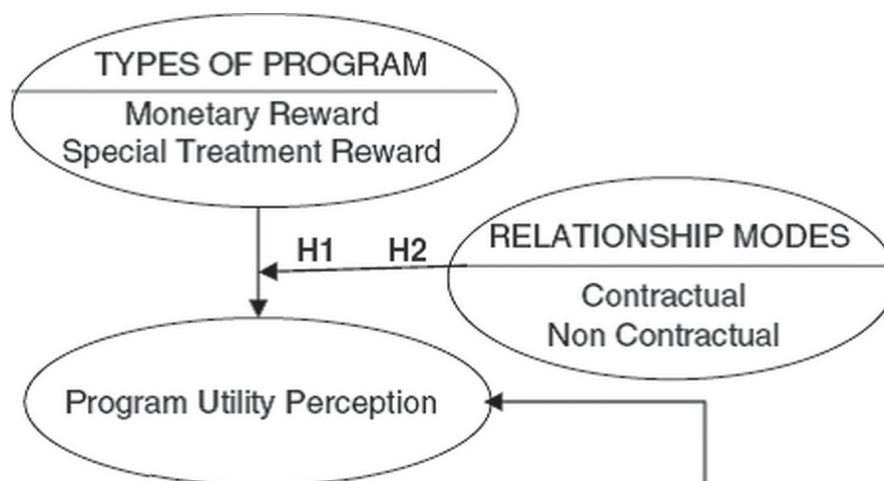


Figure 1. Research Model

are usually able to perform “conversion” of the rewards value into the equivalent cash value.

Price based rewards are, to a certain extent, analogous with utilitarian benefits. They both refer to functional, instrumental and practical benefits of offerings. In the context of consumer goods, a mobile phone’s battery life and sound volume are examples of utilitarian benefits. Price based rewards trigger the prevention emotions of confidence and security in customers’ minds (Chitturi *et al* 2008).

In practice, loyalty programs of price based reward types are at risk of being perceived to be similar with promotion programs (Youjae and Jeon 2003). Marketers must carefully design loyalty programs in such a way that they do not give instant rewards to any customers. Rewards must be given only to those customers who are potentially loyal (i.e. if the loyalty programs have not yet been implemented) and loyalty programs must be maintained at nurturing long term successful relational exchanges (Morgan and Hunt 1994) instead of maximizing short term sales for the firm.

Contractual and Non Contractual Relationships

In general, the relationship between a customer and a firm could be classified into two modes, which are contractual and non-contractual (Reinartz and Kumar 2000). The main difference between the two modes depends on whether the relationship is governed by a legal contract or membership inclusion, in the contractual instance, or neither in the non-contractual

instance. In a contractual relationship, a customer is “locked” to a firm for a specified period, whereas in the non-contractual relationship, the customer has free choice to transact with any firms at his or her own volition.

The difference between the two modes of relationship can also be seen from the point of view of switching costs. Contractual relationships force higher switching costs onto the customers, whereas non-contractual relationships have either lower or no switching costs. Figure 1 depicts the model used in this research. There are two categorical independent variables (types of program), one numerical dependent variable (contractual and non contractual), and one control variable which is the affective commitment.

Affective commitment is treated as a control variable in the current research, because prior encounter between customers and the focal firm may provide seeds of opportunities for the firm and its customers to have a strong relationship platform, which eventually give effect on how customers perceive the utility of loyalty programs. The effect of affective commitment to the utility perception must therefore be isolated.

Hypotheses Delopment

The Effect of Priced Based Rewards on Program Utility Perception

Price based rewards contained in loyalty programs will be perceived more positively by customers in contractual relationships. The nature of a contractual relationship is such that a

customer is “forced” to make transactions with a firm (Bansal, Irving and Taylor 2004), regardless of whether he or she is satisfied with the firm, until the contract period is over. Therefore, monetary rewards will be seen by the customers as a “compensation mechanism” to make up for any shortcomings experienced during the relationship period, and as a result the firm will be perceived more positively. Contractual relationships are more formal, businesslike, and straight forward in nature, which shall make the value of monetary rewards easier to align with the main product or service being offered.

In contrast, customers in a non-contractual relationship will exhibit opportunistic behavior¹⁴ or spurious loyalty if they are given price based rewards. Customers will view the loyalty programs as the same as ordinary promotion programs, since the forms of rewards are easy to convert into economic gain or advantage. Customers may decide to choose the firm as their supplier due to the rewards but it does not necessarily mean they will stay loyal in the future.

H1 : The effect of the price based rewards loyalty program type on program utility perception is contingent upon the relationship modes, and as such the program utility perception will be (a) higher in a contractual relationship and (b) lower in a non-contractual relationship.

The Effect of Privilege Based Rewards on Program Utility Perception

Non-contractual relationships entail fewer formal business procedures and no legal or administrative constraints in conducting business, and this could seed a positive, mutual relationship and bonding between a company and its customers. With such a relationship, the value of privilege based rewards is easier to align with the main product or service being offered, creating better utility perception for customers. Privilege based rewards are potential in delivering both surprise and delight to customers.

For customers in a contractual relationship, privilege based rewards would be perceived as something which is already included in the “price” they have paid to the firm. As customers are bound and attached to a firm, they ex-

pect that it will provide more tangible benefits to them in return.

H2 : The effect of the privilege based rewards loyalty programs type on program utility perception is contingent upon the relationship modes, and as such the program utility perception will be (a) lower in a contractual relationship, and (b) higher in a non-contractual relationship.

Methods

This research uses convenience sampling, which is classified under non-probability sampling (Malhotra 2007).. The research uses two service categories as the basis for data collection and sample drawing. The categories are domestic airline (as representative for non contractual relationship) and banking services (as representative for contractual relationship). Both service categories are utility driven, hence secondary demand is more expected to occur than primary demand, making airline and bank appropriate settings for the current research.

For each service category, the respondents were asked on the most recent airline (bank) they have done business with. The firms in each service category must be selected as such that the firms are considered major players in the respective category, but at the same they are more or less equally competitive in consumers’ mind.

Data for the airline service category was mostly obtained from airline passengers about to board flights departing from the domestic terminal of Jakarta’s main airport - Soekarno-Hatta. As for the bank service category, since the data were collected conveniently from university colleagues and students, and professionals, etc all domiciled in Jakarta (the capital city of Indonesia), it is considered reasonable to assume that each respondent is relatively familiar with bank services.

For each service category, there were two prepared sets of questionnaires, namely one set for price based rewards, and one set for privilege based rewards. The questionnaires firstly asked participants to answer several questions about the focal airline/bank, to measure their affective commitment as a covariate. Affective commitment is controlled in order to ensure that

respondents have high numbers of repeat visits, and to investigate the types of attachments to the firm, as required by the theoretical models (Fullerton 1999).

Next, they were asked to read one of the four prepared scenarios for a loyalty program, while assuming that the airline/bank is considering introducing such a loyalty program. They are then asked to evaluate the perceived utility of the loyalty program of the airline/bank.

The two independent variables i.e. types of loyalty program and relationship modes, are manipulated by the different sets of questionnaires (for types of program) and by the service category (for relationship modes).

Result and Discussion

Data collection was carried out in 2 (two) waves, using two different sets of respondents in two different time periods, with a time gap between the first and the second data collection of around 7 (seven) weeks.

The 1st data collection managed to obtain 105 people as eligible respondents, while the 2nd data collection (after replacing 29 non-eligible respondents with new respondents in a make up survey) eventually obtained 152 eligible respondents. The two waves of data collections make a total of 257 respondents without missing data in the current research.

H1 and H2 could be tested simultaneously using ANCOVA, such that

$Y_{ijk} = \mu + (A)_i + (AB)_{ij} + X + \epsilon_{ijk}$, whereby

Y_{ijk} = the k th observation in cell i, j for program utility perception

μ = mean value of program utility perception

X = covariate, which is the affective commitment to the firm prior to evaluating the loyalty program

$(A)_i$ = parameter of the effect of the i th level of the reward types

$(AB)_{ij}$ = parameter of interactions between program types and relationship modes in cell i, j .

ϵ_{ijk} = random error

The null hypothesis is $(AB)_{ij} = 0$, for each i and j .

The regression equations for ANCOVA, obtained from the parameter estimates using SPSS 14.0 of 1st data collection and 2nd data collection respectively, are as follows:

Program Utility Perception (1st data collection)
 $= 10.941 - 0.05*[A=1] + 0.058*[A=1]*[B=1] - 1.363*[A=2]*[B=1] - 0.113*X$

Program Utility Perception (2nd data collection)
 $= 10.781 + 0.073*[A=1] + 0.928*[A=1]*[B=1] - 1.152*[A=2]*[B=1] - 0.100*X$

The results give support to H1 but failed to support H2. Price based rewards are perceived better by bank customers (contractual relationship) compared to airline customers (non-contractual relationship). As for privilege based rewards, both bank customers and airline customers perceive the programs as the same insofar as utility is concerned, with no significant differences existing between the two modes of relationship.

Insignificant support for H2 suggests that there are exogenous factors which attenuate the moderating role of relationship modes. A recent research shows that there are asymmetric additivity effects between a base product and additional features embedded in the base product (Gill 2008). Specifically, utilitarian products with additional hedonic features create more value than those with additional utilitarian features, whereas hedonic products with additional hedonic features create more value than those with additional utilitarian features.

Airline and bill payment services (i.e. the base products) which are more utilitarian in nature, may also experience these effects. Privilege based rewards (i.e. the additional features) which are more hedonic in nature might create higher value (i.e. enjoyment and excitement) in the perceptions of customers in both relationship modes. The moderating roles of relationship modes might have dissipated due to the high excitement induced by the privilege based rewards.

Conclusion

The results show that: (a) program utility perception is indeed higher when price based rewards are offered to bank customers (contractual relationship).

tual relationship) instead of to airline customers (non-contractual relationship), and (b) there are no significant differences in program utility perception between bank customers (contractual relationship) and airline customers (non-contractual relationship) when a loyalty program is designed to offer privilege based rewards.

The research shows how managers shall plan the design of loyalty program prior to its implementation. By varying the types of loyalty programs, the notion that loyalty programs are of one static type is discarded, since different drivers of loyalty, as channeled through different types of loyalty program design, may affect customers differently in their perceptions.

Another implication is that this research specifically extends the framework of loyalty program typology, as suggested by previous scholars, by classifying the types of loyalty program design into price based and privilege based rewards. The new suggested typology of loyalty programs covers almost all forms and designs of programs as practiced by firms in various industries to date, with the objective of making the result of the current research generalizable.

Firms in contractual relationships are encouraged to design loyalty programs that contain elements of price based rewards, as these types of loyalty program designs would generate better utility perceptions from their customers. As for the privilege based rewards, both firms in contractual and non-contractual relationships should adopt them. In the latter case, firms have greater leeway to opt for which types of rewards they want to incorporate into future loyalty programs. Loyalty programs with privilege based rewards could create insignificant differences in customer utility perception.

There are several limitations in the current research. Firstly, this research uses convenience sampling, which may imply that the result is not generalizable to the whole population. Future research using different respondents and settings is plausible.

Secondly, current research uses a field experiment, which naturally contains many exogenous and confounding factors (time constraints of passengers, hot weather, fatigue, etc) that could not be controlled. Future research may attempt to replicate the setting in a laboratory experiment, to assess whether the effects obtained from the field also appear in an isolated environment. Manipulation checks in future research might also be applied in confirming the types of reward and the significance of reward manipulation in customers' perceptions (i.e. is 5% sufficient or might it be increased to 10% etc).

Thirdly, the current research uses text based stimuli to manipulate the types of programs. Stronger stimuli for types of programs (using pictures, audio, brochures, etc) are suggested for use in future research. With stronger stimuli, it is expected that different drivers of loyalty program could be more clearly observed. Future researchers may also further explore how varying levels of price based rewards (i.e. 5% vs. 10% vs. 20%, etc) and privilege based rewards (i.e. only dedicated staff vs. dedicated staff plus personalized service, etc) may exert different impacts on customer perception.

Lastly, the GLM procedures used in this research limit conclusions on causality. Future research may use Multivariate SEM as an analytical tool, in order to check simultaneous relationships among variables, and thus reach more tenable conclusions.

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