Chapter 22
Frequency Reward Programs

Abstract Frequency reward programs are customer development programs based on the theme, “Buy XXX, get a reward.” “XXX” is usually a required purchase volume, and the reward can be free product, a cash rebate, or even “points” for another company’s reward program. We discuss two ways that reward programs increase sales – points pressure and rewarded behavior – and the empirical evidence for each. We then review the rich economics literature that has endeavored to answer the question, “In a competitive environment, do reward programs increase firm profits?” We review several issues in designing reward programs, including the reward structure, and conclude with a review of reward programs offered by firms including Harrah’s Entertainment and Hilton Hotels.

22.1 Definition and Motivation

Frequency reward programs attempt to increase customer value by rewarding customers proportional to their cumulative purchases, revenues, or profitability. Reward programs are used in a variety of industries such as hotels, car rentals, supermarkets, credit cards, office products, telecom, and gaming casinos. In fact, the airline industry’s frequent flyer programs have in effect created a new currency in the “miles” travelers accumulate. In terms of the simple retention model of customer lifetime value,

\[
LTV = \sum_{t=1}^{\infty} \frac{m_t r^{t-1}}{(1 + \delta)^{t-1}}
\]  

(22.1)

frequency reward programs strive to increase both retention rate \(r\), the customer stays with the firm longer) and the amount purchased \(m_t\), the customer buys more to accumulate enough “points” to receive a reward).

We differentiate between frequency reward and customer tier programs (Chapter 23). Customer tier programs assign customers to segments or tiers
and deliver different benefits to each tier. Frequency reward programs are a narrower promotional-oriented activity. They focus on the delivery of a single reward – a free flight, an upgrade, a coupon, etc. – based on accumulated points.

Both frequency reward and customer tier programs are often called “loyalty programs.” We do not use that term because loyalty may be a goal of these programs, and they do increase purchase frequency. But whether they increase “loyalty”, defined as “a favorable attitude toward a brand resulting in consistent purchase of the brand over time” (Assael 1995, p. 131) is another matter.

### 22.2 How Frequency Reward Programs Influence Customer Behavior

#### 22.2.1 Mechanisms for Increasing Sales

There are three mechanisms by which the program can increase customer value: points pressure, rewarded behavior, and personalized marketing. Figure 22.1 illustrates.

The points pressure mechanism represents customers increasing their expenditures in order to earn the reward. The attractiveness of the reward obviously increases points pressure. Also, the reward program can create a switching cost for the customer, in that the customer who decides to purchase elsewhere forgoes the opportunity to accumulate points toward the reward (Taylor and Neslin 2005).

The points pressure effect should get stronger as the customer nears the requirements for a reward. First, the reward is subject to less discounting as it looms closer. Second, Kivetz et al. (2006) propose two psychological reasons for points pressure: (1) Goal-gradient hypothesis – this is a behaviorist

![Points Pressure Mechanism](image1)

![Rewarded Behavior Mechanism](image2)

![Personalized Marketing Mechanism](image3)

**Fig. 22.1** Customer response to frequency reward programs: How reward programs influence retention and purchase volume.