ChangeThis
186.01

THE EMERGING INEQUALITY OF CUSTOMER LIFETIME VALUE

Nelson D. Schwartz

Adam Goldstein walks a fine line.

As vice chairman of Royal Caribbean, he wants the cruise ship line's most elite passengers to have a superior experience—but at the same time, he needs to make sure ordinary guests don't feel like second-class travelers when they come aboard his ships.

It's a job that's gotten harder in recent years as Royal Caribbean has broadened its offerings to attract more deep-pocketed cruisers. Like many consumer-facing businesses, Royal Caribbean has gone after the one percent because that's where the growth is. The result is what I call the Velvet Rope Economy. On Royal Caribbean cruises, a virtual velvet rope divides passengers who dine at the Windjammer Café, which is open to everyone, from an elite oasis next door called Coastal Kitchen. There are no crowds at Coastal Kitchen and the calm atmosphere inside is a world away from the hectic scene at Windjammer. When jealous refugees from Windjammer work up the courage to open the frosted glass doors and inquire about a table, they are politely—but firmly—informed that Coastal Kitchen is only open to guests in the ship's Royal Suite Class or members of Pinnacle, Royal Caribbean's version of elite frequent-flier status on the airlines.

The split between Windjammer and Coastal Kitchen is a metaphor for contemporary consumer life. Whatever the arena—health care, education, work, travel and leisure—on the right side of the rope is a friction-free existence where, for a price, needs are anticipated and catered to. Red tape is cut, lines are jumped, appointments are secured, and doors are opened.

On the other side of the Velvet Rope, friction is practically the defining characteristic, with middle- and working-class Americans facing an increasingly Darwinian fight for a decent seat on the plane, a place in line with their kids at the amusement park, a college scholarship, or a doctor's appointment.

The evolution of class distinctions at Royal Caribbean sums up what's happened at many companies. Beginning in the late 1990s, Royal Caribbean introduced dedicated concierge lounges for suite occupants. It was a tentative process, Goldstein recalled, and executives carefully monitored guests for any sign of pushback. Initially, repeat Royal Caribbean customers in regular rooms were irritated that the concierge lounges for suite guests were off-limits to them. In response, management retrofitted ships to create additional lounges earmarked for the top tier of frequent cruisers, wherever they were staying on board the ship.

Since then, Royal Caribbean has steadily become more comfortable with heightening the contrast between the treatment meted out to ordinary passengers and the level of service reserved for upper-class passengers. "We didn't go from day to night in terms of stratification," Goldstein said. "We went from absolutely no differentiation outside the stateroom to some, and slowly but surely the guests who had the resources to do so showed they were willing to pay for it."

In addition to expecting larger rooms and softer sheets, big spenders also want to feel special nowadays—a desire companies like Royal Caribbean are happy to indulge. For example, room service requests from Royal Suite occupants are automatically routed to a different number than the one available to regular passengers, who get slower, less personalized service.

"In our sector and others, people paying higher amounts have become more conscious about receiving a higher level of services and amenities," Goldstein said. "They are looking for constant validation that they are higher-value customers. That's now accepted as the norm in today's society. This is what people have become habituated to."

But essentially telling ordinary passengers "you get what you paid for" is not a simple proposition. As new tiers of luxury and service are rolled out, Royal Caribbean is always watching to ensure that stoking a customer's aspiration to splurge on the next cruise doesn't curdle into disappointing them with a present one.

If the gap in service grows too wide, and envy tips into resentment, you risk turning off a large number of customers and losing them forever. Diminish the differences between classes, however, and there's much less incentive to trade up to a more expensive room. "Somehow, people who work here are genetically programmed to be nervous," Goldstein said. "We constantly innovate and are running scared at the same time." That's among the reasons Royal Caribbean has always closely studied the habits of its guests. "We have to be very careful to do it right."

Indeed, as Goldstein admits, consumer-facing companies like Royal Caribbean that sell experiences, rather than a physical product like a handbag or a car, must master a delicate balance.

On the other side of the Velvet Rope, friction is practically the defining characteristic…

"Where we risk a guest's discontent is if special services are delivered in people's faces," Goldstein explained. "If it's made too obvious, if they're actively sacrificing for other guests, they are likely to be disappointed. If guests have a wonderful time, and somebody else who paid a lot more money for a suite is getting a special amenity, I don't think it's a problem."

What does that mean in practice? After all, standing in line to grab a tray at a crowded buffet table while suite guests sit comfortably behind frosted glass across the way certainly sounds "in your face." But that's not how passengers perceive it, Goldstein told me.

Separate restaurants for different classes, even if they are adjacent to one another as in the case of Windjammer Café and Coastal Kitchen, don't bother people nearly as much as special seating for a few swell guests in the same restaurant. "If you have areas within a restaurant that are perceived as the choicest table, that's a level of visibility we feel less comfortable with," he said. "During your whole time at dinner, you are conscious of it."

The cruise line has continued to add more and more high-end experiences for big spenders off the ship, while retaining cheaper options for price conscious travelers. On cruises to Cozumel, for example, Royal Caribbean offers a four-hour trip to the island on a small party boat for $79. It also pitches a private catamaran tour for a family of four for $1,000.

On trips to Alaska, the luxury options are even more extravagant, including a helicopter ride to a glacier or a day trip from the ship in a seaplane for fishing and a salmon bake on shore. Budget travelers watch orcas from the deck. That said, the system does make for some odd, occasionally uncomfortable juxtapositions. When Royal Caribbean ships call at Labadee, the cruise line's private resort in Haiti, elite guests get their own special beach club–an enclave within an enclave in the Western Hemisphere's poorest country.

"It was prime," said Bob Schillo, who visited Labadee with his wife, Bobbie, during a Royal Caribbean cruise in 2018. "As a suite guest, they had a special section, and there was a person there to serve you food and whatever toys you wanted like rafts and snorkels. It was all provided."

On board ship, Schillo said he particularly liked that the best seats at shows were reserved for travelers in the biggest rooms. "You get spoiled," he said. "I didn't have to make a reservation and you don't have to fight for a decent seat. At every show, you'd just show up and sit in the first couple of rows." When their Caribbean cruise was over and the ship returned to port in Fort Lauderdale, the Schillos were escorted off ahead of the thousands of non-suite-guest passengers. "When you leave the boat, you are walked right through customs," he said. "It took less than ten minutes to get off the boat and into a cab. Wham-bam."

As long as ordinary passengers are politely told that suite passengers and the most frequent cruisers have priority, or can dine at Coastal Kitchen, and it's not a secret who gets to go and why, perks are transformed into what Goldstein calls "aspirational opportunities."

And there are plenty of other restaurants to choose from for lunch besides Coastal Kitchen; Johnny Rockets and Michael's Genuine Pub are open to all passengers. As far as Royal Caribbean is concerned, Goldstein said, "It's hard to imagine someone would think they're prevented from having a diverse culinary experience just because they can't have lunch at Coastal Kitchen."

As the opportunity to flaunt one's position has become more widespread and more socially acceptable for Americans, businesses are more than happy to oblige them. "Companies prey upon people's need for status," said Joseph Nunes, chairman of the marketing department at the USC Marshall School of Business. "People look up to figure out where they are in the hierarchy, and they look down in general to feel better about themselves," he added, citing what's known as social comparison theory.

Nunes, who has consulted for giants like Nestlé and Southwest Airlines, has spent the last twenty years examining how that natural human impulse to gain status plays out in the business world. "Status matters because the need to compare oneself with others is pervasive and often occurs whether or not individuals intend to do so," Nunes and a colleague, Xavier Drèze, wrote in a 2008 paper in the Journal of Consumer Research.

As the opportunity to flaunt one's position has become more widespread and more socially acceptable for Americans, businesses are more than happy to oblige them.

Studying existing loyalty programs and using experiments with students at USC and Wharton, Nunes developed a series of principles outlining how to leverage status-conscious consumers and help companies maximize the envy factor as they refine and expand rewards programs. Among the rules:

- The fewer people granted elite status, the more superior these people will feel.
- Firms can offset a dilution in perceptions of status as the top tier grows by creating a second elite level just below it.
- The second elite tier will elevate perceptions of status among consumers in the top tier.
- The smaller the size of the second-highest group, the greater the perception of status among consumers in the top tier.
- The presence of additional tiers below the second elite level will not affect perception of status among consumers in the top-most tier.

What does this mean for us as consumers? For starters, it forces companies to create ever-more exclusive classes at the very top of the pyramid, so the envy factor remains constant all down the line, even as the top tiers expand over time.

As more fliers achieved elite status in the late 1990s and early 2000s, airlines knew they needed to develop something more exclusive than the conventional silver, gold, and platinum levels. United created the Global Services category, choosing the top eighteen thousand fliers in its 10-million-member MileagePlus program. American responded with ConciergeKey, its own ultra-elite category. As Nunes noted, “we predict that perceptions of status will increase as the group size, or number of elites, decreases.”

A second elite tier right below the top one can bring other psychological benefits. Research has also found that even as social comparison theory allows people to look down and delight in their superior status, it simultaneously triggers fears of downward mobility and the loss of status. According to Nunes, a “second elite tier may appear as a safety net for those at the top.”

Lastly, Nunes concluded, “a program with two elite tiers is chosen over programs with either one or no elite tiers by prospective members—regardless of whether they are eligible for status and into which elite tier they would qualify.” Call it the Groucho Marx rule: consumers mostly want to join clubs that won’t have them as members.

Adding new tiers further down on the prestige chain—bronze or below—with additional gradations doesn’t threaten the status of the elite at the top, but it does reinforce the envy effect at the bottom. That helps explain why having nine separate groups board an American Airlines flight doesn’t have to be bad for business.

Fostering envy, in the final analysis, is about more than just offering tangible benefits like entrée into a special restaurant like Coastal Kitchen or taking a special elevator up to the lofty heights of the Haven. It is every bit as important to make some passengers feel like they are being rewarded more than others. Nunes and other marketing experts actually divide the perks of loyalty programs into two categories: hard benefits and soft benefits.

The former consists of concrete rewards, like twice as many frequent-flier miles for the same flight or lounge access. Soft benefits are less tangible but can be even more effective in building brand loyalty. Think of separate check-in counters, special luggage tags that advertise your status, and above all, when the cabin crew recognizes you by name as you board the plane, even before you take your seat or display your ticket. Super-elite fliers, like those in American's ConciergeKey program or in Global Services on United, can get all of the above.

"Soft benefits are even more important because they help you figure out who you are, not just how others see you," said Nunes. "Soft benefits can be a signal to the self in what we call identity formation." For example, he said, United gives out luggage tags marked 1K to passengers who fly at least 100,000 miles a year. "The bags themselves don't get priority because of the tags but when I see them it reminds me that I've achieved that status."

Adding new tiers further down on the prestige chain—bronze or below—with additional gradations doesn't threaten the status of the elite at the top, but it does reinforce the envy effect at the bottom.

These kinds of status symbols are especially powerful in the United States, which never had a titled aristocracy or inherited symbols or crests like Europe, Nunes explained. "We're supposed to be a meritocracy, so when we see these 1K tags and other soft benefits, we say to ourselves, 'Well, we earned it.' "

For airlines and other service industries seeking to entice a well off clientele, it's also vital to identify and anticipate what these consumers want, sometimes before the customers themselves are conscious of it. Three types of passengers occupy the premium cabin, according to one aviation sector consultant, and the airlines are keenly aware of the psychology of each segment.

"Some are corporate road warriors like me," he said. "We don't want champagne. We just want to be left alone so we can work or sleep." The second group, he said, consists of truly wealthy people who can't or won't travel any other way. But the fastest-growing cohort are passengers who paid out of pocket for their premium seats or cashed in hard-earned frequent-flier miles—and they're determined to enjoy every minute up front.

"They want to splurge and stay up watching movies and eat everything in sight," he said. They might take selfies and put them on Facebook or Instagram so their friends can envy them. Premium cabin menus play to these customers, the consultant said. "You're never going to impress the true rich people with food or wine," he said.

But the third group is impressed by offerings like duck, scallops, and shrimp. "It's what they think rich people eat," he said. "It's hard to prepare duck at 36,000 feet so it doesn't taste so good but duck sounds fancy to people." Meanwhile, to give coach passengers a hint of the good life up front, Delta has started serving free sparkling wine to everyone in the back of the plane after takeoff on international flights. "It's cheap as shit, but it's been a huge hit," the consultant confided.

As the number of tiers has widened and the gap between the top and everyone else has broadened, the way companies classify their customers has changed too.

In fact, companies can pinpoint and favor the wealthiest customers in ways unimaginable even a decade ago.

"At the high end, we can get into real psychographics and know who spends more time at the concierge or goes skiing in February," said Bjorn Hanson, a lodging industry researcher and consultant.

United Airlines, for example, introduced a new app for flight attendants in 2017 that lets them know who the elite frequent fliers are on each flight and where they are sitting so they get more personalized attention.

"There's been a confluence of forces," added Robert Palmatier, a professor of marketing at the University of Washington's Foster School of Business. "In the past, you couldn't identify your best customers. Grocery stores didn't know who you were, you'd buy and leave. When people buy online, it gives you way, way more information and because firms have this data they're more able to target segments."

Palmatier doesn't just study this phenomenon—as research director for the university's Center for Sales and Marketing Strategy, he also helps companies fine-tune their rewards programs.

Some firms, he said, are willing to lose boatloads of money when they set up loyalty programs, because collecting all that data ultimately pays off as the best customers are identified, rewarded with better treatment, and in turn, spend more. Even better, as these programs become more sophisticated, companies can favor the wealthiest customers while sidestepping malicious envy.

That's caused an explosion in the number of different service tiers: the Royal Bank of Canada, for example, had three tiers of customer service in 1992. By 2018, it had eighty, which are updated monthly and guide all of the bank's marketing strategies.

And thanks to loyalty programs, status means more than simply getting a better seat on the plane or disembarking first from a cruise ship. For the hapless Dr. Dao, it meant getting dragged off an overbooked flight by airport security in Chicago in 2017. If he'd had elite status on MileagePlus, the cabin crew would have found someone else to boot from the flight and someone else would have been left bloodied by security officers.

It's tempting to think that when you call the bank or another financial service provider and you are put on hold for twenty-five minutes, it's simply because it's a peak time of day and many other account holders are calling at the same moment. Tempting, but wrong. In reality, the wait time likely has nothing to do with timing and everything to do with your CLV, or customer lifetime value.

This is a calculation of how much your business is worth to whoever you are calling, and the higher the number, the better the service. At a bank or credit card company, it might be determined by your balance. Frequency of travel and spending levels help set your CLV at airlines and hotels. More and more, as soon as you call any consumer-facing company, according to Palmatier, the company's first step is to identify your phone number and then determine your CLV.

"If it's high," he explained, "they might take your call more quickly, or direct it to one of their best-performing or most highly trained representatives. We call this heterogeneity in customer service, and it's driven by the profit motive."

Until now we've focused on examples of the Velvet Rope Economy where the emphasis is on the wealthiest customers to the exclusion of everyone else—a ship-within-a-ship, a seat at the elite restaurant on Royal Caribbean, and a private suite on Emirates. But CLVs have allowed the Velvet Rope phenomenon to metastasize into the rest of the economy.

As the number of tiers has widened and the gap between the top and everyone else has broadened, the way companies classify their customers has changed too.

"We discuss very high-end wealth and services but I think this phenomenon is prevalent much deeper into the wealth pyramid," Palmatier told me. "I even think the term 'customer lifetime value' is very telling. You're judging a person on their economic value and it's like you just don't want to deal with them if it's low."

Ever since caller ID was first introduced for landlines in the 1980s, an individual banker could avoid a call from a pesky customer, just as a doctor could duck a hypochondriacal patient. But in the last few years, powerful new digital technologies like big data and sophisticated algorithms have transformed what was once an individual decision into standard practice by the biggest companies, according to Palmatier.

"When you didn't have data, CLV wasn't that big of a deal," Palmatier said. "With loyalty programs or by ordering things online, huge amounts of data are created that can pinpoint consumer behavior."

Beyond varying levels of customer support, CLVs can also enable what Palmatier terms micro-targeting, rolling out the red carpet for some customers and ignoring others altogether. "If I have enough data, I can predict how much individual customers are going to spend over their lifetime," Palmatier said.

Harrah's, the casino operator, spent millions to upgrade its hotel revenue management system and link it with their telephone reservations department to take advantage of CLVs.

When loyalty program members called, the combined system would automatically recognize the phone number of top customers, enabling operators to present them with lower prices for hotel reservations on busy weekends, based on their gaming history and the offers they'd received in the past.

On the other hand, rates would be raised for lower-value customers looking for a room on a Saturday night. "If you're a student of the Old Testament, you know that God said all people are created equally," the former chief operating officer of Harrah's, Gary Loveman, told an audience in a YouTube video.

"But she never said that all customers were created equally."

What are the factors used to determine CLVs? Besides individual data points reflecting consumer behavior, zip code, income, educational level, job type, and age can instantly determine the order in which your call is answered.

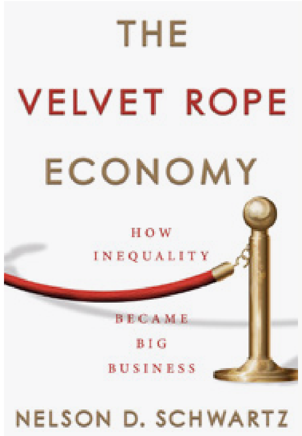
"We talk about discrimination in other contexts, but people will be left out of the economic system as more and more information accumulates," Palmatier said. At this point, CLV's are not like credit scores, which are set by independent firms like Equifax and determine everything from credit card rates to the likelihood of getting a mortgage. Instead, each company calculates its own CLV's for individual consumers.

CLVs have allowed the Velvet Rope phenomenon to metastasize into the rest of the economy.

And in a few cases, companies are going beyond the CLV and putting better treatment up for sale outright. Optimum, which provides cable and internet service in the New York suburbs, promises buyers of its Protection Plan “priority status in the call queue when calling Optimum Support.”

For executives, CLVs offer another benefit: low-CLV customers stuck on hold will never know how much better the treatment meted out to their high CLV peers can be. **It’s a world of difference from the decisions Adam Goldstein and other executives must make every day as they navigate the Velvet Rope Economy.**

Info



Ready to dig deeper into this idea?
Buy a copy of
The Velvet Rope Economy.

Want copies for your organization or for an event? We can help:
customerservice@porchlightbooks.com 800-236-7323

ABOUT THE AUTHOR

Nelson Schwartz has worked as a business reporter at *The New York Times* since 2007 and currently covers economics.

SHARE THIS

Pass along a copy of this manifesto to others.

SUBSCRIBE

Sign up for e-news to learn when our latest manifestos are available.

Porchlight

Curated and edited by the people of Porchlight, ChangeThis is a vehicle for big ideas to spread. Keep up with the latest book releases and ideas at porchlightbooks.com.

This document was created on March 4, 2020 and is based on the best information available at that time.