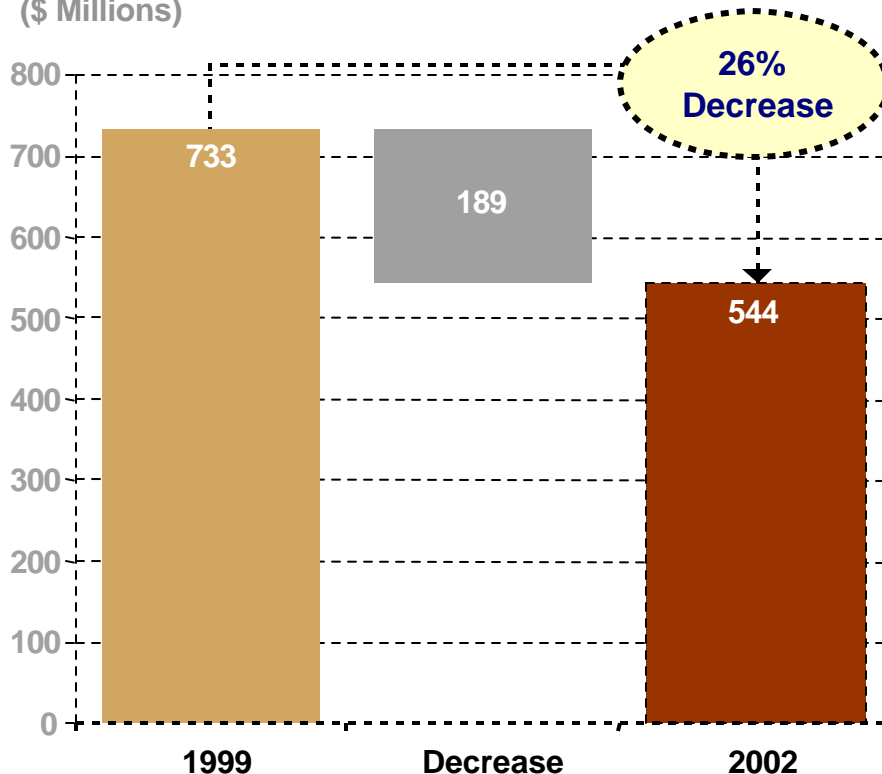


Next Frontier For Airlines: Reducing the \$1.5 Billion Expense in Payments

By: Pascal Burg, Edgar, Dunn, & Company

To stay alive, all airlines have been focusing on the same imperative: reducing expenses as much and as fast as possible. One of the key areas of focus to reduce expenses has been in distribution costs. This has resulted in a 26% reduction of the average annual airline total distribution costs from \$733 million in 1999 to \$544 million for an individual US airline in 2002¹.

AVERAGE ANNUAL DISTRIBUTION COSTS FOR AN AIRLINE (\$ Millions)



Airlines achieved this dramatic expense reduction by focusing on two of the three key distribution costs categories

Distribution costs in the airline industry fall into three categories: (1) travel agency commissions and overrides, (2) GDS fees², and (3) credit card fees (also referred to as "merchant discount rate", or "merchant fees"). Travel agency commissions were the first cost reduction focus where airlines have dramatically reduced these costs from an annual average of \$370 million to \$159 million for an individual airline over the 1999-2002 period.

¹Source: GAO-03-749 Airline Ticket Distribution

²Fees paid to organizations such as Sabre as they allow distribution of airline tickets via travel agencies that use reservation systems provided by these organizations



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A director in the San Francisco office, Pascal's knowledge and experience in payments spans across various geographies from the US, UK, France and Australia to South Korea, where he provides EDC's domestic and international clients deep expertise at every point in the payments value chain. In this month's Insight, Pascal aims his payments expertise at the airline industry where he has worked extensively to provide payments related cost savings and profitability strategies to dramatically impact the bottom line.

Airlines next cost reduction agenda has been aimed at reducing expenses in the second category, GDS fees. This involved hard negotiations with the GDSs and initiatives to by-pass GDS: for example, through Orbitz Supplier Link, or by promoting direct sales via the airline's own web site. In 2002, 37% of airline tickets were processed outside of the GDSs, compared to only 29% in 1999. Some airlines have been very successful at selling directly to consumers such as JetBlue, which generates more than 75% of its ticket sales from its own Web site.

What is left in the airline quest for further cost reductions? It is clear to us that the third cost category (costs associated with accepting payments) is the next frontier for airlines' cost reduction initiatives. We estimate that through a strategic approach to payments, the airline industry can reduce its payments related costs by 20-25%. In addition, cost reduction is only part of the equation. With the right payment strategies in place, airlines can generate new revenue enhancements, greater customer loyalty and capture new market segments.

Accepting payments by card: a \$1.5 billion expense for the US airline industry

The vast majority of airline tickets are paid for with some kind of payment card such as an Amex charge or credit card. About 83% of airline ticket sales reported to ARC (Airlines Reporting Corporation) were paid for with a payment card in 2003. We estimate that the total cost of accepting payments by card for the US airline industry amounted to about \$1.5 billion dollars in 2003 which represents the total merchant fees paid by all US airlines to MasterCard and Visa "acquiring" banks³ and the likes of Amex and Diners Club. This is equivalent to \$12.50 per average airline ticket.⁴

A three-pronged approach is required to reduce payment costs

Airlines can undertake three initiatives to reduce these payment costs:

- Initiative 1: Negotiate lower merchant fees with Amex, Diners Club and MasterCard / Visa acquiring banks
- Initiative 2: Optimize the payments mix in favor of lower cost forms of payment
- Initiative 3: Streamline and automate payment-related business processes

Initiative 1: Negotiating merchant fees is an obvious option, but how?

Negotiating the merchant relationship with Amex, Diners Club and MasterCard / Visa acquirers is an obvious option that all airlines at some point have had on their radar screen. The key question is how do you do this? Based on our experience, the challenge is to take emotions and strong egos out of the equation (as much as possible!) and apply a rigorous five-step process:

Step 1: Understand your current situation. This involves a realistic assessment of the airline's current position by collecting internal data about the merchant fees paid out (by form of payment, by country and type of tickets), and about internal "hidden" payment acceptance costs such as staff involved in reconciliation, chargeback handling, mitigating card fraud, and so forth.

Step 2: Understand your current payment partners. This involves assessing the main drivers of the airline's current payment partners by gaining a full picture of the overall relationship. For instance, Amex might have three types of relationship with an airline (a merchant contract, a cobrand card program, and a sales relationship via its travel agency arm). Ideally, the airline should estimate the revenues and costs of all these relationships from the partner's perspective.

³The acquiring bank is the bank that has a merchant contract with the airline and enables the airline to accept payments with a MasterCard or Visa card

⁴ Assuming an average fare of \$500

We estimate that through a strategic approach to payments, the airline industry can reduce its payments related costs by 20-25%. With the right payment strategies in place, airlines can generate new revenue enhancements, greater customer loyalty and capture new market segments.

Step 3: Understand your payment alternatives. This step requires identifying alternatives via RFIs/RFPs or exploratory discussions. There are a number of acquiring banks that might be interested in obtaining the airline's merchant business, even though several acquirers are moving away from the airline industry due to its higher risk level. And there are new forms of payment that an airline could add as a counter-weight. For instance, airlines might consider new forms of payment such as Bill Me Later⁵, PayPal (PayPal announced an arrangement with Paymentech that enables Paymentech's online merchants to accept PayPal). Airlines might also consider accepting debit cards (British Airways started accepting domestic UK debit cards on its Web site in 2004), and UATP (JetBlue is in the process of enabling UATP as a new form of payment).

Step 4: Understand your payment destination. Prior to negotiating, the airline should define its long-term objectives expressed in broad terms (e.g., "lower payment costs") rather than in specific positions (e.g., "I want a merchant discount rate of X%"), and conduct some scenario planning to identify different ways to achieve these negotiation objectives.

Step 5: Understand your payment role. Airlines can be in the driver's seat by setting the negotiation agenda and timeframe. Successful negotiations will require looking for joint cost savings / revenue opportunities that can be shared with the payment partners (e.g., moving to a more automated chargeback handling process). The airline should also set up an internal cross-functional team (or, at least, get input from these stakeholders), so that the key stakeholders can influence the negotiations. Typically, Treasury will be involved as it manages the merchant contract, Marketing has a role as it manages the cobrand card program, and Sales needs to be involved as airline ticket sales or travel agency arrangements might be discussed.

Initiative 2: Optimizing the payments mix requires planning and on-going management

Optimizing the payments mix is another effective strategy, but one that requires careful planning and management to deliver significant results. From the airline perspective, optimizing the payments mix involves increasing the penetration of lower cost forms of payment without putting ticket sales at risk. In our experience, rather than a tactical decision optimizing the payments mix requires a long-term policy decision that is under on-going management. Managing the payments mix includes three options to influence the buyer's choice of which form of payment to use: (1) total or partial non-acceptance policies, (2) surcharging, and (3) discounts.

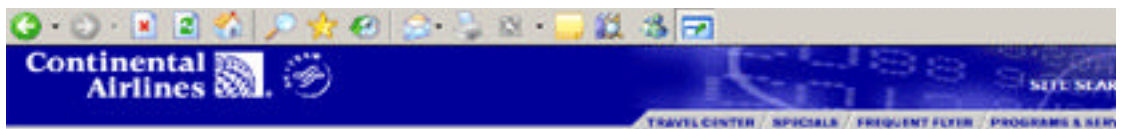
Some airlines have chosen the first option of total or partial non-acceptance of specific forms of payment to manage their payments mix. For instance, Ryanair adopted a total non-acceptance policy when it stopped accepting American Express in June 2003 on any ticket sales. British Airways chose a partial non-acceptance policy by settling a legal dispute with American Express in April 2004 to confirm its non-acceptance of any credit cards (except its own corporate card program with AirPlus which runs on the airline-owned UATP payment network) only for corporate net fares in the UK. The flip side of this first option is to make the decision to accept a new form of payment (e.g., debit cards) as we discussed earlier.

Other airlines have chosen the second option ("surcharging"), i.e., the practice of adding an extra fee to buyers based on the chosen form of payment. Going back to our Ryanair example, a buyer would not be surcharged for using a debit card such as Visa Debit/Electron, but would be surcharged £3.50 for a return flight when using a Visa or MasterCard credit card.

Continental.com provides an interesting and recent example of how an airline can use the third option by providing selective airline ticket discounts to influence the buyer's choice of a form of payment. In late October 2004, Continental.com announced that it would offer an eCertificate valid for a 5% ticket discount if its customers paid their tickets with one of three alternative forms of payment: (1) a deferred payment via Bill Me Later, (2) an online check payment via TeleCheck, and (3) a cash payment via Western Union.

⁵ Online form of payment that offers instant credit to consumers at the point of sale

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Any and all of these strategies can be combined to form a strategic approach to payment cost optimization. We expect that airlines will start to develop menus of payment alternatives incorporating rewards and penalties based on the customer's choice of payment type.

Initiative 3: Streamlining payment-related operations will require some short-term investment, but will provide a quick payback

As most airlines sell an increasing percentage of airline tickets directly, via their own web site or their call centers, they need to conduct non-core operational activities such as managing card fraud and handling chargebacks. There are significant opportunities for most airlines to automate and/or streamline most of these operational activities, for instance:

- **Central Acquiring:** Airlines can achieve operational cost savings by using a so-called "central acquiring" approach whereby the airline only has one relationship with one MasterCard / Visa acquiring bank to cover ticket sales in multiple countries instead of multiple relationships with a different bank in each country.
- **Cardholder Authentication:** Airlines can mitigate card fraud and minimize their chargeback liability by deploying cardholder authentication methods such as MasterCard Secure Code or Verified by Visa (e.g., implemented by Northwest).

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We strongly believe that cost reductions are only half of the payment opportunity for airlines. The other half is revenue enhancements.

- **Chargeback Automation:** Airlines can also reduce the internal cost of handling chargebacks by working with acquirers that use electronic exchanges of chargeback-related documentation and that automatically represent certain chargebacks.

Revenue Enhancement Opportunities

We strongly believe that cost reductions are only half of the payment opportunity for airlines. The other half is revenue enhancements. The first revenue opportunity is to launch a cobrand card program or improve the revenue performance of an existing cobrand card program by targeting segments that are still partly untapped such as small businesses.

The second revenue opportunity is to become more involved as a primary or part-issuer of a form of payment. For instance, a number of airlines (e.g., American Airlines for many years, or Varig more recently) "issue" UATP accounts⁶ directly to their corporate customers, or outsource the UATP issuance via an arrangement with a corporate card issuer (e.g., British Airways corporate card program with AirPlus). Or an airline like America West partnered with Stored Value Systems in November 2004 to sell America West Gift Cards via retailers such as 7-Eleven.

⁶15 airlines issue UATP accounts to their corporate customers who can use it as a form of payment at over 200 airlines

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The bottom line is that while payment is not a core activity for airlines, the potential financial upside justifies investing management time and resources to manage the payments function. An integrated, multi-pronged approach to payments will contribute significantly to the airlines' survival through cost savings, operational efficiencies, and revenue enhancements.

EDC has gained significant experience and expertise in helping companies such as airlines as well as acquiring banks develop their payments-related strategies since 1978 via its offices in the US, UK, Germany and Australia. If you would like more information about EDC's expertise related to the airline industry, contact Pascal Burg at pascal.burg@edgardunn.com.

About Edgar, Dunn, & Company

Edgar, Dunn & Company (EDC) is an independent global financial services and payments consultancy. Founded in 1978, the firm is widely regarded as trusted advisors in the payments industry providing a full range of strategy consulting services, expertise and market insight through in-depth industry and consumer benchmarking. Global capabilities include strategy, risk management, marketing, profitability improvement, operations, and new products and technologies. EDC's offices are located in Atlanta, Frankfurt, London, New York, San Francisco and Sydney and serve clients in over 30 countries on six continents. More information can be found at www.edgardunn.com.