



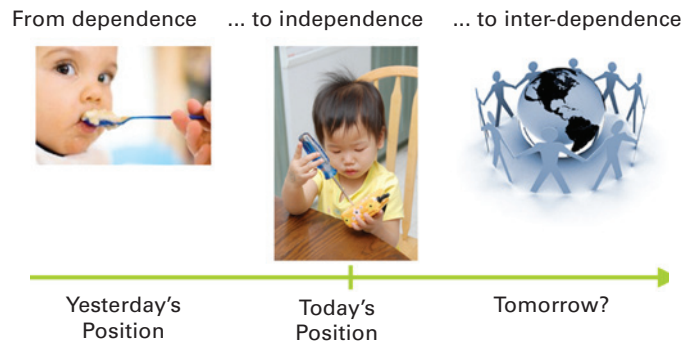
Towards a Declaration of Inter-dependence?

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What does "independence" or "inter-dependence" have to do with the payments industry?

One of the major questions to be addressed by the payments industry (and especially by merchants) is whether to move towards independence or towards inter-dependence. A recent survey completed by Edgar, Dunn & Company (EDC) among 70 airlines clearly shows their move towards independence for payments-related matters. However, it is unclear whether these merchants will move towards inter-dependence in the future.

At first, what do we mean by these words? Human beings and businesses typically grow through three phases:



Phase 1: Dependence

- The best analogy is newborns: they are completely dependent on their parents for all their needs. Just as start-up companies are completely dependent on one client or on one supplier such as their bank
- Going back to EDC's "Airline Payments" survey, interviews with airlines indicate that they used to be fully dependent upon their "acquiring" bank (with whom they signed a merchant contract enabling card acceptance) and upon the payment networks. This can be summarized by their typical comment of "we had no choice"

Phase 2: Independence

- The analogy here is toddlers or young teenagers: they are convinced that they can be completely independent and can do what they want. Just as maturing businesses can make major decisions without involving their partners
- The "Airline Payments" survey clearly shows that the majority of airlines are proactively becoming independent; this can be seen in their strong move towards accepting alternative forms of payment, surcharging credit cards, etc. (see survey results below)

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Pascal is a Director with responsibility for the Paris office. He has been with Edgar, Dunn & Company (EDC) since 1999 and has worked in the London, Sydney and San Francisco offices. Pascal has over 12 years of consulting experience in business strategy for financial services clients in multiple European, Asian and North American countries, and over four years of line management experience within the UK financial services industry. His core competencies include business case development, new product development, strategic planning, market entry strategy, benchmarking. Pascal has managed a large number of strategic planning, marketing strategy and implementation projects for clients including issuers, acquirers, card associations and large merchants such as airlines.



Phase 3: Inter-dependence

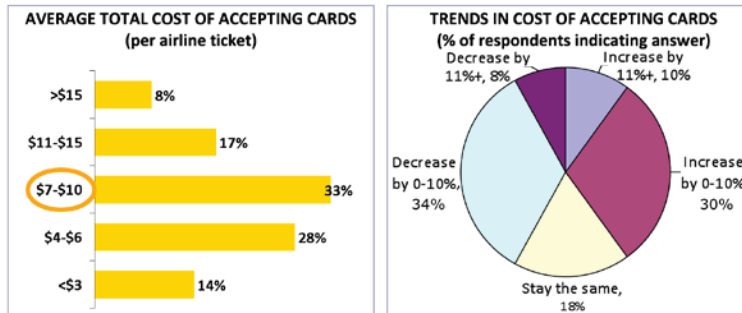
- The analogy here is adults collaborating via informal networks or formal organizations in order to achieve a greater outcome than they could achieve on their own. Just as banks got together thirty years ago to set up interbank associations such as Europay, MasterCard and Visa
- The “Airline Payments” survey shows early signs of collaboration between airlines and payment providers, such as banks and payment networks, but it is still unclear whether collaboration will become the standard modus operandi

With this framework in mind, the following reviews the key findings from the “Airline Payments” survey that EDC recently completed, in collaboration with the conference organisers, Airline Information, across 70 airlines.

1) Cost of Accepting Cards

For most airlines, traditional card brands such as American Express, MasterCard and Visa have achieved a high penetration of airline ticket sales, up to 85%-90% in some cases. As such, the cost of card acceptance is often an important “distribution cost” for airlines, alongside other distribution costs such as Global Distribution System fees or travel agency commissions.

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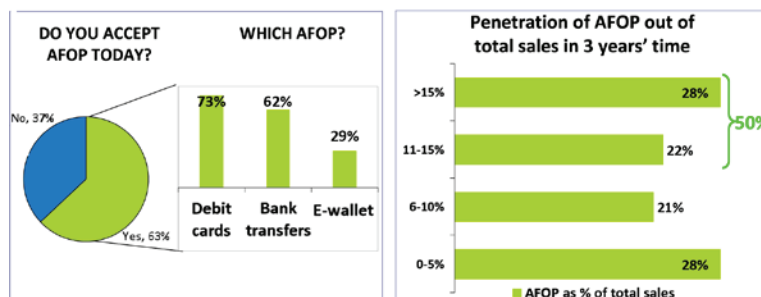
Based on responses from our sample, the average total cost of accepting cards is typically in the \$7-\$10 range per airline ticket. This cost has been attracting an increasing amount of attention among airlines, as many have already reduced, or attempted to reduce, their other distribution costs.

In terms of trends over the next 2-3 years, airlines are equally split between optimists and pessimists: 42% believe this cost will decrease vs. 40% who believe it will increase.

2) Acceptance of AFOPs (Alternative Forms of Payment)

Airlines had historically limited their acceptance primarily to international branded cards, such as American Express, Diners Club, MasterCard, Visa and UATP. One of the first signs of a move towards “independence” is the increasing number of airlines today accepting forms of payment that were not traditionally accepted, especially for online direct sales. For instance, Lufthansa started accepting PayPal in 2009 across more than 40 countries.

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When asked about their current status, about two thirds of airlines (63%) already accept AFOPs. This might look surprisingly high. However, it includes “debit cards”; airlines have been accepting MasterCard / Visa-branded debit cards and are starting to accept domestic debit card schemes. It also includes “bank transfers” that are becoming increasingly available via an Internet interface such as iDEAL in the Netherlands, BPAY in Australia, direct linkage to each bank’s online banking facility in India, etc. And finally, e-wallets such as PayPal are already accepted by 29% of these airlines.

Looking at the next 2-3 years, half of the airlines believe that AFOPs will represent a significant percentage of total airline ticket sales, i.e., more than 10%. These airlines expect that the acceptance of AFOPs will have more than a marginal impact on their cost base, especially if AFOPs do not remain constrained to the airline’s own website. As such, there is increasing interest among airlines in AFOPs for other important sales channels, such as call centres or travel agency sales.

Most airlines look at AFOP as an “addition” to their accepted forms of payment and not as a “replacement” initiative. In other words, they will continue to accept traditional card brands such as American Express, MasterCard and Visa, and are adding AFOPs for specific objectives.

In our interviews with airlines, it became clear that there are multiple objectives driving this increase in AFOP acceptance. In some cases, airlines focus on cost reduction, whilst in others, the major drivers are:

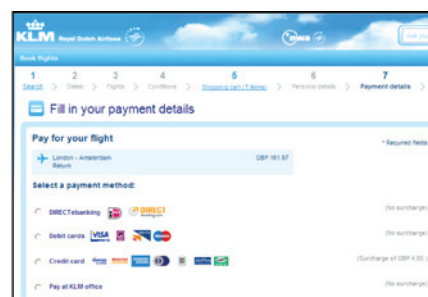
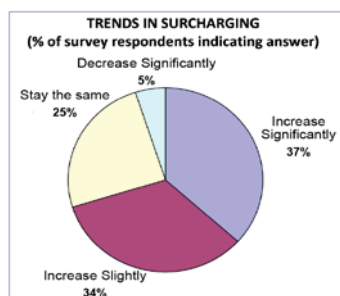
- “market reach”, i.e., accepting forms of payment that are popular in a specific domestic market
- “increased sales”, i.e., achieving a higher sales conversion rate by offering a wider range of payment methods

About 53% of airlines expect to accept mobile payments within three years.

In addition to new payment methods, there seems to be a strong interest among airlines for new payment technologies such as mobile-based payments, especially for remote payments whereby a NFC (Near-Field Communication) infrastructure is not required. About 53% of airlines expect to accept mobile payments within three years. This interest is consistent with other mobile services introduced by the likes of Air France, Lufthansa, etc. enabling mobile check-in and mobile boarding pass.

3) Increasing Usage of Surcharging

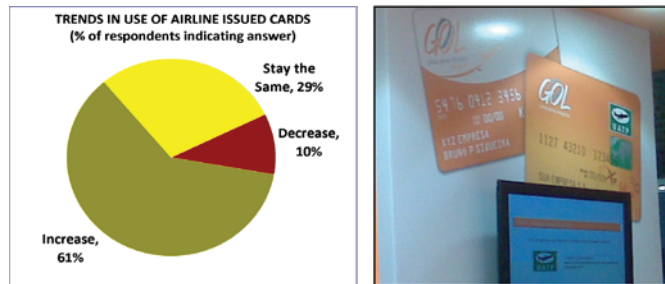
Perhaps one of the strongest signs of this sought-after “independence” is the strong interest among airlines for surcharging (i.e., charging an additional fee depending on the selected form of payment).



71% of airlines expect that the use of surcharging will increase over the next 2-3 years. It seems that the most active geographic region for surcharging is Europe. The Payment Services Directive was meant to be transposed into national laws across 27 European countries, and one of the key articles (52-3) is clearly promoting an increase in merchant freedom to surcharge. As an example, KLM in the Netherlands started surcharging credit cards across all channels in August 2009, and Low Cost Carriers such as Ryanair and EasyJet now surcharge cards as a standard practice.

4) Increased Interest in Airline Issued Forms of Payment

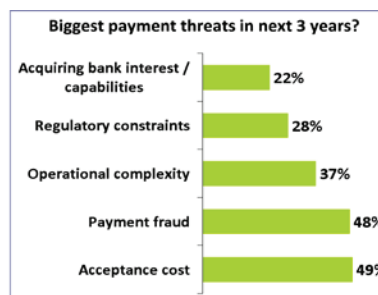
Another sign of increased “independence” is the interest among airlines for airline issued cards (private label cards, UATP, etc.).



61% of airlines expect to see further increases in airline issued cards over the next 2-3 years. Examples illustrating this trend are the recent announcements by airlines such as GOL (in Latin America) and EI AI to start issuing UATP lodged accounts to their corporate customers. In addition, other airlines, such as Lufthansa via its subsidiary AirPlus, have been successful at growing this corporate form of payment whereby the airline is the actual “issuer”

5) Future Concerns /Threats

In light of the above trends, the survey also asked the “What keeps you up at night?” question.



As could be expected, acceptance cost and payment fraud rank as the two biggest payment threats perceived by airlines over the next 3 years. On the issue of fraud, a number of airlines have adopted 3D Secure (resulting in a liability shift for some of the card transactions in the event of fraud), and nearly half of the airlines in the survey remain concerned about the impact of payment fraud.

However, more un-expectedly and interestingly, the third threat is viewed as “operational complexity.” In the interviews, a number of airlines expressed a concern over the growing operational complexity of payments, driven by the very independence that they seek. In other words, there is an emerging realization among airlines that the flip side of independence (e.g., accepting AFOPs, expanding surcharging, self-issuance) is increasing the complexity of the merchant’s internal payments operations.

Which brings us to “inter-dependence”

Towards inter-dependence?

The survey results indicate that there are two main scenarios for the future state of payments in the airline industry:

- **Scenario 1:** Merchants (airlines) become increasingly independent. This would involve mostly opposing relationships between airlines and payment providers
- **Scenario 2:** Merchants (airlines) become increasingly inter-dependent with payment providers (payment networks, banks, etc.). This would involve mostly collaborative relationships between merchants and payment suppliers

Acceptance cost and payment fraud rank as the two biggest payment threats perceived by airlines over the next 3 years.



An example of a retailer in another industry who has focused on collaboration is Whole Foods, a successful US food retailer specialized in organic food. It has developed its own “Declaration of Interdependence”

Interestingly, one of the key parts of this Declaration is the statement that Whole Foods is not a “fully self-sustaining ecosystem” on its own, hence the importance of other businesses (suppliers) in “creating an outstanding retail shopping experience”. In other words, Whole Foods recognizes the importance of collaborating with its suppliers in order to differentiate its value proposition for consumers.

Based on the airline survey and EDC’s consulting experience across the payments industry, we would suggest that merchants might well gain from collaborating with payment suppliers, such as banks or payment networks, and vice versa.

This approach would involve airlines collaborating with their payment providers potentially for a range of tactical and more strategic initiatives. This could include initiatives to co-develop payment products, to bring to market new technologies (e.g. contactless, mobile) and/to enter new countries jointly. Such a collaborative approach should help payment providers launch innovative products with a greater likelihood of success. And it should also help merchants with the introduction of products supporting even more their sales efforts and with less impact on their internal operations.

Will the airline payments industry evolve to a state of inter-dependence? It is hard to tell and EDC hopes that the survey results will contribute to this debate. Ultimately it will require two key ingredients: first, a belief that airlines and payment providers will both be better off in the long-term if they collaborate more closely; and second, a high level of trust among participants.

Early indications are that there is at least an appetite for more frequent and more engaging discussions among the parties. This is a good first step and will help build trust. But, it may be a couple of years until a clearer picture emerges.

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 a trusted advisor to its clients, providing a full range of strategy consulting services, expertise and market insight. Global capabilities include in-depth industry and consumer benchmarking, strategy, risk management, marketing, profitability improvement, operations, and new products and technologies.

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