COMPETITION TRIBUNAL
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THE COMPETITION TRIBUNAL

IN THE MATTER OF the *Competition Act*, R.S.C. 1985, c. C-34, as amended;

AND IN THE MATTER OF an application by the Commissioner of Competition pursuant to section 76 of the *Competition Act*;

AND IN THE MATTER OF certain agreements or arrangements implemented or enforced by Visa Canada Corporation and MasterCard International Incorporated.

THE COMMISSIONER OF COMPETITION

Applicant

- and -

VISA CANADA CORPORATION and
MASTERCARD INTERNATIONAL INCORPORATED

Respondents

WITNESS STATEMENT OF ELIZABETH BUSE

1. I am Group President, Asia-Pacific, Central Europe, Middle East and Africa ("APCEMEA") with Visa Inc. I am stationed in Visa Inc.'s office in Singapore. My primary responsibility is to oversee Visa's global sales and client service functions across the APCEMEA regions. Australia and New Zealand are part of Visa's Asia-Pacific region and therefore within my jurisdiction. As part of my job, I interact regularly with Visa's clients at major financial institutions in Australia and New Zealand, as well as other stakeholders within the payments

industry. I am very familiar with the setting of default interchange rates, the application of the Visa International Operating Regulations ("VIOR") and the payments industry in the regions I oversee.

2. Prior to assuming my current position, I was Global Head of Product for Visa Inc. In that capacity, I was responsible for all aspects of product strategy, development and growth. Before assuming that position, I was Executive Vice President of Product Development and Management for Visa U.S.A. In total, I have worked for Visa for 14 years.

A. <u>History of Visa in Australia and New Zealand</u>

3. Visa Australia and Visa New Zealand are units within the Asia Pacific ("AP") operating region of Visa Inc. The AP region is headquartered in Singapore, where Visa employs approximately 750 people. There are 72 Visa employees in Australia and six employees in New Zealand.

4. Visa entered the New Zealand payments business in 1978 and the Australian payments business in 1981, and has operated in Australia and New Zealand continuously since then. Currently, there are approximately 22 million Visa branded cards in circulation in Australia (of which approximately 8.5 million are credit cards) and 5.8 million Visa branded cards in circulation in New Zealand (of which approximately 1.9 million are credit cards). There are five major Issuers of Visa branded cards in Australia: National Australia Bank ("NAB"); Commonwealth Bank ("Commonwealth"); Citibank; Westpac; and the Australia-New Zealand Banking Group ("ANZ"). These Issuers account for approximately 90 percent of Visa's domestic transaction volume in Australia. There are also four major Issuers of Visa branded cards in New

Zealand, all of which are Australian-owned: Westpac NZ; Bank of New Zealand; ASB; and ANZ National.

5. As is the case in all areas in which Visa operates, Visa does not sell its core products and services to cardholders or merchants in Australia or New Zealand. Rather, Visa primarily provides a variety of services, including authorization, clearing and settlement services to issuing financial institutions ("Issuers") and acquiring financial institutions ("Acquirers") over the Visa network.

6. Visa had a No Surcharge Rule ("NSR") in Australia until January 2003 and in New Zealand until September 2009.

7. As I discuss below in greater detail, the removal of the NSR in Australia has had significant deleterious effects on the payments system, and cardholders in particular, but has had no effect on Visa's default Interchange Reimbursement Fee ("IRF") rates.

8. The evidence available in New Zealand suggests that there has been minimal surcharging in New Zealand (though at least one major airline merchant—Air New Zealand—has begun surcharging). To the extent that merchants are surcharging, such surcharging has not affected Visa's default interchange rates. In New Zealand, Visa is obligated to set a maximum interchange rate. Visa has not generally reduced the overall level of its maximum credit default IRF rates, which are publicly available, since the removal of the NSR in New Zealand, except for establishing a lower rate for charities, which was unrelated to the removal of the NSR, and was established to promote acceptance among entities that might otherwise be more reluctant to accept Visa credit cards as payment.

B. Regulation of the Credit Card Industry in Australia

Regulatory background

9. The Reserve Bank of Australia's ("RBA") regulation of the Australian credit card industry began in 1998 when Parliament amended the *Reserve Bank Act*, 1959 (Cth) ("RBA Act") and passed the *Payment Systems (Regulation) Act*, 1998 (Cth) ("PSRA"). The amendments to the RBA Act created the Payments System Board ("PSB") within the RBA. The PSRA, among other things, provides the RBA with the authority to designate a payment system for regulation, to create regulatory standards for a designated payment system, and to ensure that actors within a designated payment system comply with regulatory standards.

10. In 2001, the RBA designated Visa and MasterCard as payment systems ("Schemes") under the PSRA. In August 2002, the RBA issued two standards: "Standard No. 1, The Setting of Wholesale ('Interchange') Fees" and "Standard No. 2, Merchant Pricing for Credit Card Purchases." A copy of Standard No. 1 is attached as Exhibit "A" to this witness statement and a copy of Standard No. 2 is attached as Exhibit "B" to this witness statement.

11. Standard No. 2, which came into effect on January 1, 2003, prohibited the enforcement of the NSR, stating that "[n]either the rules of the Scheme nor any participant of the Scheme shall prohibit a merchant from charging a credit cardholder any fee or surcharge for a credit card transaction." It remains in effect today.

12. Standard No. 1, which came into effect on July 1, 2003, required that default IRF be set no higher than an RBA-dictated benchmark for each scheme, calculated from the costs of

transaction processing, authorization, fraud and fraud prevention, and funding the interest free period available to cardholders. On November 1, 2003, Visa implemented new domestic default interchange rates in order to comply with Standard No. 1. Visa set its rates as follows (exclusive of GST): consumer electronic: 0.47%; consumer standard: 0.57%; commercial: 0.95%. Based on these rates, Visa's weighted average default IRF was calculated at 0.53%.[1] Prior to these reforms, the average default IRF on Visa and MasterCard domestic credit card transactions in Australia was approximately 0.95%.

13. Standard No. 1 was replaced on July 1, 2006 by "Standard: The Setting of Wholesale ('Interchange') Fees in the Designated Credit Card Schemes" ("2006 Standard"). The 2006 Standard set out a methodology for calculating a new IRF benchmark, stating that a new IRF benchmark must be calculated in 2006 and every three years thereafter. A copy of the 2006 Standard is attached as Exhibit "C" to this witness statement.

14. In accordance with the 2006 Standard, the RBA issued a new benchmark effective November 1, 2006 ("2006 Benchmark"). According to the 2006 Benchmark, the weighted average of a Scheme's (including Visa's) credit IRF over a three-year period cannot exceed 0.5%. Although the 2006 Standard specified that the 2006 Benchmark would apply for only three years, the RBA waived the requirement to recalculate benchmarks in 2009 and 2012, and the 2006 Benchmark remains in force through to the end of 2015. A copy of the 2006 Benchmark is attached as Exhibit "D" to this witness statement.

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[1] Visa revised its rates in June 2004 (as permitted by the RBA) as follows (exclusive of GST): consumer electronic: 0.436%; consumer standard: 0.595%; commercial: 1.095%.

15. In accordance with the 2006 Standard and Benchmark, Visa has managed its domestic default interchange rates in Australia consistently with the RBA's prescribed methodology, which requires that the weighted averaged of Visa's default credit interchange rates be no higher than 0.5% over a designated period. Individual product and merchant segment rates may be lower or higher than the weighted average. For example, charities receive a 0% default interchange rate, while some premium credit cards attract a 1.70% default interchange rate, and the default interchange rate for certain transactions greater than AU$10,000 is 0.22% plus AU$22. A complete list of credit default interchange rates, inclusive of GST, is attached as Exhibit "E" to this witness statement.

16. While Visa and MasterCard have both been designated as Schemes under the PSRA, American Express has not been so designated. However, I understand that American Express has provided the RBA with a written undertaking that it will not prohibit merchants from surcharging. I understand that American Express has not provided the RBA with a written undertaking to comply with the 2006 Benchmark and that, as discussed below, although American Express has lowered its merchant discount rate, it remains higher than the 2006 Benchmark (though the 2006 Benchmark to which Visa is subject regulates IRF, not merchant discount rates).

Effects of regulation

17. I know through my experience as Group President, APCEMEA that the removal of the NSR has had significant deleterious consequences on Visa and Visa cardholders. However, the

reduction in default IRF rates witnessed in Australia has occurred solely as a result of their regulated reduction and is not in any respect attributable to the removal of the NSR.

Impact of surcharging on cardholders

Abuse of surcharging by merchants

18. In my position as Group President, APCEMEA, I regularly review the state of the payments business. Based on this experience, I know that since the removal of the NSR in 2003, surcharging has become most prevalent among large retailers, such as Telstra and Optus (major telecommunications providers), Qantas and Virgin Australia (major airlines) and almost all major hotel chains, including Hilton, Starwood and InterContinental. These are the kinds of merchants that have the ability to require cardholders to absorb the surcharge because they have fewer alternatives or because it would be very inconvenient for the cardholder to pay with a different payment method such as cash. The RBA similarly notes in its June 2011 publication "Review of Card Surcharging: A Consultation Document" ("2011 RBA Report") that surcharging is most prevalent with "very large merchants" (those with annual turnover greater than AUD$530 million) but that about 25% of smaller merchants surcharge as well. A copy of the 2011 RBA report is attached as Exhibit "F" to this witness statement.

19. Based on my experience, I am also aware that surcharges were noticeably higher in circumstances in which consumers had fewer alternatives to credit cards, such as for online payments and within the holiday travel industry. The RBA found and noted in the 2011 RBA Report that surcharges were more commonly paid for online purchases than in person (18% versus 4%), and the average amount of the surcharge was double online (4% of the purchase

value versus 2%). Consumers surveyed paid surcharges on 44% of consumer transactions relating to holiday travel (on or off-line), compared to an overall average of 5%. This is not surprising given that hotels and car rental companies often require a credit card as security for bookings and that most airline ticket sales are conducted online.

20. In my experience, in most cases, retailers surcharge in excess of their cost of acceptance, thereby using their ability to surcharge not as a mechanism to steer consumers to alternative forms of payment, but rather as a profit centre. The 2011 RBA Report found that the average surcharge on Visa transactions is 1% (or 100 basis points) higher than the merchant discount fee, that 10% merchants surcharge at five percent or higher, and that surcharge levels are increasing:

> According to the East & Partners' survey, average surcharge levels have increased substantially over the past few years (Graph 2.2). In December 2010, the average surcharge for MasterCard credit cards was 1.8 per cent, for Visa it was 1.9 per cent, for American Express it was 2.9 per cent, and for Diners Club it was 4 per cent. These average surcharge levels are around 1 percentage point higher than merchant service fees for American Express, MasterCard and Visa cards, and around 1.8 percentage points higher for Diners Club cards.

21. Another recent study by Choice ("Choice Report"), an Australian consumer organization, notes that Australian taxi companies levy a 10% surcharge on all credit card transactions, clearly well in excess of the cost of acceptance. The Choice Report is attached as Exhibit "G" to this witness statement.

22. The RBA has also recognized that the removal of the No Surcharge Rule in Australia has led to problematic results. The 2011 RBA Report states that "allowing some limit to be placed on the level of surcharges could improve the effectiveness of the reforms at relatively little cost,

particularly given that the practice of surcharging is now well established." In December 2011, the RBA published its conclusions stemming from the 2011 RBA Report ("RBA Conclusions"). The RBA stated that "surcharging is now sufficiently common, and surcharging above the cost of acceptance sufficiently widespread, that an unconstrained capacity for surcharging may no longer be appropriate. The Board is of the view that relaxing the Standards to allow schemes to limit surcharges would provide a number of public benefits." Accordingly, the RBA has proposed a modified standard under which "scheme rules may limit surcharges to a reasonable cost of acceptance, but are not able to prevent merchants from fully recovering their costs." A copy of the RBA Conclusions is attached as Exhibit "H" to this witness statement.

Merchants do not pass on savings to cardholders

23. I am not aware of any evidence that merchants in Australia have reduced the prices they charge to consumers for the sale of goods or services at retail as a result of either the IRF benchmarks or the removal of the NSR. Consistent with Visa's experience in this regard, studies have also concluded that there is no evidence of any pass-through effect of savings by merchants to consumers. Direct government intervention into setting default interchange rates has simply had no discernable effect on the retail prices that consumers pay, while pervasive merchant surcharging has increased the prices to consumers choosing to pay with Visa credit cards.

24. The RBA noted in the preliminary conclusions of a 2007-2008 review of the Australian payments system that it had received "[n]o concrete evidence... regarding the pass-through of [merchant] savings [to consumers]." A 2008 report by Robert Stillman and others of CRA International (the "Stillman Report") found that

> while the RBA's regulations have clearly harmed consumers by causing higher cardholder fees and less valuable reward programmes, there is no evidence that these undeniable losses to consumers have been offset by reductions in retail prices or improvements in the quality of retailer services. The RBA's intervention has redistributed wealth in favour of merchants.

A copy of the RBA report "Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review" is attached as Exhibit "I" to this witness statement. A copy of the Stillman Report is attached as Exhibit "J" to this witness statement.

Consumers are strongly dissatisfied with surcharging

25. In Visa's experience, consumers are very dissatisfied with increasingly prevalent merchant surcharging. In line with this experience, the Choice Report found that 88% of respondents reported being surcharged, and that over 68% of Australian consumers oppose surcharging. Additionally, a 2011 Visa internal study found that [redacted] of Australians oppose merchant surcharging and consider it "unfair." Only [redacted] of Australians consider surcharging "fair." Simply put, surcharging has been very unpopular with Australian consumers. This is consistent with Visa's position, which is that the NSR is a pro-consumer rule. A copy of this study, entitled "A Snapshot of Surcharging in Australia" is attached as Exhibit "K" to this witness statement.

26. The Commissioner's evidence suggests that after the RBA reforms in Australia, a significant percentage of merchants have engaged in surcharging, while only a small percentage of cardholders actually pay surcharges; the implication being that a merchant's threat to

surcharge is an effective mechanism to steer cardholders from Visa and MasterCard credit cards to cash or debit.

27. Based on my experience and observation in Australia, I disagree with this implication. While the Commissioner's evidence lists a number of merchants in Australia who surcharge, the Commissioner's evidence also suggests that such merchants may surcharge only the most expensive cards, such as those issued by American Express, since American Express card acceptance fees are traditionally higher than those of Visa and MasterCard. The Commissioner's evidence also refers to a Woolworths submission that states "surcharging has been a legitimate and effective tool for merchants to steer customers towards the use of lower cost cards (for example by surcharging the more expensive American Express and Diners cards but not surcharging EFTPOS, Visa or MasterCard)…" Accordingly, it is not clear whether these merchants are surcharging Visa, MasterCard or American Express transactions. It is quite conceivable that these merchants are surcharging transactions made with American Express cards *but not* transactions made with Visa or MasterCard credit cards. Attached to this witness statement as Exhibit "L" is a report prepared by Gregory John Houston that discusses the experience in Australia and notes that the vast majority of Australian merchants have chosen not to surcharge and those that do are much more likely to surcharge three party (such as American Express) than four party cards (such as Visa or MasterCard). Page eight of this report indicates that the data suggest that only 1.8% of the 1,684 merchants surveyed accepted only Visa or MasterCard cards and not American Express or Diners Club cards.

28. Likewise, when the Commissioner's evidence points to a small number of cardholders that actually pay a surcharge, it is not clear whether these are Visa, MasterCard, or American

Express cardholders. Accordingly, it is quite conceivable that the statistics say very little if anything with respect to the ability of merchants to steer cardholders from Visa or MasterCard cards to cash or debit. Rather, the statistics may have more to do with merchant surcharging of American Express and its cardholders. Furthermore, it may also be the case that consumers facing a surcharge are not steered to cash or debit, but rather choose not to shop at a merchant who surcharges and instead to shop at a merchant who accepts Visa or MasterCard credit cards without a surcharge.

Impact of surcharging on Visa

Repeal of the NSR did not affect interchange in Australia

29. The repeal of the NSR has had no effect on Visa's default IRF rates in Australia. Visa's maximum credit interchange rates in Australia are controlled by the RBA and not by Visa or any other private actor. The presence of surcharging has hurt Visa, its Issuers and Acquirers, and Visa cardholders, but has not affected IRF rates.

30. Visa has never agreed in Australia to reduce the IRF rate available to a given merchant's Acquirer in response to any threat or action by a merchant to surcharge Visa credit cards or to refuse to honour all Visa credit cards. As indicated above, while IRF rates applicable to particular merchants or merchant classes may vary, the weighted average IRF rate must not exceed 0.5% plus GST, as required by the RBA. As I describe below in greater detail, one result of the RBA reforms has been that Visa has lost business to American Express. In Australia, American Express issues its own cards directly to customers and also contracts with Issuers, who issue American Express companion cards through the Global Network Services ("GNS") system.

Since the merchant discount rates American Express charges to its merchants are not regulated, American Express can offer Australian Issuers a higher level of revenue for issuing American Express companion cards and offer Australian cardholders a greater level of rewards for using American Express-issued cards.

[redacted]

Surcharging has not steered customers to debit

32. I have seen no evidence to indicate that the 2003 reforms led to increased debit use. If the reforms were intended, in part, to help merchants steer consumers to alternative forms of payment, this goal has not been accomplished.

Unfair advantage for American Express

33. While the RBA has designated Visa and MasterCard as Schemes and accordingly regulated them, it has not designated American Express or any other three party card brand (that is, a card network that contracts directly with merchants and cardholders rather than with Issuers and Acquirers) in Australia. Therefore, while Visa has been forced to adhere to a reduced and prescribed average level of IRF rates, American Express has not been forced to implement any pricing reductions to merchants (I note that American Express, as a three party system, does not have an IRF rate, but rather charges merchants for the services it provides them).

34. My understanding is that the fees American Express charges its merchants remain much higher than the average merchant discount fee negotiated between merchants and their Acquirers for other credit card transactions. In 2011, the average card acceptance fee for American Express was 1.86%. The higher rates that American Express charges merchants allow it to offer more lucrative awards. Furthermore, ANZ, Westpac, Commonwealth and NAB now offer American Express companion cards through GNS. Not only can American Express offer stronger rewards directly to cardholders, but it can also offer a higher level of incentives to these issuers. As a result, many Visa cardholders have shifted to American Express instead of Visa.

35. Furthermore, many merchants now engage in "blended surcharging" whereby they levy the same surcharge regardless of what brand a cardholder uses. Since Visa is prohibited by law from setting IRF as high as the fees presently and historically charged by American Express, the result is that the blended surcharge rate set by merchants is often <u>above</u> the cost of Visa acceptance and usually <u>below</u> the cost of American Express. Indeed, American Express has actively promoted blended surcharging to merchants as a revenue stream. The reforms therefore

lead to merchants earning additional revenue from every Visa transaction at the expense of Visa cardholders. Because of this subsidy, a Visa cardholder—with an American Express companion card—may choose to use his or her American Express card because the rewards benefits are higher, while the surcharge on each card is the same. Thus, blended surcharging may reduce the transactions made with Visa credit cards.

36. In conclusion, it has been the experience of Visa Australia that the RBA's regulation of Visa's IRF and removal of the NSR have led to significant harm to Visa and its cardholders. Visa has seen significant volume and revenue loss to American Express, and Visa cardholders now pay more for credit with fewer rewards. Merchants, in turn, are able to use low IRF rates and their ability to surcharge to create additional profit centres. The RBA reforms have therefore resulted in little more than a wealth transfer from card networks and cardholders to merchants, especially those whose customers have little choice but to pay with credit cards.

C. Regulation of the Credit Card Industry in New Zealand

37. The New Zealand Commerce Commission began an investigation into interchange rates and surcharging in 2003 and commenced litigation in November 2006. The Commerce Commission did not make any allegations of resale price maintenance against Visa, MasterCard, or any Issuer, despite the fact that resale price maintenance is prohibited under sections 37 to 46 of the *Commerce Act 1986* (NZ), 1986/5.

38. Visa faced significant consequences if found to be in violation of the *Commerce Act*, including fines of up to $10 million per breach, or three times the commercial gain resulting from the breach, or 10% of its turnover.

39. The Commerce Commission and Visa settled the litigation in an agreement effective September 15, 2009. A copy of the settlement agreement is attached as Exhibit "N" to this witness statement. Visa did not admit any wrongdoing and was not required to pay any penalties. Under the terms of the settlement, Visa agreed not to "enforce any rule which prohibits or prevents surcharging by merchants in respect of New Zealand-acquired transactions" and not to "require or encourage acquirers to include any provision to that effect in any merchant agreement, or to take steps to enforce any such provision in an existing merchant agreement." The settlement agreement did not require Visa to forbear from enforcing the HACR and did not regulate IRF rates.

40. The settlement agreement additionally gives Visa the power to ensure surcharges are adequately disclosed and are not excessive:

> Nothing ... prevents Visa from providing in the Visa rules that if a merchant applies a surcharge for payment by any Visa card, the surcharge amount must be clearly disclosed to the cardholder at the time of purchase and must bear a reasonable relationship to the merchant's cost of accepting Visa products for payment. To avoid doubt, any such requirement imposed by Visa will not prevent merchants from applying such a surcharge on a flat rate basis, to some or all Visa branded payment cards.

41. Though Visa has not commissioned any formal studies on the matter, my experience has been that to the extent that merchants do surcharge in New Zealand, there has been no downward pressure on New Zealand IRF rates as a result.

42. As noted above, unlike in Australia, IRF rates in New Zealand are not regulated. Given that Australian IRF rates are set at their legally mandated level, it is not surprising that in New Zealand, IRF rates have not dropped since merchants have been allowed to surcharge.

ELIZABETH BUSE

April 9, 2012

EXHIBIT A

Standard No. 1

The Setting of Wholesale ("Interchange") Fees

Objective

The objective of this Standard is to ensure that the setting of wholesale ("interchange") fees in the designated credit card system is transparent and promotes:

(i) efficiency; and

(ii) competition

in the Australian payments system.

Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.
2. This Standard applies to the credit card system operated within Australia known as [ ] designated on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, and referred to as follows as the Scheme.
3. In this Standard:

   an "acquirer" is a participant in the Scheme in Australia that provides services to a merchant to allow the merchant to accept a credit card;

   "credit card" means a card issued under the rules of the Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

   "credit card transaction" or "transaction" means a transaction in Australia between a credit cardholder and a merchant involving the purchase of goods or services using a credit card;

   "financial year" is the 12 month period ending 30 June;

   an "issuer" is a participant in the Scheme in Australia that issues credit cards to the issuer's customers;

   "merchant" means a merchant in Australia that accepts a credit card for payment for goods or services;

"nominated Scheme participants" are those issuers that issued, in aggregate, credit cards which were used in at least 90 per cent of credit card transactions by value in the Scheme in Australia in the financial year prior to the date by which the applicable cost-based benchmark must be calculated, those issuers being determined by the administrator of the Scheme or the other participants in the Scheme in Australia;

"rules of the Scheme" mean the constitution, rules, by-laws, procedures and instruments of the Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in the Scheme in Australia consider themselves bound;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

4. This Standard refers to wholesale fees, known as "interchange" fees, which are payable by an acquirer, directly or indirectly, to an issuer in relation to a credit card transaction.

5. Each participant in the Scheme must do all things necessary on its part to ensure compliance with this Standard.

6. If any part of this Standard is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.

7. This Standard is to be interpreted:
   - in accordance with its objective; and
   - by looking beyond form to substance.

8. This Standard comes into force on 1 July 2003.

Interchange fees

9. On each of the dates specified in paragraph 10, the average of interchange fees implemented in the Scheme in Australia, calculated in accordance with paragraph 15 below, must not exceed the cost-based benchmark calculated in accordance with paragraphs 11-14 below.

10. For the purposes of paragraph 9, the dates are:

    (i) the thirtieth day after the date by which the cost-based benchmark must be calculated; and

    (ii) the date any interchange fee is introduced, varied, or removed.

Methodology

11. The cost-based benchmark is calculated as the aggregate value of eligible costs of the nominated Scheme participants for the financial year prior to the date by which the cost-based benchmark must be calculated, divided by the aggregate value of credit card transactions for the same period undertaken using credit cards issued by the nominated Scheme participants, and expressed as a percentage. Eligible costs are:
    - (i) issuers' costs incurred principally in processing credit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions;
    - (ii) issuers' costs incurred principally in respect of fraud and fraud prevention in connection with credit card transactions;
    - (iii) issuers' costs incurred principally in providing authorisation of credit card transactions; and
    - (iv) issuers' costs incurred in funding the interest-free period on credit card transactions, calculated using the average of the cash rate published by the Reserve Bank of Australia over the three financial years prior to the date by which the cost-based benchmark must be calculated.
12. Data on eligible costs must be drawn from accounting records of the nominated Scheme participants, prepared in accordance with generally accepted accounting principles and Australian accounting standards.
13. Data on eligible costs of each nominated Scheme participant must be provided by that participant to an independent expert agreed to by the Reserve Bank of Australia. The expert must review the data to determine if the costs included are eligible costs and must use the data on eligible costs to calculate the cost-based benchmark.
14. The cost-based benchmark must be calculated by the end of the third month after the date this Standard comes into force and by the end of the third month of every third year after the date this Standard comes into force. If the Reserve Bank of Australia agrees in writing, a recalculation of the cost-based benchmark may be undertaken at another date if changes in eligible costs or other factors warrant. In such a case, the cost-based benchmark must be calculated by the date specified in writing by the Reserve Bank of Australia.

15. For purposes of paragraph 9, the average of interchange fees is a weighted average calculated as follows:
    (i) each interchange fee rate, net of applicable taxes, is expressed as a percentage of transaction value for the transactions to which that interchange fee rate applies for the financial year prior to the applicable date specified in paragraph 10;
    (ii) the weights to be applied to these percentages are the shares of transactions to which each such interchange fee rate applies in the total value of transactions in the Scheme in Australia for the financial year prior to the applicable date specified in paragraph 10.

Transparency

16. The administrator of the Scheme or a representative of the participants in the Scheme in Australia must publish the interchange fee rates of the Scheme in Australia on the Scheme's website or make the interchange fee rates generally available through other means.
17. The administrator of the Scheme and the nominated Scheme participants must provide to the Reserve Bank of Australia the cost-based benchmark and the data on eligible costs used by the independent expert to calculate the cost-based benchmark, by the date by which that benchmark must be calculated.
18. The administrator of the Scheme and the nominated Scheme participants must each certify annually in writing to the Reserve Bank of Australia, on or before 30 November each year, that interchange fees of the Scheme in Australia over the prior twelve months ending 31 October were in compliance with this Standard.

Transition provision

19. In reference to paragraph 11, the initial cost-based benchmark for the Scheme may be calculated using data on eligible costs for the six-month period ending 30 June 2003, rather than for the full financial year.

EXHIBIT B

RESERVE BANK OF AUSTRALIA

Payment Systems (Regulation) Act 1998

The designated VISA credit card system

This notice is published in accordance with the requirements set out in Section 29(2)(a) of the *Payment Systems (Regulation) Act 1998* (the Act).

The Reserve Bank of Australia determines in accordance with Section 18 of the Act the following standards to be complied with by the participants in the designated credit card system operated within Australia known as the VISA system or the VISA network card system:

(i) Standard No. 1 entitled The Setting of Wholesale ("Interchange") Fees, as attached; and

(ii) Standard No. 2 entitled Merchant Pricing for Credit Card Purchases, as attached.

Summary of purpose and effect of Standard No. 1, The Setting of Wholesale ("Interchange") Fees

The purpose of Standard No. 1 is to ensure that the setting of wholesale ("interchange") fees in the VISA credit card system is transparent and promotes efficiency and competition in the Australian payments system. The Standard requires that interchange fees in the VISA credit card system in Australia, which are paid by acquirers of credit card transactions in Australia to credit card issuers in Australia, be set subject to an objective, transparent and cost-based benchmark and be regularly reviewed. The Standard will promote the provision of efficient price signals to cardholders and merchants by participants in the VISA credit card system. The effect of the Standard is expected to be a reduction in the current level of interchange fees paid by acquirers in the VISA credit card system, which is expected to pass through to merchant service fees; the initial beneficiaries will be merchants that accept VISA credit cards, but the reduction is expected to pass through to all consumers in the final prices of goods and services. The Standard is also expected to reduce the size of the transfer from the community to financial institutions for credit card usage.

Summary of purpose and effect of Standard No. 2, Merchant Pricing for Credit Card Purchases

The purpose of Standard No. 2 is to promote efficiency and competition in the Australian payments system by providing merchants the freedom to charge according to the means of payment. The Standard prevents the rules of the VISA credit card system and the participants in this system from prohibiting a merchant from charging a credit cardholder any fee or surcharge for use of a VISA credit card in a credit card transaction. The Standard will introduce normal market disciplines into negotiations between merchants and acquirers over merchant service fees and allow merchants, if they wish, to charge a "fee for service" for accepting credit cards. To the extent that merchants do charge, the price signals facing consumers choosing between different payment instruments would lead to a more efficient allocation of resources in the payments system, in the public interest.

Signed

IJ Macfarlane
Governor
Reserve Bank of Australia

Date 26/8/02

Standard No. 2

Merchant Pricing for Credit Card Purchases

Objective

The objective of this Standard is to promote:

(i) efficiency; and

(ii) competition

in the Australian payments system by providing merchants the freedom to charge according to the means of payment.

Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.

2. This Standard applies to the credit card system operated within Australia known as the VISA system or the VISA network card system designated on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, and referred to as follows as the Scheme.

3. In this Standard:

   an "acquirer" is a participant in the Scheme in Australia that provides services to a merchant to allow the merchant to accept a credit card;

   "credit card" means a card issued under the rules of the Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

   "credit card transaction" or "transaction" means a transaction in Australia between a credit cardholder and a merchant involving the purchase of goods or services using a credit card;

   "merchant" means a merchant in Australia that accepts a credit card for payment for goods or services;

   "rules of the Scheme" mean the constitution, rules, by-laws, procedures and instruments of the Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in the Scheme in Australia consider themselves bound;

   terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

4. Each participant in the Scheme must do all things necessary on its part to ensure

compliance with this Standard.

5. If any part of this Standard is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.

6. This Standard is to be interpreted:

- in accordance with its objective; and
- by looking beyond form to substance.

7. This Standard comes into force on 1 January 2003.

Merchant pricing

8. Neither the rules of the Scheme nor any participant in the Scheme shall prohibit a merchant from charging a credit cardholder any fee or surcharge for a credit card transaction.

9. Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a credit cardholder will be limited to the fees incurred by the merchant in respect of a credit card transaction.

Transparency

10. Each acquirer must notify, in writing, each merchant to whom the acquirer provides services of the provisions of this Standard as soon as practicable after this Standard comes into force.

Reserve Bank of Australia
SYDNEY

EXHIBIT C

Standard

The Setting of Wholesale ('Interchange') Fees in the Designated Credit Card Schemes

Objective

The objective of this Standard is to ensure that the setting of wholesale ('interchange') fees in each designated credit card scheme is transparent and promotes:

(i) efficiency; and

(ii) competition

in the Australian payments system.

Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.
2. This Standard applies to the payment systems operated within Australia known as the MasterCard system and the VISA system, which were designated as payment systems on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998,* each of which is referred to in this Standard as a Scheme.
3. In this Standard:

   an 'acquirer' is a participant in a Scheme in Australia that provides services to a merchant to allow that merchant to accept a credit card;

   'credit card' means a card issued under the rules of a Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of that Scheme and commonly known as a credit card;

   'credit card transactions' or 'transactions' means transactions in the relevant Scheme in Australia between a credit cardholder and a merchant involving the purchase of goods or services using a credit card of that Scheme (net of credits, reversals and chargebacks);

   'financial year' is the 12-month period ending 30 June;

   an 'issuer' is a participant in a Scheme in Australia that issues credit cards to the issuer's customers;

   'merchant' means a merchant in Australia that accepts a credit card for payment for goods or services;

   'nominated Scheme participants' for a Scheme are those issuers that issued, in aggregate, credit cards which were used in at least 90 per cent of credit card transactions by value in the Scheme in Australia in the financial year prior to the date by which the applicable cost-based benchmark must be calculated, those issuers being determined by the administrator of the Scheme or the other participants in the Scheme in Australia;

   'rules of a Scheme' mean the constitution, rules, by-laws, procedures and instruments of the relevant Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in that Scheme in Australia consider themselves bound;

   terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.
4. This Standard refers to wholesale fees, known as 'interchange' fees, which are payable by an acquirer, directly or indirectly, to an issuer in relation to credit card transactions in a Scheme.
5. Each participant in a Scheme must do all things necessary on its part to ensure compliance with this Standard.
6. If any part of this Standard is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.
7. This Standard is to be interpreted:
   - in accordance with its objective; and
   - by looking beyond form to substance.

8. This Standard comes into force on 1 July 2006.
9. This Standard replaces Standard No. 1, *The Setting of Wholesale ('Interchange') Fees* which applies to each Scheme.

Transition provision

10. If, prior to 1 November 2006, any interchange fee is introduced, varied, or removed in a Scheme, the average of interchange fees implemented in that Scheme in Australia on the date of that change, calculated in accordance with paragraph 20 below, must not exceed the benchmark for that Scheme calculated under Standard No. 1, *The Setting of Wholesale ('Interchange') Fees*.

Interchange fees

11. From 1 November 2006, on each of the dates specified in paragraph 12, the average of interchange fees implemented in a Scheme in Australia, calculated in accordance with paragraph 20 below, must not exceed the common cost-based benchmark calculated in accordance with paragraphs 13 to 17 below.
12. For the purposes of paragraph 11, the dates are:
    (i) 1 November 2006 and 1 November of each third year thereafter; and
    (ii) the date any interchange fee is introduced, varied, or removed in that Scheme.

Methodology

13. The cost-based measure for each Scheme is calculated as the value of eligible costs of the nominated Scheme participants in that Scheme for the financial year prior to the date by which the cost-based measure must be provided to the Reserve Bank of Australia, divided by the value of credit card transactions for the same period undertaken using credit cards issued by those nominated Scheme participants, expressed as a percentage. Eligible costs are:
    (i) issuers' costs incurred principally in processing credit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions;
    (ii) issuers' costs incurred principally in respect of fraud and fraud prevention in connection with credit card transactions;
    (iii) issuers' costs incurred principally in providing authorisation of credit card transactions; and
    (iv) issuers' costs incurred in funding the interest-free period on credit card transactions, calculated using the average of the cash rate published by the Reserve Bank of Australia over the three financial years prior to the date by which the cost-based benchmark must be calculated.
14. Data on eligible costs must be drawn from accounting records of the nominated Scheme participants, prepared in accordance with generally accepted accounting principles and Australian accounting standards.
15. Data on eligible costs and the value of transactions of each nominated Scheme participant in each Scheme must be provided by that participant to an independent expert proposed by that Scheme and agreed to by the Reserve Bank of Australia. The expert must review the data to determine if the costs included are eligible costs and must use the data on eligible costs to calculate the cost-based measure for that Scheme. The expert must provide the cost-based measure and the aggregate data on eligible costs and the value of transactions used to calculate the cost-based measure to the Reserve Bank by 15 September of the year in which the cost-based measure must be calculated.
16. Each nominated Scheme participant for a Scheme must provide to the Reserve Bank of Australia by 15 September of the year in which the cost-based measure must be calculated:
    (i) the cost-based measure, the data on eligible costs and the value of transactions undertaken by it used by the independent expert to calculate the cost-based measure;
    (ii) the data on eligible costs described in (i) divided into the categories identified in paragraph 13 (i) – (iv) and the number of transactions undertaken by it in the financial year prior to the date by which the cost-based measure must be calculated using credit cards issued by the nominated Scheme participants.

    The administrator of a Scheme must provide to the Reserve Bank of Australia, by 15 September of the year in which the cost-based measure must be calculated, the number and value of transactions undertaken by all of the participants in the Scheme in the previous financial year.

17. The common cost-based benchmark is calculated by the Reserve Bank of Australia by weighting the individual scheme cost-based measures by the shares of each Scheme in the value of credit card transactions undertaken in all the Schemes. The Reserve Bank of Australia will publish the common cost-based benchmark by 30 September of the year in which the cost-based measure must be calculated.
18. The cost-based measure for a Scheme must be calculated in 2006 and each third year thereafter. If the Reserve Bank of Australia agrees in writing, a recalculation of the cost-based measure for a Scheme and of the common cost-based benchmark may be undertaken at other times if changes in eligible costs or other factors warrant.
19. The Reserve Bank of Australia may at any time, by notification on its website, waive or suspend the requirement to recalculate the cost-based measure and the common cost-based benchmark, in which case the common cost-based benchmark in force at that time will continue to apply.
20. For the purposes of paragraphs 10 and 11, the average of interchange fees in a Scheme is to be expressed as a percentage of transaction values. It is to be calculated by dividing the total interchange revenue that would have been payable had the interchange fees implemented on the dates specified in paragraph 10 or 12 been applicable in the previous financial year, by the value of transactions in that year.

Transparency

21. The administrator of a Scheme or a representative of the participants in the Scheme in Australia must publish the interchange fee rates of the Scheme in Australia on the Scheme's website or make the interchange fee rates generally available through other means.
22. The administrator of a Scheme must certify annually in writing to the Reserve Bank of Australia, on or before 30 November each year, that interchange fees of the Scheme in Australia over the prior twelve months ending 31 October were in compliance with this Standard.

EXHIBIT D

CREDIT CARD BENCHMARK CALCULATION

The Standard *The Setting of Wholesale ('Interchange') Fees in the Designated Credit Card Schemes* sets out the process for determining a common benchmark for interchange fees in the MasterCard and Visa credit card schemes.

The common benchmark was calculated as follows:

1. Each of the two schemes identified the credit card issuers that were to provide the cost data needed to calculate the benchmark ('nominated scheme participants' or 'NSPs'). Both MasterCard and Visa nominated seven issuers, accounting for around 95 per cent of the value of transactions in each case in the 2005/06 financial year – in excess of the 90 per cent minimum required by the Standard. Each NSP provided data on eligible costs incurred in 2005/06, as well as the value of transactions over the same period.

2. For each scheme, an independent expert reviewed the scheme's NSPs' data and calculated a 'cost-based measure' by dividing the NSPs' eligible costs by the total value of the NSPs' transactions.

3. The Reserve Bank then calculated the common benchmark as a weighted average of the two schemes' cost-based measures. The weights were the shares of each scheme in the total value of credit card transactions in the 2005/06 financial year (i.e. including all issuers regardless of whether or not they were an NSP for either scheme). The result of this calculation is a weighted average of 0.50 per cent.

Accordingly, the common benchmark to apply for the three years from 1 November 2006 is 0.50 per cent.

The weighted average of a scheme's credit card interchange fees must not exceed the common benchmark on 1 November 2006 or on any date in the subsequent three years on which the scheme introduces, varies or removes a credit card interchange fee.

EXHIBIT E

VISA

Interchange

Visa Interchange on Domestic Transactions in Australia

The fees listed here are payable by Australian acquiring institutions to Australian issuing institutions in relation to domestic Visa Credit, Debit and Prepaid transactions processed over the National Net Settlement Service with effect from 30 June 2010.

Domestic Visa Credit Interchange Rates

Effective 30 June 2010, the following interchange rates apply to domestic transactions processed through Visa's National Net Settlement Service:

Description	Rate inclusive of GST*
Charity rate	0%
Large Ticket rate (exclude T&E)	A$22 + 0.22%
Strategic Merchant Program rate	0.275% - 0.385%
Government rate	0.33%
Transit rate	0.33%
Utility rate	0.33%
Recurring Payment Transaction rate	0.33%
Service Station rate	0.352%
Supermarket rate	0.352%
Education rate	0.44%
Insurance rate	0.44%
Electronic rate	0.44%
Standard, Card Not Present and Paper rate	0.495%
Platinum rate	1.10%
Super Premium rate	1.87%
Commercial rate	1.408%

** All fees are represented in Australian Dollars*

Domestic Visa Debit and Prepaid Interchange Rates

Effective 30 June 2010, the following interchange rates apply to domestic transactions processed through Visa's National Net Settlement Service:

Description	Rate inclusive of GST*
Charity rate	0.0%
Large Ticket rate (exclude T&E)	A$11 + 0.11%
Strategic Merchant Rate	4.4 cents – 66 cents
Government rate	8.8 cents
Transit rate	6.6 cents
Utility rate	8.8 cents
Recurring Payment Transaction rate	8.8 cents
Service Station rate	6.6 cents
Supermarket rate	6.6 cents
Education rate	8.8 cents
Insurance rate	8.8 cents
Electronic rate	8.8 cents
Standard, Card Not Present and Paper rate	0.33%
Platinum rate	0.44%
Commercial rate	1.10%

** All fees are represented in Australian Dollars*

% = % of the transaction value

Cents = cents per transaction

Different fees apply when a Visa transaction involves either an overseas cardholder or an overseas merchant. Merchants should direct all questions relating to interchange fees to their Acquiring Institution.

There is a precedence in which interchange fee programs and rates are applied. Generally, acceptance based rates (e.g., utility, insurance, and recurring) take precedence over product-based rates (e.g., platinum and commercial). The following table provides a brief description of Visa's domestic interchange fee programs in Australia.

Interchange Fee Programs	Definition
Charity rate	Payable on Visa transactions for merchants who are non-political fundraising organisations (organisations engaged in soliciting contributions) and social service organisations engaged in social welfare services, including advocacy groups, community organisations, and health agencies. The charity must be registered with the Australian Tax Office. Acquirers are required to hold a copy of the Charity's ATO certification and ensure that the charity complies with the defined 'characteristics'. The characteristics of a charity are: 1. It is an entity which is also a trust fund or an institution 2. It is non-profit 3. It exists for the public benefit or the relief of poverty 4. Its purposes are charitable within the legal sense of that term 5. Its sole or dominant purpose is charitable
Large ticket rate (Excludes T&E)	Payable on a Visa transaction that is A$10,000 and above excluding travel and entertainment merchant categories.
Strategic Merchant Program	Payable on Visa transactions for merchants designated by Visa to be strategic in which they meet certain volume and/or growth thresholds. The range of interchange rates available to this program is displayed.
Government rate	Payable on Visa transactions initiated at any merchant defined as a Government entity (meeting Visa's merchant classification requirements).
Transit rate	Payable on Visa transactions for local and suburban mass passenger transportation over regular routes and on regular schedules, and does not include taxicabs, limousines, and bus lines. Included in this category is railway commuter transportation.
Utility rate	Payable on Visa transactions initiated at any merchant providing electric, gas, water or sanitary utility services (meeting Visa's merchant classification requirements).
Recurring Payment rate	Payable on Visa transactions initiated at a merchant who has entered into an agreement with their Acquiring Institution to participate in the Recurring Payment Transaction Service, where the cardholder has signed an agreement with the merchant to authorize the merchant to bill their Visa card for recurring payments, the transaction details are sent to the Issuing Institution, the Issuing Institution authorizes the transaction and the merchant sends the transaction to its Acquiring Institution for clearing and settlement with the Issuing Institution within four days.
Service Station rate	Payable on Visa transactions for retail sellers of automotive gasoline and receive payment either at the counter through signing a sales slip or through the use of an Automated Fuel Dispenser (AFD). Automated Fuel Dispensers enable cardholders to purchase fuel by completing the transaction at the pump.
Supermarket rate	Payable on Visa transactions for merchants that sell a complete, full line of food merchandise for home consumption. Most of the food merchandise is perishable, including self-service groceries, meat, produce and dairy products. In addition, they also sell canned, frozen, prepackaged, dry foods, a limited selection of house wares, cleaning and polishing products, personal hygiene products, cosmetics, greeting cards, books, magazines, household items, and dry goods. These merchants may also operate specialized departments such as an in store deli counter, meat counter, pharmacy, or floral department. NOTE: Merchants typically known as a convenience stores and sell a limited selection of products or specialty items are not eligible for this rate.

Education rate	Payable on Visa transactions for designated schools that accept Visa for payment. Schools include elementary, secondary, universities, correspondence schools, business and secretarial schools and vocational and trade schools.
Insurance rate	Payable on Visa transactions for merchants that sell all types of personal or business insurance polices. This includes merchants that provide the following types of insurance: automobile, life, health, hospital, medical, and dental insurance, homeowners and renters insurance, real estate title insurance, pet health insurance and flood, fire or earthquake insurance. This also include direct marketing insurance services e.g., accidental death, travel insurance, etc.
Electronic rate	Payable on Visa transactions initiated at any merchant where a cardholder presents a consumer magnetic stripe card or a chip card, the card is used at an electronic terminal, all data on the card is successfully transmitted to the Issuing Institution, the Issuing Institution authorizes the transaction and the merchant sends the transaction to its Acquiring Institution for clearing and settlement with the Issuing Institution within four days.
Standard, Card Not Present and Paper rate	Applicable to all transactions on a standard consumer card that do not qualify for any other rate detailed. Typically these are transactions on Visa Classic and Gold cards that are used in a card not present environment (e.g., internet) or a non-electronic transaction (paper based). An electronic Classic or Gold transaction that is not settled within 4 days would receive a standard interchange rate.

Other Key definitions

- ***Commercial card*** - a generic name given to the following card products: Visa Business Card, Visa Corporate Card, Visa Purchasing Card and Visa Distribution Card
- ***Standard consumer card*** - a generic name given to the following card products: Visa Classic, Visa Gold and Visa Electron
- ***Platinum consumer card*** - a premium card product
- ***Super Premium consumer card*** – a generic name given to the following card products: Visa Infinite and Visa Signature
- ***Acquiring Institution*** – a Financial Institution which has applied and been granted membership to Visa in Australia for the purpose of acquiring payment card transactions in Australia
- ***Issuing Institution*** – a Financial Institution which has applied and been granted membership to Visa in Australia for the purpose of issuing payment cards in Australia
- ***Cardholder*** – a person who has a Visa card issued by an Issuing Institution which is a member of Visa in Australia
- ***Merchant*** – an entity which has entered into an agreement to accept credit cards for the purchase of goods and services with an Acquiring Institution which is a member of Visa in Australia
- ***Domestic Visa Credit card transaction*** – a transaction in Australia between an Australian cardholder and an Australian merchant involving the purchase of goods and services using a Visa Credit card
- ***Domestic Visa Debit card transaction*** – a transaction in Australia between an Australian cardholder and an Australian merchant involving the purchase of goods and services using a Visa Debit card

EXHIBIT F

Review of Card Surcharging: A Consultation Document

JUNE 2011

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1. Introduction

The Payments System Board imposed the no-surcharge Standards – requiring the removal of no-surcharge scheme rules – on the MasterCard and Visa credit card systems effective from 1 January 2003 and the Visa Debit system effective from 1 January 2007. Other international card schemes provided voluntary undertakings to remove their equivalent rules. The removal of these rules has allowed merchants to pass on the cost of credit card and scheme debit card transactions to customers via surcharges. The Board identified in *Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review*, released in April 2008, that the benefits of the no-surcharge Standards have been substantial, particularly in improving price signals to cardholders about the relative costs of different payment methods. The Board also noted that, in time, the Standards might be expected to add to the downward pressure on interchange fees.

As part of the 2007/08 Review, the Board considered whether a modification to the Standards to allow schemes to limit the size of any surcharges imposed by merchants was necessary. This reflected concerns expressed through consultation that surcharging was being exploited by firms with market power. The Board decided, however, that the isolated cases of high surcharges, at that time, did not provide sufficient grounds to allow the schemes to impose restrictions on all merchants and hence limit their negotiating flexibility. In fact, given that the high surcharges were likely to be a reflection of the market power of the merchants concerned, a cap on surcharges would not necessarily prevent higher prices being passed on in some other way. Survey data also suggested that, on average, surcharges were being set with reference to merchant service fees.

Since then, there has been increasing evidence to suggest that it is now becoming more common for merchants to set surcharges at levels that are higher than average merchant service fees. The increasingly widespread nature of this practice has the potential to distort price signals to cardholders and to thereby reduce the effectiveness of the reforms.

This document sets out the Board's analysis of current surcharging practices and some proposed changes that could be made to the no-surcharge Standards. Section 2 sets out current merchant surcharging behaviour and consumers' reaction to surcharging. Section 3 discusses recent surcharging practices that have raised concerns, while Section 4 sets out some proposed modifications to the no-surcharge Standards to address these concerns. Section 5 sets out the issues for consultation and Section 6 provides details of the next steps in the process.

2. Background

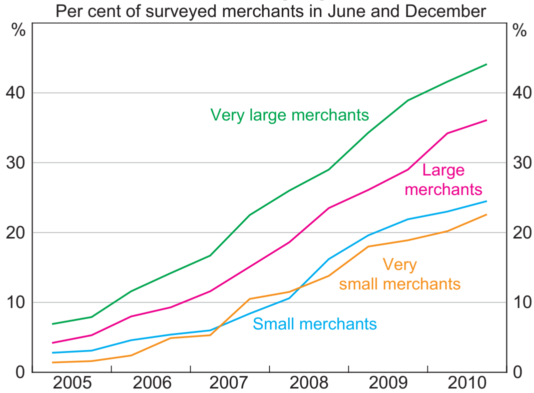
The Removal of No-surcharge Rules and Merchant Surcharging Behaviour

In 2003, the Reserve Bank began implementing reforms to the debit and credit card systems in Australia. As part of these reforms, a number of restrictions that had been placed on merchants by the international card schemes were removed. One such restriction was the no-surcharge rule, which prevented merchants from surcharging for credit card and scheme debit card transactions. These rules had masked price signals to cardholders about the relative costs of different payment methods. They had also contributed to the subsidisation of credit card users by all other customers, as merchants would build the costs of accepting card payments into the overall prices of their goods and services, which were paid by all customers regardless of the payment method they used. Finally, these rules limited the ability of merchants to put downward pressure on their merchant service fees and interchange fees by threatening to charge the customer for using a credit or scheme debit card.

The Reserve Bank imposed standards requiring the removal of no-surcharge rules from 1 January 2003 in the MasterCard and Visa credit card systems and from 1 January 2007 in the Visa Debit card system.[1] The American Express, Diners Club and Debit MasterCard systems each provided voluntary undertakings to remove their equivalent rules.

Surcharging was slow to develop among merchants in the first few years following the removal of no-surcharge rules. This likely reflected inertia on the part of merchants and the strong expectation by cardholders that no surcharges would apply, given the history of these practices being prohibited. In recent years, though, the rate of surcharging appears to have grown significantly; data from East & Partners' semi-annual survey of the merchant acquiring business suggest that almost 30 per cent of merchants imposed a surcharge on at least one of the credit cards they accepted in December 2010 (Graph 2.1).[2] Surcharging appears to be more common among very large merchants (those with annual turnover greater than $530 million), although around one-quarter of smaller merchants (those with annual turnover between $1 million and $20 million)

Graph 2.1
Merchants Surcharging Credit Cards
Per cent of surveyed merchants in June and December



Source: East & Partners' Merchant Acquiring & Cards Market program

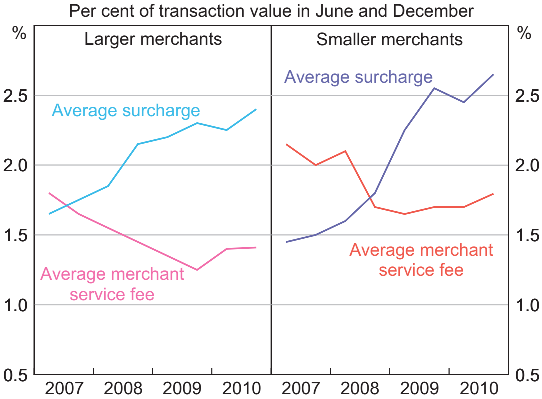
1 The Standard titled *Merchant Pricing for Credit Card Purchases* and the Standard titled *The 'Honour All Cards' Rule in the Visa Debit and Visa Credit Card Systems* and the *'No Surcharge' Rule in the Visa Debit System*.

2 East & Partners (2010), *Australian Merchant Acquiring and Cards Markets: Special Question Placement Report prepared for the Reserve Bank of Australia*, December.

are also reported to impose surcharges. According to these data, most other merchants are considering imposing surcharges, with only around 20 per cent of merchants having no surcharge plans.

According to the East & Partners' survey, average surcharge levels have increased substantially over the past few years (Graph 2.2). In December 2010, the average surcharge for MasterCard credit cards was 1.8 per cent, for Visa it was 1.9 per cent, for American Express it was 2.9 per cent, and for Diners Club it was 4 per cent.[3] These average surcharge levels are around 1 percentage point higher than merchant service fees for American Express, MasterCard and Visa cards, and around 1.8 percentage points higher for Diners Club cards.[4] Surcharges also vary substantially across different merchants; East & Partners' data indicate that around 10 per cent of surcharging merchants apply a surcharge of 5 per cent or more.

Graph 2.2
Surcharges and Merchant Fees by Merchant
Per cent of transaction value in June and December



Source: East & Partners' Merchant Acquiring & Cards Market program

Consumer Responses to Surcharging

In the Board's view, the benefits from the removal of no-surcharge rules have been substantial, particularly in improving the price signals cardholders face when making payments. While merchants that apply surcharges are becoming increasingly commonplace, consumers appear to respond to price signals by avoiding surcharges where possible. According to the Bank's 2010 Consumer Payments Use Study, consumers paid a surcharge on just 5 per cent of their credit card transactions over the one-week diary period, with this proportion little changed from a similar study conducted in 2007 despite the greater prevalence of surcharging.[5] These surcharges were found to be most commonly paid in the holiday travel industry (44 per cent of credit card transactions in that industry). This possibly reflects the fact that for this industry, online purchases are more common than in other industries and credit cards provide the most readily available means to undertake online transactions. In addition, most hotel or car rental bookings require a credit card as a form of security deposit or 'hold' on funds to cover potential damages, often resulting in customers paying the final bill with the same card.

The Consumer Payments Use Study also provides evidence on how consumers respond to price signals from surcharging. The study specifically asked consumers how they would react when faced with various surcharging scenarios. Across the scenarios, the results suggest that around half of consumers that hold a credit card will seek to avoid paying a surcharge by either using a different payment method that does not attract a surcharge (debit card or cash) or going to another store. The results

3 East & Partners has attributed the sharp increase in surcharges on Diners Club cards in December 2010 to the inclusion of several merchants that surcharge aggressively.

4 A merchant service fee is a per-transaction or *ad valorem* fee paid by a merchant to the acquirer when a cardholder undertakes a transaction.

5 As part of the Payments System Board's Strategic Review of Innovation in the Payments System, the Reserve Bank commissioned Roy Morgan Research to conduct a study of payment patterns. The 1 241 individuals participating in the study were asked to record details of every payment they made during one week, including whether they paid a card surcharge on the payment. A report of the results of this study will be available in June.

also indicate that consumers respond to differential surcharging: when faced with a surcharge that is higher on one type of credit card than another, only around 10 per cent of consumers indicated that they would complete the transaction with the card attracting the higher surcharge, while around 40 per cent indicated they would complete the transaction with the card attracting the lower surcharge.

Past Consideration of Surcharging

The Board reviewed the no-surcharge Standards as part of its broader review of the card payment reforms in 2007/08. During consultations for this Review, some industry participants expressed concerns about surcharging being exploited by merchants with market power. Reflecting these concerns, the Board considered two broad options: the removal of the no-surcharge Standards; and the allowance of caps on the surcharge level. The case for removing the no-surcharge Standards was considered weak at that time given the substantial benefits it had provided in improving price signals to cardholders.

By contrast, the arguments for and against allowing schemes to cap surcharges were considered to be more finely balanced. On the one hand, a consumer group, the card schemes and smaller financial institutions had expressed concerns about some cases of excessive surcharging; it was argued that a cap could ensure that any surcharge set would be in line with the cost to merchants of accepting a particular card.

On the other hand, the Board assessed that caps would limit the negotiating flexibility of merchants who might agree to limit the amount of their surcharge in exchange for a lower merchant service fee. Weighing up these arguments, the Board assessed that the isolated cases of high surcharges did not provide sufficient grounds to restrict surcharging for all merchants. Indeed, at that time, survey data suggested that, on average, surcharges were in line with merchant service fees, and the isolated cases of considerably higher surcharges were more likely a reflection of the market power of the merchants concerned. In the latter case, a cap on surcharges would have limited effect on the overall prices of goods and services charged by such firms.

3. Concerns about Surcharging Practices

The purpose of removing no-surcharge rules from the credit and scheme debit card systems was to promote efficiency and competition in the Australian payments system by providing merchants the freedom to charge according to the means of payment. The intent was that the Standards would introduce normal market disciplines into negotiations between merchants and acquirers over merchant service fees and, to the extent that merchants surcharge, improve price signals facing consumers choosing between different payment methods. This in turn would lead to a more efficient allocation of resources in the payments system, which is in the public interest. The Standards therefore prevent scheme rules or any participant in a scheme from prohibiting a merchant from charging a cardholder *any* fee or surcharge for use of that card. At the time, it was generally expected that retail competition would ensure that merchants would not exploit cardholders, who had the option to turn to other payment instruments or go to other stores.

As discussed above, there is evidence to suggest the removal of no-surcharge rules has improved price signals to cardholders and has thereby improved efficiency in the payments system. Nevertheless, in recent years, it has become apparent that merchants have increasingly been adopting a number of surcharging practices that have the potential to distort price signals and thereby reduce the effectiveness of the surcharging reforms. Two practices are of particular concern to the Board: 'excessive' surcharging; and blended surcharging.

Excessive Surcharging

As discussed above, the available data indicate that the margin by which the average surcharge is above the average merchant service fee has been increasing in recent years (Graph 2.2). There is also some evidence to suggest that this margin tends to be quite wide for some industries and payment channels. These industries and channels also tend to be the segments where a higher proportion of transactions are surcharged. For example, data from the 2010 Consumer Payments Use Study suggest that the incidence of surcharging is much higher for online purchases than those made in person; respondents paid a credit card surcharge on around 18 per cent of transactions made online compared with 4 per cent of those made in person. East & Partners' data suggest that surcharges paid for online transactions also tend to be higher, at around 4 per cent of the purchase value, on average, compared with around 2 per cent for merchants with a physical presence. A related concern about surcharging that has been expressed by both industry participants and consumers is that there may sometimes be a lack of genuine payment alternatives where credit card surcharges are applied to online payments.

While there is potentially a large variation in the card acceptance costs faced by merchants, justifying significant variation in surcharges, concern has been expressed to the Bank that some merchants may be using surcharging as an additional means of generating revenue, rather than simply covering the costs of card acceptance. A similar conclusion was reached in a report published by CHOICE in November 2010, commissioned by the New South Wales Department of Fair Trading.[6]

Blended Surcharging

The second concern is an apparent increase in the use of blended surcharging. This is where different cards are surcharged at the same rate despite significant differences in acceptance costs. For instance, a merchant may apply the same surcharge to American Express, Diners Club, MasterCard and Visa cards even though the merchant's acceptance costs are likely to be higher for some cards than others. Hence, a merchant may not be recovering all its acceptance costs, or it may be recovering its costs for some cards and more than its costs for others. In some cases, these blended surcharges have been encouraged by the higher-cost schemes. While some merchants may prefer the simplicity of applying only one blended surcharge across card schemes, this practice dulls price signals to consumers about the relative costs of different card systems.

A related issue is that there appear to be few, if any, instances where merchants apply different surcharges for different cards within a card scheme (that is, 'differential' surcharging). Given that premium/platinum cards typically are more costly for merchants to accept than standard or gold cards, we may expect that some merchants would impose different surcharges on these different card types. While it is ultimately the merchant's choice as to how they impose surcharges, this outcome may, in part, be the result of the structure of merchant pricing. Most merchants tend to pay one blended merchant service fee to their acquirer for a particular card scheme, with little knowledge of how this blended fee depends on their particular mix of card transactions. While many merchants prefer this simple fee structure, it provides them little information on the cost of acceptance for each different card type; hence, they may be charging the same rate for different cards simply because they do not know how different cards affect their total cost of card acceptance.

6 CHOICE (2010), *CHOICE Report: Credit Card Surcharging in Australia*, November.

4. Policy Options and Discussion

Since the 2007/08 Review, there has been increased evidence of adverse surcharging practices. The Board, therefore, believes there may be a case for varying the no-surcharge Standards. The Board has identified two potential modifications to the Standards: allowing scheme rules to impose caps on surcharges; and providing clarification on differential surcharging. These suggested modifications are set out below. The possible need for disclosure of merchant service fees is also discussed.

Capping of Surcharges

The Board believes that allowing some limit to be placed on the level of surcharges could improve the effectiveness of the reforms at relatively little cost, particularly given that the practice of surcharging is now well established. There are two possible options the Board could take to implement such a change: determine a specific permissible cap that the schemes could impose; or allow scheme rules to limit surcharges to an amount that is either reasonably related, or equal, to the merchant's cost of card acceptance. Given that the Bank has no direct influence over merchant pricing, either approach would best be implemented by allowing schemes to alter their rules to incorporate the cap.

Under the first option, the Board could determine a specific permissible cap, possibly expressed as a percentage of the transaction value, for the designated MasterCard and Visa credit card systems, and the Visa Debit system.[7] This would be the lowest cap that schemes rules could choose to impose. That is, scheme rules may choose to impose a cap at a higher level than that specified in the Standards, or to not impose caps at all, but any cap below the level specified would not be permitted.

This option has the appeal of being transparent and easy for schemes and consumers to monitor compliance. There is, however, the practical difficulty of determining the appropriate level for the cap. If the cap is set too high, merchants with market power would be encouraged to set surcharges at the level of the cap. If the cap is set too low, the ability of merchants to put downward pressure on merchant service fees and interchange fees would be limited. A permissible cap that is specified in the Standards would also be unresponsive to competitive pressures that might influence merchant service fees over time.

The second and more flexible option is to modify the no-surcharge Standards to allow scheme rules to limit surcharges to an amount that is either reasonably related, or equal, to the merchant's cost of card acceptance. Under the current Standards, acquirers and merchants may come to an agreement that the amount of the surcharge will be limited to the costs of card acceptance. However, it is not clear that this has been used in practice, as acquirers for the four-party schemes have little incentive to impose restrictions on their merchant clients in exchange for reducing merchant service fees. Hence, this limit may be more effectively implemented through scheme rules.

7 The American Express, Diners Club and Debit MasterCard systems could modify their relevant voluntary undertakings accordingly.

Under this second option, the Standards might need to define the cost of card acceptance. The widest definition of the cost of acceptance would be the merchant service fee plus 'other' costs, such as annual fees, terminal rentals or other transaction fees. Determining what other costs should be included, though, is not straightforward because of the complexities of merchant pricing. One way to limit the scope of the costs that can be included is to only allow costs charged by the acquirer. However, there are legitimate costs for processing card transactions that are not necessarily charged by the acquirer. For example, while some merchants rent their terminals and incur terminal rental fees, others invest directly in terminals themselves; if only costs imposed by acquirers could be passed through, merchants that rent their terminals from acquirers could impose a higher surcharge. Also, in the case of online payments, some merchants have their card transactions processed by a payment gateway, which is not necessarily the same as the merchant acquirer. Therefore, any fee associated with transaction processing by the third-party gateway could not be passed through as a surcharge under such arrangements. Another consideration is that other costs cannot always be entirely attributed to a particular card's acceptance. For example, terminals are used to process many types of payments and so these costs would need to be apportioned across payment methods appropriately.

Given the difficulties involved in determining the appropriate scope for other costs, a more transparent and consistent alternative is to define the cost of acceptance as, simply, the merchant service fee. While it may be somewhat restrictive for some merchants, it may be the most straightforward way to address the concerns of excessive surcharging while still providing appropriate price signals to consumers.

Another consideration under this more flexible option is whether surcharges should be capped at a level equal to the defined cost of acceptance, or whether they need only be 'reasonably related' to that cost. Allowing for a reasonable relationship between surcharges and the cost of acceptance implies some level of tolerance around any surcharging cap. What constitutes 'reasonable' in this case could be left unspecified. Alternatively, a level of tolerance could be defined more precisely, for instance in terms of basis points for credit cards.

Clarification on Differential Surcharging

The second proposed modification to the no-surcharge Standards is to provide clarification on the ability of merchants to surcharge differentially across card types within a particular card scheme. However, consideration needs to be given to the different models of merchant pricing.

As mentioned in Section 3, the majority of merchants receive a blended merchant service fee across all cards of a particular scheme and most prefer this simple fee structure. This blended merchant service fee, in part, reflects the merchant's expected mix of card transactions as indicated by recent experience or industry norms. Therefore, premium/platinum card transactions, for example, do not explicitly cost more than standard card transactions for a merchant on a blended merchant service fee, but a sustained increase in the proportion of premium/platinum card transactions is likely to flow through to a higher blended rate over time. Blended merchant service fees, therefore, make it difficult for merchants to assess the cost of accepting a particular card type and to surcharge accordingly.

By contrast, some larger merchants receive 'interchange-plus' merchant pricing, where for each transaction the merchant is charged the interchange fee applying to that card or transaction type plus the acquirer's margin. A transaction made with a premium/platinum card will, therefore, at many merchants incur a higher merchant service fee than a transaction on a standard card because premium/platinum cards attract a higher interchange fee. Reflecting this, the merchant may choose to signal the different costs of acceptance for different card types by imposing card-specific surcharges. Alternatively, they may choose to surcharge one rate across all cards of a particular scheme. If surcharging were tied to acceptance costs, such merchants would need to calculate (or be provided with) their own weighted-average (blended) merchant service fee for each card scheme they accept.

Considering these different models of merchant pricing, for efficiency reasons revised Standards should ensure that scheme rules capping surcharges are not imposed in a way that prevents a merchant from surcharging differentially across cards within a card scheme if they have the capacity to do so. The Board is seeking views on the ways merchants may retain the flexibility to apply differential surcharging in conjunction with a possible surcharging cap. For example, one option might be to clarify in the no-surcharge Standards that scheme rules capping surcharging cannot prohibit merchants applying a surcharge that is either:

- a blended rate for each particular card scheme; or
- the cost of accepting each card within a card scheme.

In order to enable merchants to differentially surcharge, revisions to the Standards could also require acquirers to pass on information about the merchant's cost of acceptance for each different card type if it is requested by the merchant. At the same time, the Standards could require acquirers to pass on information about the weighted-average merchant service fee for those merchants on 'interchange-plus' arrangements.

Disclosure

The Board has also considered whether there is a case to promote the disclosure of merchant service fees. The disclosure of surcharges by merchants has been addressed in a guide on *Merchant Pricing for Credit Card Payments* produced jointly by the Australian Competition and Consumer Commission, and the Australian Securities and Investments Commission.[8] The additional disclosure of merchant service fees by merchants would provide consumers with information about the cost of card acceptance, against which the reasonableness of any surcharge could be assessed. Alternatively, the Bank could collect and publish more detailed data on merchant service fees, such as the range and average of these fees across merchant categories for each card scheme. The Board is seeking the views of interested parties on the merits of these approaches to disclosure.

8 http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/news_for_business.pdf/$file/news_for_business.pdf.

5. Summary of Issues for Consultation

Reflecting the discussion in the previous section, the Board is seeking input from interested parties on the following issues:

i. Is there a case for modifying the Standards to allow schemes to limit surcharges?

ii. Is a surcharge cap best implemented by the Board setting a transparent and specific permissible cap that is specified in the Standards, and may then be imposed in scheme rules? Or, should the Standards allow scheme rules to limit surcharges to an amount that is either reasonably related, or equal, to each particular merchant's cost of card acceptance?

iii. Should there be some level of tolerance allowed around any surcharge cap?

iv. Is the merchant service fee an appropriate measure of the cost of card acceptance (that can be applied consistently across all merchants)?

v. Should the no-surcharge Standards clarify that, notwithstanding any surcharging cap, scheme rules cannot prohibit merchants from applying a surcharge that is either a blended rate for each card scheme or the cost of accepting each card *within* a card scheme? Are there alternative ways to allow for differential surcharging?

vi. Should the no-surcharge Standards require acquirers to pass on information about the merchant's cost of acceptance for each different card type if it is requested by the merchant? And, for those on 'interchange-plus' pricing, should the no-surcharge Standards require acquirers to pass on information about the weighted-average merchant service fee if it is requested by the merchant?

vii. Is there a case for disclosure of the cost of card acceptance by merchants? Or, would it be sufficient for the Bank to collect and publish more detailed data on merchant service fees, such as the range and average of merchant service fees across merchant categories for each card scheme?

6. Next Steps

The Board's proposals set out in this document are preliminary, and the Bank is now seeking submissions from interested parties on these proposals and the issues for consultation, as set out in this document. Formal written submissions by no later than 20 July are welcome and should be sent to:

Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

or by email to pysubmissions@rba.gov.au.

All submissions will be posted on the Reserve Bank's website (www.rba.gov.au). Parties making submissions will be provided with an opportunity to discuss their submission with Reserve Bank staff.

EXHIBIT G

CHOICE REPORT CREDIT CARD SURCHARGING IN AUSTRALIA

choice

The people's watchdog

choice

CHOICE REPORT: CREDIT CARD SURCHARGING IN AUSTRALIA
PREPARED ON BEHALF OF NSW FAIR TRADING

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COVER ILLUSTRATION by Michel Streich

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Introduction

In 2003, retailer surcharges for customers paying with credit and debit cards became permissible. This followed the Reserve Bank of Australia's reforms to the payments system, which removed card schemes' 'no-surcharge rule' and reduced the interchange fees paid behind the scenes. While the initial take up rate of the surcharge option by traders was low, this has increased significantly in recent times. The suspicion in some cases is that surcharges have little correlation with business costs, and that excessive surcharging is being used as a new revenue stream. The increased incidence of internet commerce transactions, which particularly rely on credit card payments, also has important implications for consumers in this context.

With the above factors in mind, the NSW Office of Fair Trading (OFT) approached CHOICE to conduct a joint research project on the application of surcharges on credit card payments for the purchase of consumer goods and services in the Australian marketplace. CHOICE conducted the research and field work, and provided this report.

The aim of the project is to identify:

- Current market practices;
- Examples of overcharging and consumer detriment;
- Consumer attitudes and experiences of surcharging.

In order to meet the research objectives a number of quantitative and qualitative research techniques are used. These include:

- An online survey of 1435 CHOICE members;
- A two-week diary of credit card activity among 140 CHOICE members;
- Desk research and interviews.

Key findings

- 88% of the online survey respondents report paying a credit card surcharge in the previous year. More than 50% paid a surcharge between one and five times, while 22% had paid surcharges more than 10 times in the previous 12 months.
- Surcharges were most often experienced by survey respondents in industries such as air travel, telecommunications, holiday travel, restaurants, utilities, taxis and petrol stations.
- There is widespread consumer opposition to and disapproval of surcharges. 68% of the survey respondents believe that retailers and other businesses should not be allowed to charge customers extra when they pay with their credit card.
- The presence of surcharges encourages consumers to use lower cost payments systems. However, when last presented with a surcharge, 64% of the survey respondents report paying the fee. In some cases, this may reflect customers' lack of another option at point of sale, particularly for sectors where credit card payments are the norm. At other times, inadequate fee disclosure by merchants means consumers aren't aware of the fee until it's too late. Some consumers may conclude that a surcharge is worth paying, due to the convenience of using a credit card, the interest-free period or rewards received.
- It's very difficult for consumers to know if the surcharges they're presented with are fair and reasonable, or if they're being used as a profit centre by merchants.
- Surcharges are usually ad valorem fees, meaning they're applied as a percentage of the transaction amount. However, there are some cases of flat dollar fees, including airlines and taxis, which often lead to concerns around excessive surcharging.
- The reforms that enabled surcharging are criticised by the card schemes and banks, and often by international research, sometimes sponsored by industry. However, governments in countries including the US and Canada are moving towards similar reforms. In the US alone, the potential savings from Australian-style reforms are estimated at around US$36 billion per year.
- The rationale for surcharges is hidden behind the complexity of the payments system reforms, which are poorly understood, despite their impact on the daily lives of millions of consumers. More easily digestible public information about the consumer benefits of the reforms would be helpful.
- There is much consumers can do to lower their transaction fees, to help retailers to reduce their costs, and to support the uptake of efficient and innovative payment systems. Options include choosing to pay with EFTPOS debit cards, cash, and a range of new online payment systems that don't attract surcharges.

1 Payment system reforms

Paying to pay

Nobody likes being asked to pay new fees, and often our reaction as consumers is to object and find a way to avoid the extra cost. And that has been the response of many consumers to the introduction of credit card surcharges. Anger at the fees is understandable too, especially if they're excessive, if consumers feel tricked into paying a fee that wasn't adequately disclosed, or if no genuine alternative payment option was available.

But surcharges are an efficient way for retailers to recover their costs and to encourage the use of better value payment systems. Surcharges imposed at the counter or petrol pump can be fair – when they relate to the retailers' underlying cost of cost acceptance. To understand the rationale for what may appear an argument in favour of fees, it's necessary to understand some of the background to the famously complex credit card payments system.

Fixing an inequitable, inefficient system

In 2003 the Reserve Bank of Australia (RBA) introduced sweeping reforms to the domestic payments system. Chief among the regulator's concerns was the level of interchange fees (see A complex market, below), and market dynamics that resulted in higher than necessary costs. Before 2003, interchange for MasterCard and Visa credit card transactions was around 0.95% of the value of each transaction customers made, nearly double what it is today.

The credit card market is different to most markets, in that it is 'two-sided', with two sets of customers – merchants (retailers and other businesses) and cardholders and requires balancing the charges to both. It is based on a platform provided by the card schemes such as American Express, MasterCard and Visa. The card schemes provide a payment service to customers and a card-issuing and payment-processing service to banks. The schemes compete for banks to issue their cards by offering them interchange fees that the banks can pass onto the merchants. Banks issuing credit cards also compete for cardholders through their interest rates, fees and rewards programs. In this market, banks will try to maximise profits by keeping the cost low to their cardholders and recovering that through the charges on merchants.

Unlike most 'normal' one-sided markets, there's often insufficient competitive pressure to keep interchange fees in check. In some cases, the competitive pressure on interchange fees is upward, as card schemes compete for banks to issue their credit cards with interchange fees.

In the US, unregulated and unchecked credit card interchange fees are now in the range 0.95% — 2.95% (for each Visa transaction) and 0.9% — 3.25% (MasterCard), yielding banks and card schemes tens of billions of dollars each year. These fees flow on to higher costs to merchants, which are eventually reflected in higher than necessary consumer prices, which are not only paid by the cardholders who benefit from this system, but by all consumers.

A COMPLEX MARKET

Interchange is the complex system of payments that goes on behind the scenes each time a credit or debit card is used. In a simple retail transaction example, after a customer swipes their credit card to buy something, the shop's bank (known as the 'acquiring' bank) pays a fee, known as interchange, to the bank that issued the customer's credit card (the 'issuing' bank). To cover this interchange cost and to generate a profit margin for the acquiring and issuing banks, the shop pays a 'merchant service fee' (MSF) to its acquiring bank.

The diagram on page 10 shows a typical flow of fees for a four party system transaction, based on the current interchange fee (0.5%) and an average merchant fee of 1%.

> Before surcharges, the 'price signal' to credit card users — telling them they were using a more costly system — was muted.

In Australia, despite technological and other advances, without regulation or caps there was insufficient downward pressure on interchange fees over time. As a result, merchants' overheads were inflated, as were the prices that consumers paid for goods and services.

Retailers cornered

Meanwhile, the card schemes' 'no-surcharge rule' in their contracts forbade merchants from passing on an explicit fee to customers to cover their credit card processing costs. Retailers that accepted credit cards for payment were forced to include their inflated merchant service fees in the prices of goods and services that all customers paid. Before surcharges, the 'price signal' to credit card users – telling them they were using a more costly system – was muted.

This combination of high interchange fees and an absence of consumer price signals to guide people to lower cost payment methods gave credit cards an artificial competitive advantage over cheaper, more efficient systems such as EFTPOS debit cards and cash. It created a situation where the cost of credit card use was subsidised by the excessive interchange fees that merchants – and therefore all their customers – funded. In fact, many credit card users were effectively paid to use their credit cards – bloated interchange revenue picked up the tab for loyalty points and interest-free periods that a section of society enjoyed at the expense of all shoppers.

Bloated interchange revenue picked up the tab for loyalty points and interest-free periods that a section of society enjoyed at the expense of all shoppers.

This enormous cross-subsidisation was worth hundreds of millions of dollars each year. In 2002, CHOICE labelled it inefficient and inequitable. "The banks have created a system whereby normal pricing and incentive signals are suppressed by cross-subsidisations and bribes, largely in the form of loyalty points, aimed at encouraging cardholders to use credit cards to the exclusion of other payment methods," we stated. "The introduction of loyalty schemes changed the pace and nature of credit card uptake, and has been funded by those who gain little or no benefit from them … this [loyalty points] bribe is being funded by other credit cardholders through high interest rates and by all consumers in higher prices for goods and services charged by merchants recouping the merchant fee they pay to cover the high interchange rate set by banks."

Three major outcomes

CHOICE was generally supportive of the payments system reforms which began in 2003, resulting in three major changes to the credit card market.

Regulation of interchange fees

Average interchange fees for MasterCard and Visa (the two regulated card schemes) were reduced to around 0.5%, down from around 0.95%. This has had a predictable flow-on effect to merchant service fees, which have reduced, on average, from 1.45% of each customer's MasterCard or Visa transaction, to about 0.86% now. The diagram on page 10 shows this dramatic change.

A lowering of costs for MasterCard and Visa also placed some competitive pressure on the merchant fees for the two unregulated credit card schemes, American Express (Amex) and Diners Club. Amex and Diners are three-party systems, which negotiate merchant fees directly with each business that accepts their cards, rather than with a 'middleman' acquiring bank. Average merchant fees for Amex have reduced from 2.51% to 1.93%, while Diners Club's have reduced from 2.36% to 2.11%.

Removal of the 'honour all cards' rule

Before the reforms, the major credit card schemes required merchants that accepted their credit cards to also process the same companies' debit cards when presented for payment, and vice versa.

For example, a shop that accepted Visa credit cards was required to process Visa Debit cards. Since 2006, merchants have been free to choose which cards they accept, allowing them to reject payment cards they feel are too costly. This puts competitive downward pressure on merchant service fees.

Perhaps the most recognisable example of the removal of 'honour all cards' started this year, when Woolworths and its group of stores decided to stop processing MasterCard and Visa ('scheme') debit cards, which are more expensive for retailers to process than EFTPOS debit cards. Woolworths has continued to accept MasterCard and Visa credit cards. It also processes EFTPOS debit cards, which are better value for retailers and more profitable for Woolworths.

The removal of the 'no-surcharge' rule

The third major outcome of the reforms, and the primary focus of this report, was the banning of card schemes' 'no-surcharge' rule on merchants. Before 2003, credit card schemes, in their contracts, required that the merchants did not pass on an explicit fee to customers to cover their costs of card acceptance. Rather, these merchant service fees had to be bundled into a retailer's overall costs and prices. If a retailer felt that a particular type of card was too expensive, it could choose not to accept that type of card, but would risk losing customers as a result.

Now, merchants may charge fees to customers using various cards. This means the credit card user, and not everyone, pays the acceptance costs. It also sends 'price signals' to customers – encouraging the choice of payment methods that have lower overall costs.

While only the four-party credit card schemes (MasterCard and Visa) are regulated, American Express and Diners Club provided the RBA with written undertakings to remove merchant surcharging restrictions, too.

Enter surcharging, "in the national interest"

Initially, the merchant take-up of surcharging was slow. When businesses introduce new fees, they may fear the potential for a public backlash, reputation damage and ultimately loss of business. Consumers often react negatively to new fees, 'fair' or otherwise. It is not surprising that retailers and other businesses were cautious.

By 2006, just 7% of merchants were surcharging, according to MasterCard. This appears to have been a concern for the RBA. "The problem is that surcharging remains relatively uncommon and, given overseas experience and what we have heard from the merchants, this is likely to remain the case," Dr Philip Lowe, the RBA's Assistant Governor, Financial System Group, said at that time. RBA Governor Ian McFarlane praised merchants that had introduced the new fee, even stating "we think [merchants] are acting in the national interest when they [surcharge]."

Since then, the rate of surcharging has increased significantly. A 2007 RBA paper stated that 15% of very large companies were surcharging credit card users; 9% of large merchants; 6% for small; and 5% for very small merchants, leading the bank to state in 2008 that, "while some merchants remain reluctant to surcharge, particularly in a face-to-face environment, the culture against surcharging is changing and is doing so faster than many had expected." The RBA was encouraged that the growing prevalence of surcharging had promoted better price signals, particularly for bill payments.

These trends continued into 2010, with the percentage of companies surcharging rising to between 20% (small or very small merchants) and 40% (very large merchants), according to RBA research, (the actual number of transactions being surcharged is much

No evidence of lower prices?

Overall, the RBA estimates savings to merchants through lower merchant fees at about $1.1 billion per year. But it is hard to prove that this has led to lower retail prices to consumers, an argument often raised by banks and card schemes. $1.1 billion is worth around 0.1% to 0.2% of the value of the consumer price index, according to the RBA. With underlying inflation running at around 2.5% per annum on average, a 0.2% reduction is not observable in retail prices. But, according to the RBA, economic theory tells us that, ultimately, changes in business costs are reflected in the prices that businesses charge. Arguably, it's impossible to produce evidence showing the impact on retail prices resulting from these cost decreases. Of course, nobody argues that the reverse situation is untrue - when businesses face new costs, such as taxes and levies, the inevitable result in competitive markets is a higher retail price.

smaller), with the average surcharge 2.7% for American Express and Diner's Club transactions and 1.7% for MasterCard and Visa transactions.

Many other companies indicated that they were considering introducing surcharges. And, as our consumer research in the next chapter shows, 88% of consumers surveyed reported paying a credit card surcharge in the past year, with 22% paying these fees more than 10 times.

Shonky behaviour

When Ian McFarlane said that retailers adding a surcharge were acting in the national interest, he probably wasn't thinking about those accused of profiteering through excessive fees. Some businesses appear to have embraced surcharges as a new revenue stream, and, once the fee is disclosed and avoidable with another payment method, there's nothing to stop them from doing so. American Express, MasterCard and Visa all told us that there are merchants charging customer fees that exceed their costs of card acceptance.

In 2009, CHOICE awarded Qantas the dubious honour of a Shonky award for its $7.70 (including GST) to $25 per passenger credit card surcharges , while Cabcharge, the dominant company in the taxi payments industry, continues to levy a 10% surcharge for all cards (including debit cards that cost just cents to process). The next chapter investigates whether some merchants are profiteering from surcharges.

Surcharging opposed by card schemes

Unsurprisingly, most credit card schemes, which opposed the payments system reforms, are also strongly opposed to merchant surcharging. These fees directly impact on the likelihood that consumers will use their cards.

Visa thinks merchants should include the acceptance costs in their price, just as a shop does with other expenses such as providing a car park or paying staff more on a Sunday, (even though not all customers drive, or shop on a Sunday). "One of the core tenets of the consumer experience is that the price of an item as advertised or on the price tag should be the actual price paid at the checkout," argues General Manager Chris Clark. "This fundamental consumer protection has been recognised by governing bodies around the world. If more merchants impose surcharges, it will unfairly penalise consumers at a time when they are already facing the challenges of a difficult economy and increased cost of living expenses."

MasterCard's opposition to surcharges is also fundamental – "our core issue is that surcharging passes the cost of accepting payment onto consumers. And that's absolutely not fair," says David Masters, Vice President, Strategy & Corporate Affairs. MasterCard argues that accepting card payments is a normal cost of doing business and shouldn't be separately charged. "Merchants get a lot of benefits from cards that they don't get from cash or cheques. Obviously, instant payment and protection from credit losses and fraud. And, when they accept a payment by card (as opposed to cash) the money goes straight into their account without having to protect and transport it. And the big difference – the existence of credit cards provides merchants with sales they wouldn't get if people could only spend the cash they could carry in their wallet. Before credit cards as we know them today, the extension of credit was something retailers did themselves – that risk (fraud losses) is now carried by banks."

American Express also told us that it believes the costs of card payments are, like all other costs, already built into the cost of goods sold. And the card industry regularly points out that its main competitor – cash – has associated costs for retailers that are often ignored.

[1] A Qantas spokesperson says, "Qantas strongly rejects any suggestion, including by CHOICE, that its card payment fees are somehow 'shonky' or that Qantas is gaining a windfall from them …". See further comments, page 18.

We only found one credit card scheme – Diners Club – that hasn't taken a public stand against surcharging. Perhaps one factor is because, as the smallest and least-accepted card scheme, it has less bargaining power with retailers than the others. "We have never sought to discourage our merchants from asking for whatever payment method they prefer, so the regulation of surcharging was not an issue for us," it said in 2006 evidence to a House of Representatives hearing. "We regard surcharging as an issue between the retailer and the customer, not between the retailer and us. If the retailer believes that it is positive for their relationship with their customer to negate and refuse their payment choice, then that is what the retailer should do. Retailers in more competitive situations have chosen not to do that. Our observation is that retailers who feel they are subject to less competitive pressure have tended to surcharge."

AN INTENDED OUTCOME: REWARDS CARDS LESS ATTRACTIVE

One of the intended outcomes of the reforms was to end, or at least reduce, the cross-subsidies whereby inflated interchange fees, funded by all shoppers, paid for free flights, shopping vouchers, and low annual fees of those with rewards credit cards. And, to some extent, this objective has been achieved – after the reforms, we saw credit card reward programs become more expensive, the value of points reduced, annual fees introduced or increased – for cardholders. CHOICE research has demonstrated that loyalty schemes often aren't worth the additional annual fees that cardholders themselves are now required to pay. This is particularly true for people who end up paying interest, because that cost will cancel out the benefit of any rewards.

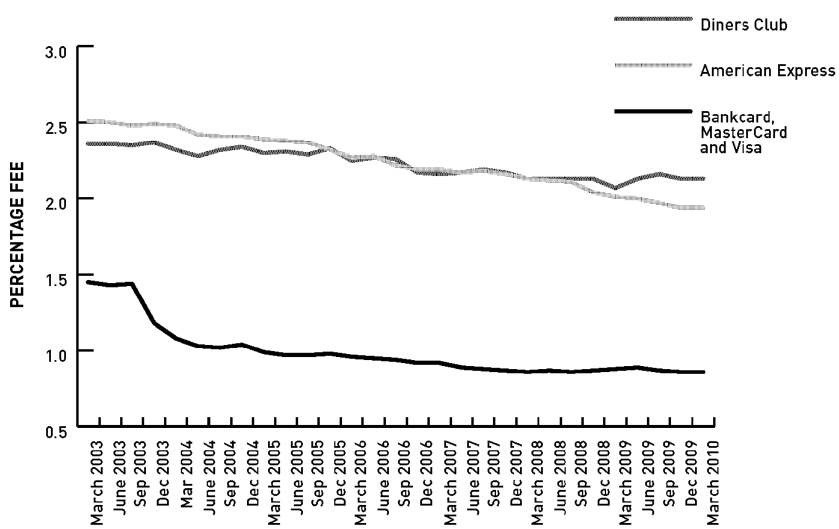
However, in the absence of merchant surcharging, cross subsidisations to fund loyalty points continue. Over 50% of our online survey respondents make a conscious effort to use their credit card to earn rewards points, because they must see a personal benefit in doing so. In most cases, they won't be surcharged.

Merchant fees for American Express and Diners Club cards have reduced in the past eight years, but remain, on average, more than double those for MasterCard and Visa transactions. So one would expect the three-party schemes' cards to provide more generous rewards, loyalty programs and other cardholder benefits than the four-party schemes' standard cards. Higher merchant fees are also used to provide benefits to the other customer in this two-sided market – the merchant itself. For example, American Express may run a marketing campaign aimed at increasing the sales or bringing new business to a merchant / client – for example, an advert enclosed with the customer's monthly statement.

Some see these higher and unregulated merchant fees placing American Express and Diners Club at an unfair competitive advantage over Visa and MasterCard. Indeed, we've seen many banks issuing Amex ' companion' cards to their MasterCard and Visa customers, presumably to cash in on the greater merchant fee revenue that's available. Through their Amex offers, the issuing banks can also entice consumers with higher-value loyalty schemes and rewards.

*Reading some of the overseas literature, it's apparent that, rather than painting the structural change as having created a somewhat more equitable system, critics use the reduction in 'free' credit card benefits as evidence that the reforms have damaged Australian consumers. The trick being played here is equating cardholders with all consumers – but millions of people do not have or benefit from credit cards. The critics often fail to mention that those shoppers without credit cards – and others with no-frills cards that don't come with loyalty programs – now longer cross-subsidise credit card benefits to the extent they did before.

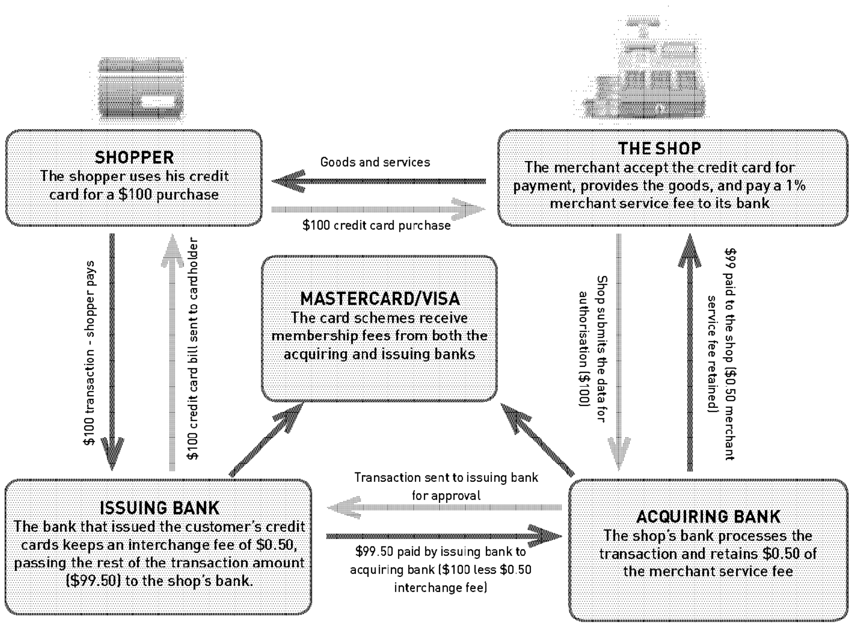
DECLINE IN MERCHANT SERVICE FEES, 2003-2010



EXAMPLE OF A FOUR-PARTY CREDIT CARD TRANSACTION

In this example, a shopper buys an item for $100 from a shop, using his credit card. We assume:

- the interchange fee is 0.5%.
- the shop pays a 1% merchant service fee.



11

2 The surcharging environment

The opening chapter describes the payments system reforms and the increase in the number of merchants choosing to surcharge their customers. This chapter looks at:

- Industries where surcharging has become prevalent
- What fees consumers are being asked to pay
- Whether retailers are profiteering from surcharges
- Level of fee disclosure
- Options for avoiding surcharges
- 'Blended' surcharges
- Special focus on the airline and taxi industries.

Which industries?

We asked our survey respondents to indicate the industries and sectors where they have witnessed surcharges for credit card payments. Airlines, telecommunications, holiday travel, restaurants, utilities, taxis and petrol were the most common industries identified. Around 64% of respondents had seen surcharges applied by airlines, and particularly when booking online, these fees are hard to avoid. We take a closer look at airlines' practices later.

The survey results may in part reflect the consumption habits of respondents; for example, just 26% had seen surcharges in taxis, but we know the fees are ubiquitous in that industry (a section below focuses on surcharging by taxis, a special case).

How often are consumers surcharged?

The chart (right) shows that 88% of 1374 online survey respondents paid a credit card surcharge in the previous year. More than 50% paid a surcharge between one and five times, while 22% had paid surcharges more than 10 times in the previous 12 months.

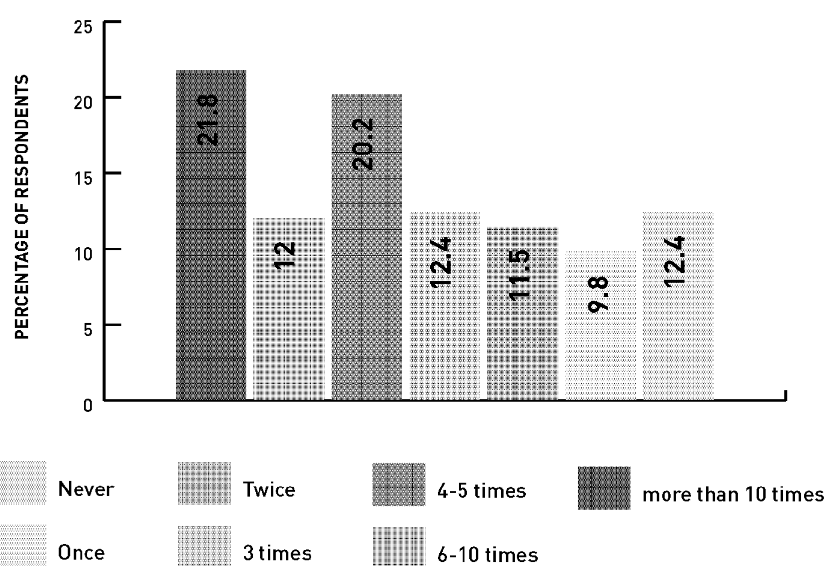
WHERE DO CONSUMERS SEE SURCHARGES?

QUESTION: In which industries have you seen surcharges applied for credit or debit card payments? *(n = 1204, Source CHOICE member survey, multiple responses were allowed)*

Industry	Response percent
Airlines	63.8
Telephone/Mobiles/Internet	41.9
Holiday Travel	36.2
Restaurant/Formal Dining	32.0
Utilities (e.g. electricity, gas, water)	27.2
Taxis	26.4
Petrol	21.8
Groceries	18.4
Appliances	16.2
Council rates	15.8
Insurance	13.7
Clothing/Footwear	12.0
Sporting/Entertainment	11.8
Take Away/Fast Food	8.2
Health/Medical Care	7.9
Education/Childcare	3.2
None of the Above	0.7

HOW OFTEN CONSUMERS PAY SURCHARGES EACH YEAR

(n=1374, Source: CHOICE Member Survey)



In a 2002 submission to the RBA, CHOICE argued that the Australian Competition and Consumer Commission should be granted a surveillance and enforcement power, "to monitor any instances of direct charging, and take action against merchant profiteering from the abolition of the no-surcharge rule. Double-dipping by the banks on cost recovery must not be replicated in other sectors," we warned. "Less competitive markets, such as aviation, will require monitoring and enforcement action against profit-taking."

What are the fees?

The appendices [Appendix II, Tables 11-14; Appendix IV, Table 8] list some of the fees that survey respondents recall having paid or witnessed.

Our consumer surveys find that surcharges are usually ad valorem fees, meaning they are applied as a percentage of the transaction amount. However, there are some cases of flat dollar fees, including among airlines and taxis.

Surcharges are more likely to be applied to the costlier American Express transactions, and such fees are likely to be higher than surcharges for MasterCard and Visa.

Are retailers profiteering?

"A 1.5% surcharge by a hotel, for example, based upon the RBA's published average merchant rates, represents a 70 – 80% margin for the merchant," says Jeremy Griffith, Visa Director of Corporate Relations in Australia, New Zealand and the South Pacific. "For certain retailers and hotels, excessive surcharging is money for jam".

"Some merchants are surcharging over and above the costs of card acceptance," agrees American Express. Even in 2006 the company was stating that "we have numerous cases of merchants that are still charging more than we charge them, with limited controls or consumer protection to our benefit".

But the difficulty in answering the question of whether an individual merchant is profiteering is that, apart from the obvious cases, we need to know the merchant service fee (MSF) that a retailer pays, before knowing for sure whether the surcharge represents an excessive fee. Merchants are under no obligation to publish their MSFs; indeed this information is often considered commercial-in-confidence by the parties involved. If the RBA was to publish more details, such as the specific merchant fees paid, or even the average fees that small, medium and large volume businesses pay, it would be easier for consumers to know if the surcharges are reasonable.

"We don't know the commercial arrangements between merchants, such as Qantas, and their acquiring bank," says Chris Clark, General Manager of Visa. "They're blending their American Express fees with the four-party fees, and we don't know what Qantas is including in its costs, so it is hard to say if they're profiting on surcharges. At present, it is pretty much impossible for consumers to know what a fair surcharge is". Says one survey respondent, "there is no way for the average consumer to know [the average cost that retailers pay to process transactions], because these arrangements are blatantly concealed by commercial providers."

A Qantas spokesperson says, "Qantas strongly rejects any suggestion, including by CHOICE, that its card payment fees are somehow 'shonky' or that Qantas is gaining a windfall from them. Qantas introduced card payment fees following the changes introduced by the Reserve Bank of Australia in 2002, which provided all merchants in Australia with the freedom to charge fees in relation to the use of payment cards to help reduce the level of subsidisation of card users by non-card users. Qantas offers consumers the choice of other methods of payment to avoid these fees. Qantas does not claim that its card payment fees directly reflect the specific amount that a financial institution charges in respect of any particular transaction. This amount varies between transactions and is only one of the costs incurred in providing this service."

Average merchant fees

Although merchant service fees are not publicly available information, as described in Chapter 1, the Reserve Bank publishes average MSFs. As at June 2010 they are:

- 0.86%: MasterCard and Visa
- 1.93%: American Express
- 2.11% Diners Club

Naturally, you can expect large merchants to pay significantly less than the average (though the interchange fee for MasterCard and Visa is the floor beneath which the merchant fee for those transactions cannot fall). Large merchants and those with higher credit-card processing volumes are in a better position to negotiate good rates with their acquiring bank, or with one of the three-party schemes. And the very largest retailers – including Coles and Woolworths – have set themselves up to 'be' the acquiring bank for these transactions.

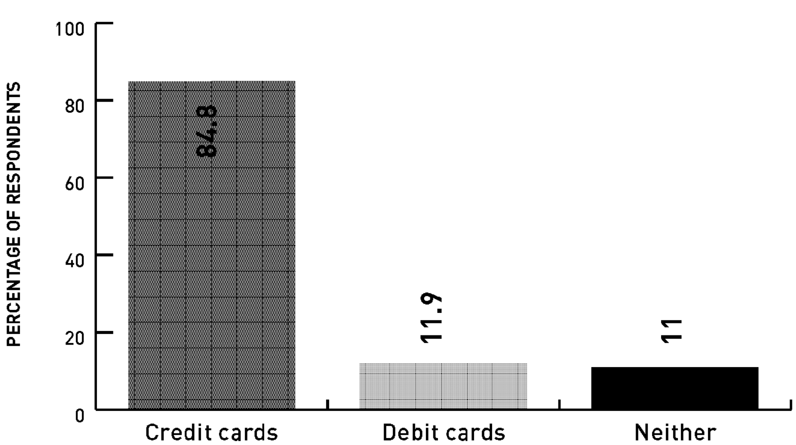
It follows that if an average-sized retailer is charging far in excess of the percentages above, they are probably using surcharges as an extra revenue stream.

On the other hand, small merchants and those processing relatively low volumes of credit card transactions, may pay far in excess of the average merchant service fees quoted above (so, when consumers see a small merchant that isn't surcharging, they may like to consider the various costs retailers face before choosing which card to use).

The MSFs above take account of merchant costs, including annual fees, payment terminal fees, terminal rentals, monthly fees, joining fees and other associated costs charged to merchants. Such costs can impact on particular industries' fees. Card fraud frequently originates in taxis, for example. And one card industry expert told us that "houses-of-ill-repute" pay up to a 6% merchant fee with certain cards, "which entirely reflects the fraud risks". Unsurprisingly, none of the respondents to our consumer surveys provided information about the surcharges that may apply in such establishments.

HAVE YOU PAID A SURCHARGE IN THE LAST 2 YEARS WHEN YOU HAVE USED ANY OF THE FOLLOWING CARDS?

(n=1359, Source: CHOICE Member Survey)



*MULTIPLE RESPONSES ALLOWED FOR CARDS

Debit cards

More than 10% of our online survey respondents had paid a surcharge to use their debit card in the previous two years (see chart below). And this is where the fees can appear very excessive. The card schemes have a range of interchange rates depending on the type of merchant processing the debit card transaction. Here are examples of some of the rates, all of which are available on the schemes' websites:

- 4 – 5 cents: EFTPOS purchases, paid from the issuing bank to the acquiring bank, and in some cases, to some large retailers directly (Coles and Woolworths, for example, account for about 25% of the acquiring market). The interchange fee for 'cash out' – when customers use retailers for cash withdrawals – is at least three times higher than the fee for purchases.
- 12 cents is the cap on the weighted average interchange fee for Visa Debit transactions; MasterCard provided a voluntary guarantee to also adhere to that cap. Individual rates vary. For example: the Visa Debit electronic transaction rate is 8.8 cents, while the supermarket rate is 6.6 cents. The Debit MasterCard rate for all consumer cards containing an EMV compliant chip is 13.2 cents. All of these rates include GST, and are paid by the acquiring bank to the issuing bank.

In general, these are flat fees, irrespective of the size of the transaction. So, when a taxi applies a surcharge of say $3 to pay with a debit card for a $30 cab ride, the fee is around 25 times the average MasterCard and Visa Debit interchange fees, and 60 times the fee that is paid to the taxi's acquiring bank for EFTPOS transactions. However, as explained later, the actual merchant service fee paid depends on the deal negotiated.

"We were charged by a large hotel chain, and the amount seems exorbitant when the small company I work for can negotiate a lower rate with the bank than what we were charged. But who wants to carry around thousands of dollars cash to pay for your holiday?"
- *CHOICE Survey respondent*

Opportunism and market power

It's often reported that high surcharges are more likely when companies enjoy positions of significant market power. This is sometimes the case, though not always; the two major supermarket chains, for example, dominate the grocery market, but neither applies surcharges.

Surcharges are often evident in industries where consumers particularly rely on credit cards to make payments, including websites, and large merchants relying on cardholder-not-present channels of payment (for example, for utility bill payments). "If the customer has no choice but to use a scheme credit or scheme debit card, there's much more propensity to surcharge," says Bruce Mansfield of EFTPOS Payments Australia Limited.

Take, for example, hotels. A few nights' stay in most city hotels can easily lead to bills of $500 to $1000 when the consumer goes to check out. These days, few people use options other than plastic cards to settle such bills. The practicalities and security concerns of carrying that amount of cash make it unattractive for many people. This places hotels in a good position to surcharge, in the knowledge that their guests will have little option to pay the fee, whatever it might be. And CHOICE survey respondents often commented that hotels do apply surcharges. "Hotels are starting to surcharge, but how else do they ever get paid?" asks David Masters, Vice President, Strategy & Corporate Affairs at MasterCard. "When was the last time you stayed at a hotel and paid in cash? In fact, when was the last time you booked a hotel room and they didn't ask you for your card details to secure the booking? How else would they do that?"

A related point is that business travellers often care less about paying a surcharge, because ultimately their employer will cover the expense. The person deciding which payment method may not have a choice (for example, when they are provided with one credit card for business expenses) and in any case are not price-sensitive to surcharges. They may have other incentives – such as frequent flyer points – to use the card.

How well are surcharges disclosed?

"The number-one complaint we hear from consumers is that they didn't know there was a surcharge until it was too late," says Luisa Megale, a spokesperson for American Express.

To find out how well surcharges are being disclosed to consumers, we asked participants in our 'payment diaries' survey to record what they experienced. We found that, in some cases, disclosure was inadequate, with respondents reporting that, in 12.3% of the 163 recorded surcharging instances, they did not recall being notified at all. Of those who were notified, 25.7% recalled feeling that the method of notification was not prominent enough. In a separate question, respondents who had been notified felt that in 17.4% of 132 recorded cases, the timing of notification was inadequate. Sometimes this was because disclosure was only made after the transaction had gone through. For example, one participant, Susan, only noticed that Origin Gas has a 0.6% fee after she paid – "there's a small notation on the bill about the surcharge – the fee is added to the next bill". Another said of an airline's surcharge notification, which she felt was too late and not prominent enough, "I would have paid cash had I known." As outlined later, cash usually isn't an option when booking flights online, but there are some other ways to avoid credit card surcharges.

When disclosure is verbal, rather than in writing, similar problems can arise. Ken, a diary respondent, found that a 3.5% fee for American Express at a hardware store was disclosed verbally and only as the transaction was being processed. He felt the timing was inadequate, and that he should have been told about the fee much sooner.

What should merchants disclose?

The Australian Competition and Consumer Commission (ACCC) states that, when merchants charge their customers a credit card fee, they must ensure that consumers know:

- the credit card fee will apply;
- the amount of the fee before they enter into the transaction.

"Businesses should get advice about how to avoid misleading or deceiving consumers about this charge. If in doubt, the sensible thing to do is to err on the side of stronger disclosure," according to the ACCC website. It says options for informing consumers (particularly for retailers) include "clear and prominent messages on bills or tax invoices," and "clear and prominent in-store and/or point-of- sale signage."

American Express is more descriptive in its disclosure requirements to merchants: "Merchants should display clear and prominent in-store and/ or point of sale signage informing customers that a fee for credit card use will be charged, and the amount or percentage of the fee. This also applies to telephone sales, internet-based sales and direct mail catalogues. Any bills or tax invoices issued by your organisation where credit cards are an accepted form of payment should clearly state if a surcharge is to be applied, and the amount of the surcharge."

Blended surcharges

Often, merchants charge the same surcharge for all payment cards, even though they have very different costs. For example, a hotel might be charged a 2% merchant service fee for Amex and 1% for Visa and MasterCard, so it decides to apply an average 'blended' surcharge to consumers of 1.5%. Airlines also commonly blend their surcharges, with the high use of corporate and premium cards driving up the costs for everyone.

Amex (and its customers) benefit more than MasterCard and Visa customers from blended surcharges. In the above hotel example, the fees of Amex customers are being subsidised by those of MasterCard and Visa. The four-party schemes aren't pleased. "Blended surcharges subsidise American Express users. There's an unfair playing field in favour of the unregulated schemes, American Express and Diners Club," says Visa General Manager, Chris Clark. "Our cardholders are basically subsiding American Express, whose merchant service fees are much higher than those on MasterCard," says David Masters of MasterCard.

Amex disagrees that it has been given an unfair advantage, and, notwithstanding the fact it wants no surcharging at all, believes that "equity is achieved when one fee applies for all cards. All costs are factored into a sale price, it is price discrimination to only surcharge one card scheme on the areas where people are considered more capable of paying," says Luisa Megale of American Express.

From the consumer's point of view, blended surcharges fail to send the price signals that the RBA intended. When all surcharges are the same – or when there's no surcharge at all – there's little personal incentive for consumers to choose the best-value payment system.

We asked online survey respondents whether they support a shop's right to charge different surcharge amounts for different cards, assuming the shop has

Airlines also commonly blend their surcharges, with the high use of corporate and premium cards driving up the costs for everyone.

WHAT DO CONSUMERS THINK ABOUT DIFFERENT SURCHARGES FOR DIFFERENT CARDS?

QUESTION: If a retailer has decided to apply a surcharge for credit card payments, how do you feel about different surcharges applying for different types of cards, such as one fee for Amex, another for Visa, etc? *N = 1435, Source CHOICE member survey.*

I support this, because shops have to pay different fees depending on what type of credit card I pay with	36.1%
I would prefer if the retailer had one fee for all types of credit cards	8.2%
They shouldn't be applying any surcharges for card payments	50.2%
Don't know	2.2%
Other	3.2%

QUESTION: Imagine a shop has the following surcharges: 0.9% for Visa/MasterCard credit cards, 1.9% for American Express, no fee when paying cash or EFTPOS. Which of the following do you agree with most? *N = 1435, Source CHOICE member survey.*

All credit cards should have the same fees	6.6%
There should be no extra fee for cash or cards	50.6%
This is generally a fair way to charge customers	30.4%
The shop is ripping off customers (overcharging for credit card payments)	7.9%
Other (please describe)	4.5%

Banks and retailers could agree to cap surcharges at a reasonable level for consumers.

decided to surcharge. The results above suggest that 36.1% support shops that apply different surcharges, but most respondents prefer no surcharges at all.

In a separate survey question, 6.6% of respondents stated their belief that all cards should attract the same surcharge, 30.4% agreed that surcharges close to the average merchant service fees for each card are fair, while again, 50.6% stated that there should be no extra fee for cash or cards.

Should surcharges be capped?

On several occasions, the RBA looked at whether a capping of surcharges is merited, but decided against it on the grounds that introducing a surcharge cap would reduce the downward competitive pressure on interchange fees.

American Express has advocated greater consumer protection and transparency on surcharges, but doesn't go so far as to advocate a cap. MasterCard told CHOICE that it doesn't believe a regulated cap would work, because that fee would become the norm.

The Australian Payments Clearing Association (APCA), an industry group focused on creating an efficient and competitive payments system, does not oppose merchant surcharging or advocate for a cap. APCA is sympathetic to the RBA argument that surcharges help to keep interchange fees lower, but would like to see sufficiently low barriers to market entry, and competition between payments systems, that would enable interchange fee regulations to be removed altogether. "In APCA's view, the long-term interests of consumers are best served by maximising competitive payment alternatives for them, rather than by pricing regulation," says APCA Chief Executive Chris Hamilton.

During our research, we came across just one country where a cap is imposed (Denmark), although there may be others (see International trends, later).

But, closer to home, we did discover that there is a mechanism for capping merchant surcharges – if merchants and their (acquiring) banks agree to do so. For example, part 9 of Visa's scheme standard (Standard 2 – Merchant Pricing for Credit Card Purchases), set down by the RBA, states that "...an acquirer and a merchant may agree the amount of any such fee or surcharge charged to a credit cardholder will be limited to the fees incurred by the merchant in a respect of a credit card transaction." This means that banks and retailers, could, if they wished, agree to cap surcharges at a reasonable level for consumers.

Yet it seems these parties are unwilling to agree to limit surcharging. Banks may fear that attempts to do so would cause their merchant to look for another acquiring bank that doesn't try to limit its surcharges. So there's no real incentive for banks to limit surcharges. And it is easy to see why retailers wouldn't want to put a cap on their credit-card revenue.

The Australian Bankers' Association (ABA), which opposed the Reserve Bank's credit card reforms, says it is not the banks' role to limit surcharging – "this is the role of the regulator or the merchant itself," says Steven Münchenberg, Chief Executive of the ABA. "It is at the merchant's discretion. The standard says a merchant and an acquiring bank can 'agree', but the bank cannot require a cap on a merchant's surcharge. The option of constraining the surcharge to the fee is decided by the merchant, not the bank. The ABA is unaware if there have been any discussions or agreements made – we have not surveyed our member banks."

Further, banks and card schemes probably need to be careful in their negotiations with retailers. According to the ACCC website, "Part IV of the Trade Practices Act prohibits anti-competitive arrangements between competitors, such as price fixing, market sharing and boycotts. This means that businesses must make their own independent decision on whether to impose a credit card surcharge. Businesses must not engage in anti-competitive conduct. Businesses must not enter into agreements or understandings with other businesses, such as whether or not to impose a credit card fee; or the amount of the credit card fee that they will charge. Such agreements or understandings are contrary to the competition provisions of the Trade Practices Act and significant penalties may apply."

Amex discourages merchant surcharging

American Express told us that it has been able to dissuade some merchants from surcharging, and to reverse their decisions to do so, by demonstrating figures for the lost sales that it claims surcharges cause. It also argues the benefits to the merchant of accepting American Express, which include marketing promotions, targeted customer communications and referrals. Amex also told us it doesn't reduce the merchant fees for a retailer that doesn't want to accept Amex – it tries to show retailer the benefit of accepting Amex – for example, by running a marketing campaign.

Industry focus: Airlines

The table on the following page shows surcharge details for airlines in Australia. All apply surcharges, but their strategies and pricing vary. Virgin Blue, for example, charges a flat fee of $3.50 per passenger, per segment (flight), for domestic travel, and $6 per passenger, per segment, for international flights. "We are completely transparent in relation to the fees we charge and we are satisfied they are at a level which covers operating costs while not being excessive," said Colin Lippiatt, Manager of Corporate

Surcharge Best Practice Code?

There may be an opportunity for banks, retailers and consumer groups to develop a Best Practice Surcharge Code of Conduct, in which merchants agree not to surcharge beyond their merchant service fee, or the MSF plus a reasonable margin. Code displays at point of sale would assure customers of the fairness of the fees.

Communications, Virgin Blue Group of Airlines. The website states that credit and debit card surcharging "is in line with industry practice".

Qantas also charges $7.70 to $25 for each passenger on a single booking. These flat dollar fees may mean the surcharges paid on small-value bookings heavily subsidise those paid on large-value bookings. Also, because all cardholders pay the same blended surcharge, people with less costly cards (such as the regulated schemes' standard cards) subsidise the costs of those with more costly corporate cards, unregulated scheme cards, and so on. In other words, less costly cards continue to help pay disproportionately for the 'free' benefits of those with loyalty programs. A Qantas spokesman says "Qantas offers consumers the choice of other methods of payment to avoid these fees. We believe our approach is straightforward, transparent and ensures consumers are always aware of what the additional cost will be. Where a customer chooses to pay using a card that attracts a fee, it is displayed or advised upfront at the time of payment and is disclosed in our advertising."

Rex is the only airline examined that applies percentage fees, which vary depending on the card. "Rex has applied the various surcharges in line with the merchant fee applicable, as we believe this is a fairer way, as opposed to lumping a standard surcharge into the fares," a spokesperson said.

We don't know what merchant fees Rex pays, but its surcharges far exceed the average merchant fees published by the RBA.

Is there a genuine alternative?

"It drives me nuts that the car hire companies force you to pay by credit card and then charge you for it." – CHOICE member.

When a surcharge applies and is not included in the price of goods and services, customers must be given a way to avoid that fee. As the airline table above shows, the alternatives presented to online customers are not always practical.

For example, Qantas allows customers to avoid credit-card surcharges by using Debit MasterCard, or by making a BPAY bank transfer – but the latter has to happen at least seven days before flying. For the

AIRLINE	SURCHARGE *(DOMESTIC SURCHARGES INCLUDING GST WHERE APPLICABLE)*	HOW IT IS APPLIED	ALTERNATIVE PAYMENT TO AVOID SURCHARGE
Jetstar	$3.50 (domestic) $5 (international)	Per flight Per passenger	Jetstar MasterCard Jetstar Platinum MasterCard Jetstar Voucher Internet Banking (POLi) Direct Payment (14 days before flights)
Qantas	$7.70 (domestic and trans-Tasman) $25 (international)	Per booking Per passenger	BPAY 7 days before flights MasterCard Debit
Virgin Blue	$3.50 (domestic) $6 (international)	Per sector Per passenger	Internet Banking (POLi)
Rex	1.76% (Visa/MasterCard) 2.86% (Diners Club) 3.96% (American Express)	Per booking	Cash
Tiger	$7.20 (domestic)	Per sector Per passenger	MasterCard Debit

WHICH NEW PAYMENT METHODS DO CONSUMERS USE?

QUESTION: Which of the following payment methods have you used in the past 12 months?

N = 1435, Source: CHOICE member survey, multiple responses were allowed.

Bpay	92.1%
Pay anyone from your internet banking account	73.4%
Paypal	66.7%
POLi	1.5%
Paymate	0.7%
NETELLER	2.2%
Moneybookers	0.6%

segment of customers flying within a week of their booking – presumably quite common, particularly for late 'specials' – this is not an option. Indeed, another intermediary website that specialises in these late bookings told CHOICE that 48% of its domestic flight bookings made through the website are for travel within seven days.

Rex allows customers to pay in cash at its airport counters to avoid surcharges, but it is not clear how internet customers could do this.

Virgin Blue customers can use an internet payments system called 'POLi' to avoid surcharges (see New payment systems, below). While it is encouraging to see new competition for payments enter this space, consumer awareness and use of the systems is often very low, and some survey respondents were critical:

- "There is some other system but it requires you to use a windows computer to make the transaction – doesn't work for a Mac."
- "There was another option, but it wasn't available on my computer."
- "Their POLI system doesn't link to my bank account, so I can't use it."

Jetstar provides a number of ways to avoid payment surcharges, but, again, they're not always practical. Direct payments (for example, bank transfers) must be made at least 14 days before flying, while the only credit cards without surcharges are the airline's branded Jetstar MasterCard and Platinum MasterCard.

New payments systems

Innovation in the payments system is providing new ways to avoid surcharges and the use of credit cards, particularly for online payments. According to a 2008 report by the Australian Payments Clearing Association (APCA), the availability of a range of alternatives including recent entrants and product innovation from Paymate (2000), Paypal (2002) and POLi (2007) have contributed to "workable competition" in the online payments system.

2008 Nielsen research found a range of internet payment choices are available to consumers, but credit cards dominate. The research found that credit card had been used at some time by nearly all internet users for online purchases, and remain the preferred method for around 50%. Paypal, BPAY and direct deposits were the next most popular payment methods.

We asked online survey respondents whether they had used some of the newer internet payment systems in the last year. Use of established systems, such as BPAY and internet banking 'pay anyone' was high, and PayPal wasn't far behind. The use of other internet systems such as Paymate and POLi was low.

"We recently hired a car from Thrifty while on holidays. You are required to pay by credit card and are charged 1.5% for the 'privilege'. Apparently, the only exception to this requirement and charge is 'if you are billing back to a trading account'. I'm pretty sure I don't have one of those, nor probably access to one of those."

- CHOICE survey respondent

Industry focus: Taxis

Long before the 2003 reforms, Cabcharge, the company that dominates the industry with payments systems in around 95% of taxis nationwide, charged 10%. The fee applied even before the advent of credit and bank cards and goes back to the time when paper-based payment methods, such as the 'blue dockets' similar to those you still see today, were the only option other than cash. Today, the 10% fee applies whether passengers use the company's own branded paper dockets and plastic cards, or credit cards and debit cards (including EFTPOS).

For Cabcharge, the average 'service-fee margin' on these transactions is staggering – on average, about 90%. For example, for every $100 of fares paid for with a card, the surcharge is $10. Of that, $9 is Cabcharge's margin. The company prefers that the words "profit margin" are not used in this context and pointed out that average fares are about $21 per trip. It outlined to CHOICE the significant costs Cabcharge faces after the service fee margin is earned, including commissions to taxi networks, costs in running the payments system, research, development and maintenance. The company's net profit after tax has steadily risen over the last decade and in 2009 financial year was $61 million, providing a 21.6% total shareholder return, much higher than the rest of the ASX share market (7.2%, but it was a bad year for financial markets). Cabcharge is a diversified company, with revenues and profits derived from various sources and ventures, and not just the payments business.

The service fee margin is higher on some payment cards than others. When customers use Cabcharge-branded cards and dockets, there's no merchant service fee (MSF), so the margin is close to 100%. When third-party credit or debit cards are used, the margin depends on the MSF that has been negotiated behind the scenes. Several taxi and card industry sources confirmed that taxis' MSFs tend to be higher than the broader retail industry's fees, mainly due to the extremely high levels of card fraud originating in taxis. But the service fee more than covers the merchant fee. For example, Cabcharge's MSF might be 3% to 4% for an American Express card (so a 60%-70% service fee margin on such transactions), or just a few cents for an EFTPOS transaction (so closer to 100% margin, depending on the amount of the fare). On average, the service fee margin works out at 92% (and has been rising slightly according to the company's publicly available 2009 financial results).

We asked Cabcharge why this fee has remained unchanged for nearly 50 years, despite all the technological and other advances that have taken place in that time. Group General Manager John D'Arcy said the company doesn't know the origins of the 10% fee, but thinks it "probably originally came about because it is easier for passengers to calculate, rather than having to work out 7.72% of the fare, for example. For all we know, the actual costs back in history may have been greater than 10%, but 10% was chosen for ease of information and because it was easy for a passenger to calculate." D'Arcy also disputed that technological advances always lead to lower costs, stating that the introduction of chip cards and compliance have increased the company's costs.

A lack of competition among payment systems may explain how such fees survive. In September 2010, legal proceedings initiated by the Australian Competition and Consumer Commission (ACCC) resulted in declarations by the Federal Court that Cabcharge had misused its market power, contravening s46 of the Trade Practices Act 1974 on three occasions.

Two of the contraventions involved a refusal by Cabcharge to allow competitors to process Cabcharge-branded products, while the third related to meters and updates which were supplied below cost, for anti-competitive purposes.

The Federal Court ordered that Cabcharge pay a pecuniary penalty of $14 million for the contraventions, the highest penalty imposed in misuse of market power (section 46) proceedings brought by the ACCC.

While the ACCC action did not relate to the surcharging, more competition between payment systems used in taxis might help with lowering surcharges.

Competition increases

In recent years, Cabcharge's market share of the electronic payment systems in taxis has declined from 70% to around 50%. The financial market analyst, Veritas Securities Limited, stated in a December 2008 report that Cabcharge's monopoly was over. "CAB's historic dominance of its market has allowed it to charge a 10% service fee for transactions, a processing fee that is un-matched in the Australian retail landscape," the report stated. "CAB has a proven business model, a near monopoly position in the Australian electronic taxi payment market and generates above average returns, with ROE [return on equity] averaging 17.8% since FY00 [financial year ended June 2000]. We believe that CAB's near-monopoly position in taxi fare payment processing is unwinding rapidly, in line with improvements in payment technology."

While Cabcharge still sees its major competitor as cash, there are now five electronic payment systems competing in taxis. One is Live Payments, which competes not for passengers through lower surcharges, but for drivers by sharing a cut of the 10% fee. Cabcharge, on other hand, pays a quarter of the fee it receives to taxi networks (some of which it owns), as a commission. But it is up to the taxi network to decide whether to share any of this with drivers.

Another system launched in 2010 by the Australian Taxi Drivers Association, called Transport Australia Xpress, charges 8.49% for credit and debit card payments, and 5% for customers that open an account. The company's website states that other costs may apply "at times of peak demand and congestion." While the merchant service fees it pays are commercial-in-confidence, industry sources say typical taxi industry rates are in the range 2.5% for MasterCard/Visa credit cards, and 5% for American Express. So the new entrant can still make a healthy profit on these transactions while undercutting the dominant company in the market. It will also share about 20% of the surcharge revenue with drivers.

Live Payments says smaller merchants, such as taxi payment services, are unfairly criticised for their surcharges. It says their fixed costs, as a proportion of the money that goes through their terminals, is much higher than that of retail giants such as department stores and airlines. Cabcharge points out that unlike other surcharging industries, such as airlines, taxi fares are regulated and drivers do not have the option to include the costs of credit-card acceptance. It adds that the 10% fee helps to subsidise low sale-volume cabs in regional areas, in what is a low-turnover business.

But the level of the 10% surcharge is almost universally derided – by consumers, card schemes, banks, and so on. It will be interesting to monitor developments in competition and pricing resulting from the ACCC action.

3 Consumer understanding, reaction and action

Often consumers' intuitive reaction, when presented with new fees, is to object. In many cases, such a reaction is justified and effective – a backlash over what many saw as unfair and excessive bank penalty fees in the last five years, for example, resulted in major banks reducing or eliminating these fees. And a backlash against surcharges may mean consumers will choose cheaper forms of payment for them.

Reaction to the allowance of surcharging has at times been vehement, and, given the seemingly impenetrable workings of interchange fees and payments systems for most consumers, it's not surprising that a range of parties are blamed for the new fees. Below are some consumer comments CHOICE received:

We designed specific questions in our online consumer survey to find out more about what people know and feel about the surcharging regime, and to gauge public understanding and opinion.

Is surcharging legal?

When asked whether they think it's legal for retailers and other businesses to charge consumers extra when they pay with a credit card, just over half of the respondents said "yes". 17% said "no", 23% didn't know and 8% didn't pick any of these options. Several commented that they believed surcharging was acceptable legally, but not morally or ethically.

Interestingly, the response was markedly different when survey participants were asked the same question about debit cards. Just 20% of the 1435 respondents believe surcharging for payment with a debit card is above the law, and 45% believe it is illegal. The truth is, debit card surcharging is permissible and has gone on for many years in taxis, for example, where EFTPOS, Debit MasterCard and Visa Debit attract 10% fees.

Which party pays the highest fee?

Most respondents had a broad understanding of the direction of the flow of interchange fees for credit card transactions. 84% of respondents understand that, when a shop processes a credit card transaction, it pays a fee to its bank or card scheme, rather than the other way around. And 37.6% of respondents correctly identified the closest option we gave for the average merchant service fee that shops pay to process Visa transactions (1%). However, just 28.7% identified the average American Express merchant service fee, rounded to the nearest percentage point (2%), while 32.3% of respondents believed the fee to be 5%. Perhaps this is because consumers are much more likely to see surcharges for American Express transactions.

CONSUMER COMMENTS

- "I am trying to understand how the RBA allowing credit-card surcharges is good for consumers? I cannot understand why this was allowed. Consumers should not be charged extra for a chosen payment method. It is something I would really like CHOICE to take up."
- "Merchant fees have only been passed on directly in my experience by my ex-telco and airlines. Still I will persevere in having this change reversed for what it is – a profit grab. I cannot believe the nonsense written by the Reserve Bank. Following letters to Treasury, Dept of Communications (after my ex Telco introduced the fee of 1%), it appears that the Reserve Bank sponsored the change. Why is the Reserve Bank involved with social engineering that favours big business?"
- "It's disappointing when a Government puts a surcharge on a bill."

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Are shop signs required?

54.5% of respondents believe that shops must disclose surcharges for credit card payments to consumers before the transaction goes through, with the form of this disclosure at the retailer's discretion. That's correct – the main requirement is that the fee is disclosed before the sale, and that consumers are not misled or deceived about the existence or amount of the surcharge. Just 3.9% of respondents believe that merchants are not required to disclose surcharges verbally or in writing, while 7.7% did not know what is required.

Who profits from surcharges?

We were also interested in finding out if people know which party stands to gain most from surcharges – for example, the shop, the bank, card scheme, or someone else? From consumer comments received by CHOICE in previous work, it seemed some of the anger over surcharges was misdirected. And this is fuelled by the confusing information consumers receive from retailers. One of our payment diary participants, Adam, was charged 2% to use his credit card by a restaurant that blamed American Express for the fee. That might have been justified, perhaps, but, when Adam visited the restaurant the following week and offered his MasterCard for payment, this time the restaurant "blamed the federal government" for the 2% surcharge.

When presented with the example of a medium shop with a 5% surcharge for accepting Visa, 50.6% of responses indicated that the shop stood to gain the most from this fee. We are satisfied that this was the 'correct' response, given the average merchant service fee for Visa credit card transactions is under 1%, and the interchange fee is about 0.5%. 15.6% of respondents believed that the card issuing bank gained most from this fee, while 13.0% believed Visa was the main beneficiary.

We asked a similar question in relation to taxis surcharging 10%. Interestingly, 45.2% of respondents believe the taxi companies keep the biggest cut of the 10% of this fee, while the most correct answer – 'Cabcharge or another payment system in taxis' - was chosen by just 28.6%. However, the former response is understandable, given that Cabcharge owns many of the taxi networks, including the nation's largest (Combined Taxi Services), while holding close to a very dominant position in the taxi payments industry.

Strong anti-surcharge sentiment

Most survey respondents disapprove of and dislike surcharges. 68.4% of respondents think that retailers and other businesses should not be allowed to charge customers extra when they pay with their credit card. When given an opportunity to add open-ended comments, the response was clear.

WHO DO CONSUMERS THINK BENEFITS MOST FROM HIGH SHOP SURCHARGES?

QUESTION: Imagine a medium-sized shop charges customers a 5% surcharge to accept a Visa credit card for payment. Who do you think keeps the biggest cut of this 5% fee?

(n = 1435, Source CHOICE member survey)

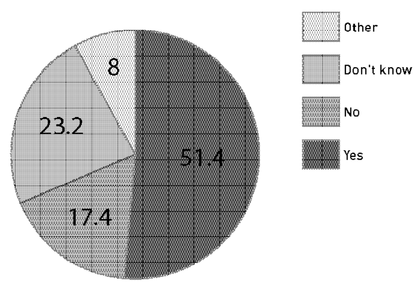
The shop	50.6%
The bank that issued the credit card	15.6%
Visa	13.0%
The shop's bank	10.6%
Don't know	9.3%
Other	0.9%

CONSUMER COMMENTS

- "It is wrong that surcharges need to be paid. When credit cards first emerged, it was stated that this would never be the case. However, convenience in using a credit card often outweighs paying by other means."
- "I just hate paying that extra 1 – 3% for nothing! Airlines are awful. There is always a credit- card fee for online booking, but you can't pay any other way to my knowledge, so they have you over a barrel. It's very unfair and inequitable to my mind. Shops and other services in my experience generally don't charge you any fee."

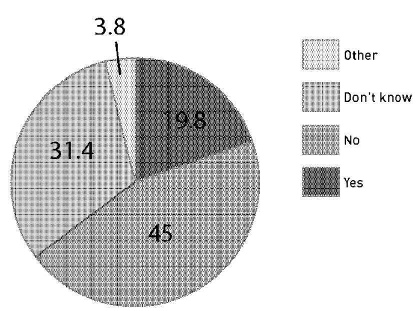
Do you think it is legal when retailers and other businesses charge customers extra when they pay with credit cards?

(n = 1435, Source CHOICE member survey)



Do you think it is legal when retailers and other businesses charge customers extra when they pay with debit cards?

(n = 1435, Source CHOICE member survey)



What do consumers do about surcharges?

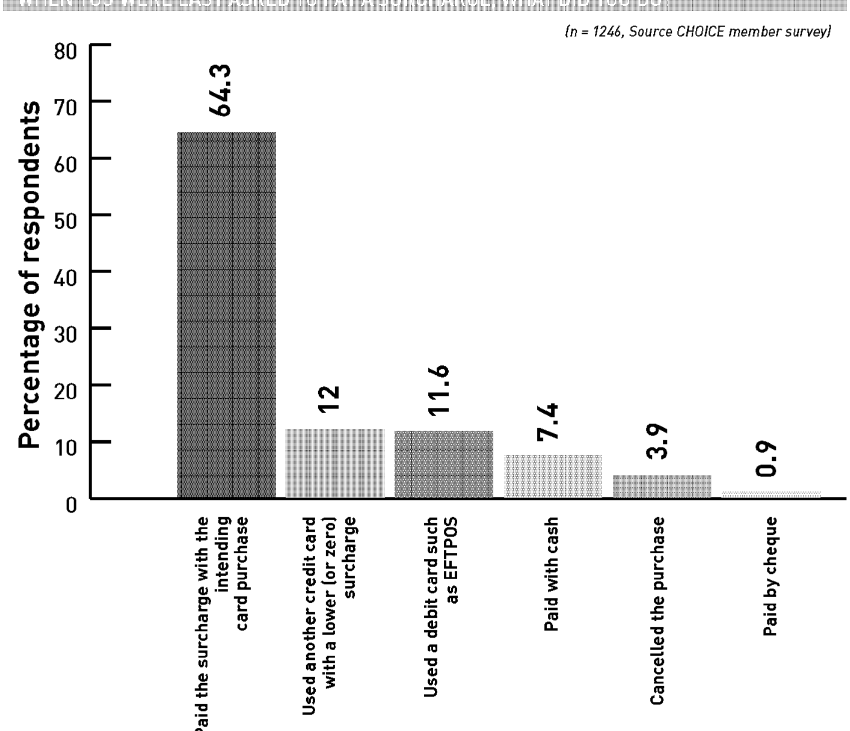
As intended, strong anti-surcharge feelings often lead to consumer action and changes in payment behaviour. When last asked to pay a credit-card surcharge, 35.8% of 1246 survey respondents who had been presented with a surcharge stated that they chose another payment method or cancelled their purchase (31.9% and 3.9% respectively). However, that leaves 64.3% of respondents who paid the surcharge.

However, the fact that people often pay a surcharge when presented with one doesn't mean they feel positive about this experience. Many told us how they would consider not returning to the surcharging business again. "I don't pay surcharges as a matter of principle – they lose my business," said one survey participant.

What would you do?

We also asked respondents what they would most likely do if presented with a 2% surcharge in a shop or restaurant. Just 13.8% indicated that they would pay the fee without adding a condition (e.g. "pay once but not return", dependent on amount), while 59.8% stated that they'd attempt to pay with a method that doesn't attract a surcharge. 1.8% indicated that they would cancel the transaction, with 20.7% responding that they would go to another merchant that doesn't apply the surcharge instead.

WHEN YOU WERE LAST ASKED TO PAY A SURCHARGE, WHAT DID YOU DO?



PAYMENT SYSTEM PRICE SIGNALS IN ACTION

In 2009 ATM 'direct charging' was introduced. This means, when customers use another's bank network's ATM, the fee they pay appears on the screen before the transaction is processed. Customers then have the option to decline the transaction if they don't want to pay the fee.

While initially some consumers objected to being asked to pay such fees, in reality we had already been paying these costs – they just weren't explicitly disclosed. Direct charging now sends a 'price signal' designed to influence behaviour; consumers are told the cost of using another bank's ATM at point of sale, and can decide whether to complete or terminate the transaction. Many customers are now deciding foreign ATM fees are not worth paying; in 2005, around 47% of ATM withdrawals were made at other banks' ATMs; by May 2010, the figure had dropped to about 37% (source RBA statistics, Table C4).

CONSUMER COMMENTS

- "A lot of stores impose a surcharge for Amex, if so I use MasterCard instead".
- "Amex often attracts surcharges, which I refuse to pay, instead opting to use my Visa card, which rarely, if ever, attracts surcharges."
- "I normally refuse to pay a surcharge and use other means when I'm asked to do so."
- "I usually ask if there is a surcharge. I try not to use the card if there is a fee."
- "If a surcharge is involved, I make an alternative payment."
- "Amex-accepting shops sometimes ask for a surcharge, so I use Visa instead."
- "I did not return to the store. When given the choice (extra to pay by credit card), I have opted for use of the EFTPOS card."
- "I will go out of my way to avoid surcharge. Have only paid it by accident (missed the fine print). Have worked out that the rewards points I get are approximately equal to 1% surcharge on Visa and 2% surcharge on Amex."
- "American Express is the worst offender and so I often choose Visa over it."
- "These days, I generally ask if there is an extra charge for using credit cards. Our insurer GIO, and broker AFM Insurance brokers, charge for credit cards. Telstra started charging for the use of credit cards a couple of years ago. In these and similar cases, my general response is to use an alternative method of payment, direct deposit via internet banking, cheque or scheduled repayments from our savings account."

"I normally refuse to pay a surcharge and use other means when I'm asked to do so."

4 International developments

A 'test case' for the world

Most countries have not moved to regulate credit card interchange fees, or to legislate against the schemes' 'no surcharging' and 'honour all cards' rules. However, such reforms are being considered in many other countries. In recent years, more than 50 lawsuits concerning interchange have been filed merchants against the card networks in the US, while in about 20 countries, public authorities have taken regulatory actions. Meanwhile, investigations related to interchange fees are happening in many more countries. The section Selected country analysis details some results.

Criticisms of Australian reforms

It's no surprise that foreign regulators, industry and consumers are taking a keen interest in the impact of Australian regulatory changes. Government reviews in countries such as the US and Canada have recommended similar reforms, with variations.

During our research it also became evident that much of the third-party (non-government) commentary and research overseas, sometimes sponsored by the card or banking industry, is highly critical of the RBA's reforms. Again and again, we found references to Australian consumers having been harmed by the reforms, with criticisms that often contradict the conclusions of the 2006 House of Representatives review, and the 2008 RBA assessment of its own reforms. The criticisms invariably focus on:

- The absence of evidence that retail prices have reduced in Australia, despite a billion dollar cut in merchants' annual interchange costs. Note, such reports don't generally claim the prices are not lower than they would have been without the reforms, just that there's no evidence to prove it.
- Credit cards becoming more expensive or reward programs less attractive. Of course, such outcomes were among the aims of the reforms – to shift the cost of card use, interest-free periods and rewards programs to the people actually benefiting from these features (those with credit cards) rather than all consumers.
- Surcharges harming consumers. In relation to excessive surcharges, this is valid – we've described how some merchants appear to be surcharging in excess of the costs they're likely to face.

In many cases, it seems that what at times appears to be a campaign against the Australian reforms has worked overseas. It's quite rare to see reports or commentary that support the lowering of interchange fees, allow the introduction of surcharges or remove the honour-all-cards rule, even from some consumer groups. Of course, that the card schemes would put time and resources into this area should come as no surprise; it's estimated that a reduction of the interchange fee to 0.5% in the US alone would be worth $36 billion ($US) per year. "The card schemes are fighting these battles overseas, but they're increasingly losing," says one Australian payments system expert. "Since their demutualisation, the international card schemes' point of view [as stated in Australia] is understandably driven by their commercial objectives, which may be global in nature" says another expert, Chris Hamilton of the Australian Payments Clearing Association. It seems that what at times appears to be a campaign against the Australian reforms has worked overseas.

Selected country analysis

UNITED STATES

No surcharges MasterCard and Visa are the two largest card networks in the United States, controlling 80% of the credit and debit card market. They do not allow for surcharges on any of their payment card transactions. These prohibitions are stated in the card networks' rules, similar to the situation in Australia before 2003. Merchants must abide by the rules in order to accept these network-branded cards.

Further, 10 US states have passed laws to prohibit surcharges on credit-card transactions: they are California, Colorado, Connecticut, Florida, Kansas, Maine, Massachusetts, New York, Oklahoma and Texas. In the last year, a number of states have introduced legislation or have pending legislation which would prohibit debit-card surcharges (including prepaid cards). The consumer advocacy group, Consumers Union, has either sponsored or supported this legislation in California and in New York.

Interchange fees Interchange fees for Visa and MasterCard range from 1% to 3.5%, and average 1.5% to 2% per transaction (compared with around 0.5% in Australia). This is estimated to yield about US $48 billion (around A$55 billion in July 2010) per year in interchange revenue. "Merchants pass along much of these fees in higher prices, which all consumers bear, regardless of how they pay for their purchases," says a 2010 report by Consumers for Competitive Choice, "a diverse national coalition of Americans who support a strong, vibrant and consumer-focused economy". The report, written by former US Under Secretary of Commerce Robert J Shapiro, and Jiwon Vellucci, says "much of this fee revenue goes to support rewards programmes that disproportionately benefit higher-income households." Its report states that for one retailer, Target, merchant service fees have become its second highest store-level cost, behind payroll.

"If the United States were to reduce the interchange rate from 2.0 percent to 0.5 percent, the savings would be (US) $36 billion per year, less some relatively small offsets," wrote consumer advocate Albert A Foer, in an April 2010 opinion piece for the New York Times. "All consumers pay more at the store and more at the pump because of unfair, non-negotiable non-transparent merchants interchange fees imposed by the card networks," said Ed Mierzwinski, Consumer Program Director at the US Public Interest Research Group. And a report by The Merchants Payments Coalition, a group of retailers "fighting for a more competitive and transparent card system that works better for consumers and merchants alike" and with member associations collectively representing 2.7 million stores with 50 million employees, claims that US consumers would have saved US $125 billion in four years if similar reforms to Australia had been introduced in the US (details at UnfairCreditCardFees.com).

Legislation to reduce interchange fees has been proposed by Richard Durbin, chair of the US Senate Subcommittee on Financial Services and General Government and author of an interchange amendment to a financial-overhaul bill. A June 2010 US Treasury report found that the federal government alone, in the credit card fees it pays through its agencies such as rail services (Amtrak), defence forces and postal services, could save $36 to $39 million annually if it was able to negotiate interchange fees with MasterCard and Visa.

Interestingly, MasterCard US Chief Executive, Robert Selander, reportedly

> "A handful of large financial institutions and dominant credit card companies have long set these interchange fees by fiat, and then divided them among themselves. To maintain these fees at five times their transactional and operational costs, the card companies have had to insulate them from normal market pressures ... and so they have done, in arrangements which economists recognise as sharing many of the characteristics of a classic cartel."
> *- Robert Shapiro and Jiwon Vellucci, Consumers for Competitive Choice (US)*

claims that consumers would be disadvantaged by such measures to reduce interchange fees, citing supposed consumer detriment in Australia. "Selander said consumers in Australia saw their annual fees and finance charges increase when regulators adopted rules to reduce interchange fees," according to a Fox Business report. "Moreover," he argued, "there is no evidence that merchants pass on their savings to consumers."

As explained, Selander's comments do not accord with the conclusions of an Australian independent House of Representatives review of the reforms.

CANADA

In June 2009, a Standing Senate Committee on Banking, Trade and Commerce recommended significant changes as part of wider reforms to the credit-card and debit-card payments systems. Similar to the RBA's reforms, they would:

- Permit merchant surcharging (with no cap), and discounts;
- Require merchants to display surcharges at point of sale;
- Permit merchants to tell consumers about relatively lower cost payment options;
- Prohibit the card schemes' honour-all-cards rule.

Perhaps surprisingly, a paper published by the Consumers' Association of Canada opposed these reforms, citing supposed consumer harm in Australia. "The Australian experience has demonstrated that government-imposed price controls on those merchant fees end up harming consumers," CAC stated in a June 2009 report. It also sees surcharging as harmful. "Surcharging means higher prices for consumers. One clearly displayed price should apply regardless of payment. Our concern is that merchant surcharges will not be clearly explained to consumers and will far exceed the cost of card acceptance to the merchant. There are disturbing examples of this already happening in Canada."

The report also argues against the ability of merchants to decide which types of cards to accept – for example, refusing to process cards with excessive merchant fees. "When a consumer is told that a merchant accepts Visa, they want to know that their particular Visa card will be accepted by the store," the CAC report states. "Allowing merchants to accept some Visa credit cards but not others will create massive consumer confusion. This recommendation is unworkable and anti-consumer."

Nevertheless, the Canadian Senate recommends the changes outlined above. It is now up to the Canadian parliament to decide whether to enact these recommendations.

NEW ZEALAND

As a result of August 2009 settlements reached with the card schemes and bank defendants, following legal action by the Commerce Commission, merchants can now surcharge for MasterCard and Visa credit card transactions. Previously, as in Australia, surcharging was prohibited through the various contractual arrangements between the schemes, banks and merchants.

Nevertheless, according to CHOICE's sister organisation in New Zealand, Consumer, surcharging is currently limited to a few industries and firms. Here are a few we found:

- Taxis routinely apply surcharges.
- A group of five independently-owned BP service stations in Wellington started surcharging in 2010, introducing $0.60 for purchases under $30 and $0.90 for every transaction over $30.
- The phone utility company, Telecom, charges the following 'convenience fees' for credit card payments, Visa

US debit card changes mirror Australia

US Congress passed legislation in June directing the Fed to regulate fees and charges for debit cards. Robert Shapiro, former Under Secretary of Commerce in the US, told us "we modelled it largely on Australia."

and MasterCard: 3%, American Express and Diners Club: 2%. Telecom claims it "does not receive any part of this additional fee".

- The police charge an extra 3% for people paying fines by credit card.
- A large car park operator charges customers a flat 50c fee for paying by credit card.

As in Australia, card schemes and banks are free to enter into agreements with merchants requiring their surcharges to bear a reasonable relationship to the cost of accepting the credit card. MasterCard's scheme rules now state that "surcharges must bear a reasonable relationship to the merchant's costs of accepting MasterCard products." But any such condition and its potential enforcement are contractual matters between the relevant schemes, banks and merchants, and not the responsibility of the regulator (the Commerce Commission).

EUROPEAN UNION (EU)

In the EU, there are two distinct levels of laws: European law and national law. Interchange and surcharging are two distinct issues and should be treated separately, as we describe below.

Surcharging Before the EU Payment Services Directive, which came into force in November 2009, rules on surcharging were set at member state level – some allowed it, most did not. The Directive's main provision on surcharging, Article 52, seeks to allow surcharging or discounting generally throughout the EU. Section 52(3) states "the payment service provider shall not prevent the payee from requesting from the payer a charge or from offering him a reduction for the use of a given payment instrument."

However, EU member states can opt out, as described in the second part of Section 52(3). "Member States may forbid or limit the right to request charges taking into account the need to encourage competition and promote the use of efficient payment instruments."

According to EuroCommerce, an organisation representing the retail, wholesale and international trade sectors in Europe, many member states have made use of this opt-out to forbid surcharging in various ways, to the disappointment of the European Commission. Some of the surcharging practices in various European countries are detailed below.

Interchange fees Action at EU level has been under Article 81 (now 101) of the Treaty on the functioning of the European Union (EU competition rules). Therefore any decisions apply directly to cross-border multilateral interchange fees only.

At member state level, some EU member states have taken separate action against multilateral interchange fees under their national version of Article 101. This action is generally taken by the competition authorities in member states.

In some other member states, 'deals' have been reached between retailers and banks. In France, there is a recent move towards regulation by legislation.

EU level actions The European Commission (EC) has taken several actions against the four-party schemes, mainly for alleged anti-competitive behaviour in how these fees are set. Some governments of member states have also taken action at a national level.

In 2007 the Commission stated that MasterCard's multilateral interchange fees (MIF) for cross-border payment card transactions in the European Economic Area violate competition rules because they increase the cost of transactions without passing on the benefits to consumers. The Commission concluded that "MasterCard's MIF, a charge levied on each payment at a retail outlet when the payment is processed, inflated the cost of card acceptance by retailers without leading to proven efficiencies."

MasterCard disputed this claim but eventually agreed to drop the interchange fee to 0.3% for credit cards and 0.2% for debit cards. Both are cross-border weighted averages, and only apply to cross-border transactions, not to the interchange fees applying in the same country that the card was issued in. MasterCard still disputes the Commission 2007 decision: it is under appeal to the European Court. The settlement is provisional (on Commission costs of cash study and on results of appeal, of course).

In 2008 the Commission started formal competition proceedings against Visa Europe Limited in relation to its MIF for cross-border point of sale transactions within the European Economic Area, and the honour-all-cards rule as it applies to these transactions. The proceedings will seek to establish whether these practices constitute infringements of European legislation forbidding restrictive business practices such as price fixing.

Previously, in 2001 the European Commission had cleared Visa's honour-all-cards rule, and in 2002 exempted Visa's proposed MIF after the company offered substantial reforms – a progressive reduction of its average interchange fee from 1.1% to 0.7% until the end of 2007, and a cap on the MIF at the level of costs for specific services.

Visa has now offered partial commitments in response to the 2008 Commission action (the exemption provision from which Visa benefited in 2002 no longer exists).

UNITED KINGDOM

Surcharging for any form of payment has been allowed since 1991. Discounting for cash and all other payment methods is also allowed.

According to the consumer group Which?, while most retailers don't surcharge, fees are common in certain sectors, namely train ticket booking, travel agents, airlines and concert/event ticket sellers. "Some retailers impose a set charge of, say, £4 per transaction, whilst others charge a percentage of, say, 3%," says Which? principal researcher, Martyn Saville. "Concert and event ticket sellers are probably the worst in this area, as they often charge a per-ticket surcharge, even where multiple tickets are being purchased in one transaction."

Similar to Australia, retailers don't have to include the credit or debit card charge in the advertised price of a service or product, as long as they offer at least one payment method that doesn't incur a surcharge.

2010 research by Edgar, Dunn & Company Management Consultants found that surcharging in UK has become prominent only in the last three to five years, and that:

- Almost a quarter of the 50 retailers contacted applied a surcharge for online card-not-present transactions, but almost none for over-the-counter (cardholder-present) transactions. Ikea was the only retailer from the sample applied an in-store surcharge, at £0.70 (around $1.23) for credit-card transactions.
- Online card surcharges are standard practice in the following industries: ticketing for cinemas, entertainment, sporting and theatre events; airlines; travel agents; and government.
- There is "some anecdotal evidence" that merchants that are not surcharging have increased their retail prices.
- There is concern about merchants surcharging in excess of their acceptance costs.

As in Australia, UK airlines have been the subject of criticism. The table below shows some UK airlines' surcharges, which at times are higher than in Australia. Budget carrier Ryanair has come in for particular criticism in the media, with a £5 per passenger per flight surcharge. "Even if you pay with Ryanair's own branded credit card, they still charge you the £5 fee!" says Martyn Saville of *Which?*

DENMARK

Surcharging is allowed, but the government is one of the few to place a cap – according to the Danish consumer group's Tænk Penge (Think – Money) magazine, the fees are limited to a maximum of 3.75%.

TABLE: UK AIRLINE SURCHARGES

AIRLINE	£ SURCHARGE PER RETURN TICKET	$A EQUIVALENT (1)
BA	9.00	15.85
BMI	4.50	7.93
Easy jet	8.00	14.09
Thomson Flights	2.5%	2.5%
Ryanair	10.00	17.61
Virgin Atlantic	6.30	11.10

***Source:** Edgar, Dunn & Company Management Consultants, Potential Introduction of Surcharging in France – Impact Study, Summary of Findings, March 2010. (1) CHOICE calculation using the exchange rate A$1 = £0.5677, source RBA, 19 July 2010.*

FRANCE
Surcharging is currently prohibited by the card schemes. Credit card use is not widespread in France.

In 2010, the French banking Federation (Fédération Bancaire Française, FBF) asked Edgar, Dunn & Company (EDC) to conduct an independent impact study about the potential introduction of surcharging in France. This study took place between January and March 2010. The report states "The observations and conclusions in this document are entirely those of EDC and are not intended in any way or form to reflect the views or perspectives of the FBF." After interviews with the finance industry, retailers and seven consumer representative groups, it found that:

- Consumers in France are "strongly against surcharging", the rationale being the "negative impact for consumers because of likely retail price increase or at least an increase in retail price complexity."
- Consumer groups expressed "strong concern about surcharging making consumers more "captive" (i.e. harder to compare retail prices across merchants). There was also strong concern that there might be potential abuse in sectors where merchants have high bargaining power; for instance, where the merchant has a very high market share or a "temporary" monopoly (e.g. taxis).
- Concern that large retailers will benefit from surcharging but not small local retailers (one consumer association believes that surcharging will have a major negative impact on these small local retailers).
- There was consensus that surcharges should be capped to avoid merchant abuse. There was no consensus about how to set this maximum limit.

GERMANY
Retailers and other merchants usually accept credit and debit cards without surcharges. However, according to the consumer group, Stiftung Warentest, surcharges are common for online air travel bookings, and, to a lesser extent, in the taxi industry. "Airlines charge between €4 and €10, says Stiftung Warentest. "Berlin taxi drivers charge €0.50, but they want to be allowed to charge €2".

THE NETHERLANDS
Since 1994, the schemes' no-surcharge rule has been prohibited, so merchants and retailers are permitted to add a surcharge when accepting payment cards. According to Consumentenbond, a consumer group with 500,000 members, the practice for over-the-counter payments is very rare, but more likely to happen online, particularly with credit cards.

"The Dutch don't like to pay for paying," Consumentenbond Financial Services advisor Ben Schellekens says. "Surcharging for small amounts paid with debit card was quite common up until two years ago. Retailers and banks launched a campaign, klein bedrag pinnen mag, which translates 'Small amount, debit card payment allowed free of charge'. When a retailer or merchant already accepts debit cards, additional payments with debit card cost less than cash payments."

It's worth noting that the use of payments systems in the Netherlands has marked differences to that of Australia. Consumentenbond says the Netherlands payments system is Europe's second cheapest, after Bulgaria. 38% of over-the-counter payments are made with a debit card, while credit-card payments account for just 1%. Cash accounted for 61% of over-the-counter payments in 2009. Electronic (internet) banking is widely used; cheques are regarded as obsolete.

BELGIUM
"Despite the fact that our regulation has not limited or banned surcharging, consumers are not really faced with this problem," Test-Achats, the Belgian consumer group, told us. "There are just a limited number of retailers who surcharge (a very small amount: generally five or 10 cents) for small payments (generally less than €10) made by debit card".

Test-Achats considers that the price paid by the consumer to purchase a good or a service must be the same and should not vary depending on the mean of payment used. "This principle ensures transparency and allows the consumer to compare prices knowingly."

The EU's Payment Services Directive provides that Member States can decide to forbid or to limit the right to surcharge taking into account the need to encourage competition and promote the use of efficient payment instruments. In Belgium, the national regulator has not transposed this option, but Test-Achats foresees a possibility to use this option in the future by means of a Royal Decree.

5 What consumers can do

As has been shown, the experience of surcharging in Australia is widespread, with 88% of online survey respondents paying a surcharge in the previous year and 22% doing so more than 10 times. However, despite payments systems reforms impacting daily on the lives of millions of consumers, there is often confusion about the rationale for surcharges and the complex way in which they operate.

Of all parties involved in a credit-card transaction, it is the consumer who is most likely to be disempowered by a lack of information. Inadequate awareness of options for dealing with surcharges, and of avenues of redress when it is felt that the charging has been unfair, may contribute to the feelings of distrust, dissatisfaction and entrapment frequently expressed by consumers. As recorded above, such sentiments came through clearly in our survey results, with 68% of participants believing that retailers and other businesses should not be allowed to charge customers extra when they pay with their credit card.

Payments system reforms are intended to empower both retailers and consumers to choose cheaper forms of payment. To lower transaction fees, help retailers reduce their costs, and support the uptake of efficient and innovative payment systems consumers can:

- **Ask how to avoid surcharges:** When retailers and other merchants state a price, if there is a surcharge it must be included in the price, unless there is a way to avoid it. If that doesn't happen, make an official complaint to the Australian Competition & Consumer Commission (ACCC) and the Australian Securities and Investments Commission (ASIC). Alternative payment methods without surcharges might include a debit card, cash, or another newer online payment method. However, some companies make consumers jump through hoops to avoid the surcharge – for example, a bank transfer a week in advance of flights, or a fairly obscure internet payment system.

- **Compare surcharges:** Many merchants charge different amounts for different payment cards. When surcharges are cost-based, one would expect debit cards to have zero or very low surcharges, and MasterCard and Visa credit cards to be cheaper than those of American Express and Diners Club.

- **Report non-disclosure:** Businesses that surcharge must ensure that consumers know a fee will apply, and the amount of that fee, before the transaction occurs. If this doesn't happen, it could be misleading or deceptive conduct and a breach of the requirement to disclose the full price including non-optional surcharges. Consumers can make a complaint to ASIC.

- **Help retailers to reduce their costs:** Despite being allowed to surcharge, many retailers don't, because they fear the potential customer backlash and loss of sales. Even when consumers are not presented with a surcharge, by choosing the most efficient payment method they'll not only help retailers keep their overheads down, but they (and all consumers) will save money in the long-run, due to less inflationary pressure.

- **Use EFTPOS and other debit cards:** There's often no surcharge, and the interchange and merchant fees are lower than those of credit cards.

- **Question the value of rewards cards:** In 2008 CRA International claimed that, as a result of the reforms cardholders in Australia were paying around $480 million more in additional fees for credit cards each year (its calculations were based on 2006 data). In 2007, the Australian Bankers' Association estimated the annual figure at an additional $1 billion, reflecting "increases in fees and charges and a dilution in the value of credit card loyalty points". We don't know who is correct, but we do know that loyalty and rewards programs are worth less now than in the past, because there's less interchange revenue in the system to subsidise their costs. The real value of rewards is often illusory anyway – if you ever pay interest on your credit card that will probably cancel out the benefit of any rewards consumers later receive. And, if cardholders are now paying retailer surcharges to use their rewards card for goods and services, they should try to work out if they're benefitting at all.

- **Find a better-value credit card:** Credit card fees may have increased overall, but that doesn't mean consumers have to stick with a poor value card. Many are available with up to 55 interest-free days and no annual fee.

- **Pay lower bank fees:** As a result of Woolworths' decision to process EFTPOS but not MasterCard and Visa Debit cards, attention turned to the fees that banks and credit unions charge customers for EFTPOS transactions. Some charge anything from $1 to $2.50, when their processing cost for EFTPOS purchases is just 4-5 cents. Of course, the rip-off here lies in the bank or credit union's court, and not with Woolworths. Again, consumers don't have to put up with paying high EFTPOS fees to their financial institutions. 2010 CHOICE Best Buy low-fee bank accounts from NAB (Classic Banking) and ING Direct (Orange Everyday) have no fees for an unlimited number of EFTPOS transactions, and no fees for most other everyday transactions.

6 References

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- Aldi
- Australian Securities and Investments Commission (ASIC)
- American Express
- Australian Bankers Association
- Australian Payments Clearing Association
- Cabcharge
- Coles
- Consumentenbond, The Netherlands
- Consumer, NZ
- Consumers Union, US
- Diners Club
- EFTPOS Payments Australia Limited
- Eurocommerce, Belgium
- MasterCard
- Online travel company
- Qantas
- RBA
- Rex
- Stiftung Warentest, Germany
- Taenk, Denmark
- Test-Achats, Belgium,
- The Commerce Commission, NZ
- Virgin Blue
- Visa
- Vodaphone
- Which, UK
- Woolworths

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APPENDIX I

CHOICE Credit Card Surcharge Online Survey

You are invited to participate in a survey conducted by CHOICE which will help to determine the incidence, attitudes and behaviour of consumers when faced with credit card surcharges at a National level.

Credit and debit card surcharges are sometimes charged by retailers when you use these cards, making the item you're buying more expensive than it would be if you paid cash. We're not referring to interest or fees your credit card provider may charge you later, for example. Information gained from this survey will be used to challenge the policies surrounding credit card surcharges.

The survey should take approximately 10 minutes to complete. To start the survey click on the NEXT button at the bottom of this page.

Your survey responses are strictly confidential. The data from this research will be encrypted and stored on a secure server, with results to be grouped and reported in aggregate.

Please provide an answer for all questions in the survey. There is the option to click back to the previous page (if necessary). Please note that your responses are saved as you move through each page.

Have you used a credit or debit card (including EFTPOS facility) in the last 2 years?
- □ Yes
- □ No

Which of the following payment cards do you own?
- □ Visa Credit Card
- □ Visa Debit Card
- □ MasterCard Credit Card
- □ MasterCard Debit Card
- □ American Express Card
- □ Diners Club Card
- □ EFTPOS (ATM) card
- □ None of the above
- □ Other (please describe)

Do you make a conscious effort to use your credit card to gain rewards points?
- □ Yes
- □ No
- □ I don't have a credit card with a rewards scheme
- □ Other (please describe)

Have you paid a surcharge in the last 2 years when you have used any of the following cards?
- □ Credit card
- □ Debit card
- □ Neither

Thinking back to the last time when you were asked to pay a surcharge, what card were you using?
- □ Visa Credit Card
- □ Visa Debit Card
- □ MasterCard Credit Card
- □ MasterCard Debit Card
- □ American Express Card
- □ Diners Club Card
- □ EFTPOS (ATM) Card
- □ None of the above
- □ Other (please describe)

What was the establishment's name the last time you were asked to pay a surcharge?
[Open response]

What was the approximate amount of the purchase?
[Open response]

What was the surcharge rate you were asked to pay? (% or $)
[Open response]

Was this an online (internet) or offline transaction?
- □ Internet
- □ Offline (eg. in person, by phone or mail)

□ Other (please describe)

Could the fee be avoided by using another payment method?
□ Yes
□ No
□ Don't know
□ Other (please describe)

If the fee could be avoided, please describe which alternative payment method you could use to avoid the fee? (select all that apply)
□ Another credit card
□ A debit card
□ Cash
□ Cheque
□ Another payment option (please describe)

Was the same fee applied for all type of credit cards?
□ Yes
□ No
□ Don't know
□ Other (please describe)

Approximately how many times have you paid a credit card surcharge in the last year?
□ Never
□ Once
□ Twice
□ 3 times
□ 4-5 times
□ 6-10 times
□ More than 10 times
□ Other

In which industries have you seen surcharges applied for credit or debit card payments?
□ Airlines
□ Appliances
□ Clothing/Footwear
□ Council rates
□ Education/Childcare
□ Groceries
□ Health/Medical Care
□ Holiday Travel
□ Insurance
□ Petrol
□ Restaurant/Formal Dining
□ Sporting/Entertainment
□ Take Away/Fast Food
□ Taxi
□ Telephone/Mobiles/Internet
□ Utilities (eg. electricity, gas, water)
□ None of the Above
□ Other (please describe)

When you were last asked to pay a credit card surcharge, what did you do?
□ Paid the surcharge with the intending card for purchase
□ Used another credit card with a lower (or zero) surcharge
□ Used a debit card, such as EFTPOS
□ Paid with a cheque
□ Paid with cash
□ Cancelled the purchase

What is the *highest* percentage (%) surcharge you have seen? (*please round to the closest* %)
□ 1%
□ 2%
□ 3%
□ 4%
□ 5%
□ 6%
□ 7%
□ 8%
□ 9%
□ 10%
□ More than 10%

What was the name of the business charging the *highest* percentage (%)?
[[Open Response]

What is the *second* highest percentage (%) surcharge you have seen?
(*please round to the closest %*)
□ 1%
□ 2%
□ 3%
□ 4%
□ 5%

- ☐ 6%
- ☐ 7%
- ☐ 8%
- ☐ 9%
- ☐ 10%
- ☐ More than 10%

What was the name of the business charging the second highest percentage (%)?
[Open Response]

What is the highest flat dollar ($) surcharge you have seen? (*please round to the closest $*)
- ☐ Less than $1
- ☐ $2-$5
- ☐ $6-$10
- ☐ $11-$15
- ☐ Other

What was the name of the business charging it?
[Open response]

Do you think it is legal when retailers and other businesses charge customers extra when they pay with a credit card?
- ☐ Yes
- ☐ No
- ☐ Don't know
- ☐ Other (please describe)

Do you think it is legal when retailers and other businesses charge customers extra when they pay with a debit card?
- ☐ Yes
- ☐ No
- ☐ Don't know
- ☐ Other (please describe)

When a shop processes a credit card transaction, how do you think the fees flow behind the scenes?
- ☐ The retailer PAYS a fee to its bank or the card scheme for each credit card transaction it processes
- ☐ The retailer RECEIVES a payment from the bank/card scheme each time the customer uses their credit card
- ☐ Don't know
- ☐ Other (please describe)

What figure do you think is the closest to the average cost retailers pay for each Visa/MasterCard transaction they process?
- ☐ Not applicable – retailers receive a payment for each transaction
- ☐ No fee
- ☐ 1%
- ☐ 2%
- ☐ 5%
- ☐ 10%
- ☐ Don't know
- ☐ Other (please describe)

What figure do you think is closest to the average cost retailers pay for each American Express transaction they process?
- ☐ Not applicable – retailers receive a payment for each transaction
- ☐ No fee
- ☐ 1%
- ☐ 2%
- ☐ 5%
- ☐ 10%
- ☐ Don't know
- ☐ Other (please describe)

Which of the following statements do you think is correct?
- ☐ Shops must disclose any surcharge for credit card payments to consumers before the transaction goes through. Whether to display the fee in writing or disclose it verbally is at the shop's discretion.
- ☐ Shops are not required to disclose surcharges verbally or in writing.
- ☐ Disclosure must be in writing – for example, signs in the shop.
- ☐ Disclosure must be verbal – for example, at the counter.
- ☐ Disclosure of surcharges must be both verbal and in writing.
- ☐ Don't know
- ☐ Other (please describe)

Imagine a medium-sized shop charges customers a 5% surcharge to accept a Visa credit card for payment. Who do you think keeps the biggest cut of this 5% fee?
□ The shop
□ Visa
□ The bank that issued your Visa card, eg. ANZ (if it was an ANZ Visa card)
□ The shop's bank
□ Don't know
□ Other (please describe)

Imagine a taxi charges customers a 10% surcharge to accept a Visa credit card for payment. Which of the following organisations do you think keeps the biggest cut of this 10% fee?
□ The taxi company
□ Cabcharge/or another payment system in taxis
□ The taxi driver
□ The consumer's bank that issued the Visa card – eg. ANZ Bank (if it was an ANZ Bank Visa card)
□ The taxi company's bank
□ Don't know
□ Other (please describe)

Do you think retailers and other businesses should be allowed to charge customers extra when they pay with a credit card?
□ Yes
□ No
□ Other (please describe)

If a merchant (eg. a shop or restaurant) applied a 2% surcharge for credit card payments, what would you most likely do?
□ Pay the surcharge
□ Try to pay with a method that doesn't attract a surcharge (eg. cash or a debit card)
□ Cancel/terminate the transaction
□ Go to another merchant who doesn't apply the surcharge
□ Other (please specify)

If a retailer has decided to apply a surcharge for credit card payments, how do you feel about different surcharges applying for different types of cards, such as one fee for Amex, another for Visa, etc?
□ I support this, because shops have to pay different fees depending on what type of credit card I pay with
□ I would prefer if the retailer had one fee for all types of credit cards
□ They shouldn't be applying any surcharges for card payments
□ Don't know
□ Other (please describe)
Credit Card Surcharge Survey

Imagine a shop has the following surcharges: 0.9% for Visa/MasterCard credit cards, 1.9% for American Express, no fee when paying cash or EFTPOS. Which of the following do you agree with most?
□ All credit cards should have the same fees
□ There should be no extra fee for cash or cards
□ This is generally a fair way to charge customers
□ The shop is ripping off customers (overcharging for credit card payments)
□ Other (please describe)

What is the reason for your response above?
[Open response]

Which of the following payment methods have you used in the past 12 months? (select as many as apply)
□ BPAY
□ Moneybookers
□ NETELLER
□ 'Pay anyone' from your internet banking bank account
□ PayPal
□ Paymate
□ POLi
□ Other (please describe)

Are you...?
□ Male
□ Female

What is your age?
□ Under 20
□ 0-24
□ 25-29
□ 30-34
□ 35-39
□ 40-44
□ 45-49
□ 50-54
□ 55-59
□ 60-64
□ 65-69
□ 70+

What state or territory do you live in?
□ NSW
□ VIC
□ QLD
□ WA
□ SA
□ TAS
□ ACT
□ NT

What best describes the area where you live?
□ City
□ Regional area
□ Rural

What is the highest level of education you have completed?
□ Primary school
□ High school to year 10 or 11
□ High school to year 12
□ TAFE/CIT
□ Degree or diploma
□ Post graduate degree or diploma
□ Doctoral or Post Doctoral degree

What is your total household income before tax?
□ Less than $35,000
□ $35,001 - $50,000
□ $50,001 - $70,000
□ $70,001 - $100,000

- ☐ $100,001 – $150,000
- ☐ Over $150,000
- ☐ Prefer not to answer

Which of the following best describes your employment?

- ☐ Professional, manager
- ☐ Para professional eg. clerk, office worker
- ☐ Tradeperson
- ☐ Unskilled eg. labourer
- ☐ Unemployed
- ☐ Home responsibilities
- ☐ Retired
- ☐ Student
- ☐ Self-employed
- ☐ Other (please specify)

What industry do you work in?

- ☐ Finance
- ☐ Retail
- ☐ Travel
- ☐ Trade
- ☐ Manufacturing
- ☐ Retired
- ☐ Other

Please indicate if you would be happy for CHOICE to contact you to discuss your answers in more detail.

- ☐ Yes
- ☐ No

If yes, please provide your contact details below.

Name
Email
Phone

Thank you for completing our survey.
Your time and opinions are very valuable to us.

APPENDIX II

CHOICE CREDIT CARD SURCHARGE ONLINE SURVEY - RESULTS

Criteria:
Screening Question: Have you used a credit or debit card (including EFTPOS facility) in the last two years? (if yes, continue)
1435 respondents met this criterion and continued on to the survey.

a) Credit Card Ownership and Use of Rewards Schemes
Sample "Other" responses for **Table 2**:
- Yes, but only if there is no disadvantage.
- I subscribe to awards schemes with CBA and Amex but do not allow it to change my spending patterns.
- I am always aware I am getting points and that it is an advantage however I don't always make a "conscious" effort.
- Have two cards one with rewards – prefer to use latter.
- For large payments like rates I make a conscious effort to use to get points.

TABLE 1: WHICH OF THE FOLLOWING PAYMENT CARDS DO YOU OWN?	N	% OF 1435 RESPONDENTS
Visa Credit Card	988	68.9
MasterCard Credit Card	757	52.8
EFTPOS (ATM) card	746	52.0
American Express Card	547	38.1
Visa Debit card	484	33.7
MasterCard Debit Card	125	8.7
Diners Club Card	36	2.5
TOTAL (MULTIPLE RESPONSES ALLOWED)	**3683**	

TABLE 2: DO YOU MAKE A CONSCIOUS EFFORT TO USE YOUR CREDIT CARD TO GAIN REWARD POINTS?	N	% OF RESPONDENTS
Other	15	1.0
Yes	751	52.3
No	418	29.1
I don't have a credit card with a rewards scheme	251	17.5
TOTAL	**1435**	**100.0**

TABLE 2A: DO YOU MAKE A CONSCIOUS EFFORT TO USE YOUR CREDIT CARD TO GAIN REWARD POINTS? (BREAKDOWN BY TYPE OF CARD)

	VISA CREDIT CARD %	VISA DEBIT CARD %	MASTERCARD CREDIT CARD %	MASTERCARD DEBIT CARD %	AMERICAN EXPRESS CARD %	DINERS CLUB CARD %	EFTPOS (ATM) CARD %
Yes	58.7	39.5	50.3	48.8	80.6	86.1	52.8
No	28.2	33.7	32.0	28.8	15.9	8.3	29.2
I don't have a credit card with a rewards scheme	12.2	25.8	16.2	20.8	2.0	5.6	16.6
Other	0.8	1.0	1.5	1.6	1.5	0	1.3
TOTAL	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Experience of Surcharging
Open-ended responses from this section of the survey made it clear that despite the definition provided in the survey introduction (see Appendix I), a number of participants confused the concept of surcharging with costs such overdue payment fees, interest charged on credit accounts, currency conversion fees and ATM usage fees.

Respondents who appeared to have answered questions in this section based on payments other than credit card surcharges by merchants were therefore excluded from analysis (along with those who provided other kinds of invalid response), leaving a base sample size of **1374** respondents.

For the questions represented in Tables 3 to 8, which dealt with recalling a specific instance of surcharging, a further 15 respondents were excluded (leaving **1359**) for responses that were otherwise invalid (e.g. inconsistent within question or could not recall whether they had *paid* a surcharge in the last two years or not, though they understood what it was).

Please note that all data in this section reflects respondents' recollection only (they were not required to refer to, or provide, records in order to answer any of the questions).

Of the 149 respondents who indicated that they had not paid a surcharge with a credit card or debit card, 21 (14%) noted in open-ended responses that they made an effort to avoid surcharges when presented with them.

Sample comments made by respondents in response to question in **Table 3:**

- Yes, all auto bill payments such as Optus incur fees. Fees are higher for Amex cards than for Visa. I have been re-evaluating the value of using credit cards for payment if it costs more.
- Yep, and it's BS that I am made to pay it on top of mark-ups in the store, plus my yearly fee.
- Will go out of my way to avoid surcharge. Have only paid it by accident (missed the fine print). Have worked out that the rewards points I get are approximately equal to 1% surcharge on Visa and 2% surcharge on Amex.
- When I am asked to pay a surcharge, I change the way in which I pay in order to avoid the surcharge.
- We were charged by a large hotel chain, and the amount seems exorbitant when the small company I work for can negotiate a lower rate with the bank that what we were charged. But who wants to carry around thousands of dollars cash to pay for your holiday? We also always ask if Amex charges a surcharge or higher surcharge as we won't use it if it does.
- Usually when purchasing over the web. It is not appreciated, because often, the supplier offers only an in-person alternative without a surcharge, and this is not always easily done. I particularly dislike airlines charging the surcharge for credit card bookings, as I believe they do so "because they can" – and it simply adds to their bottom line. Also, it seems very difficult to ascertain whether the actual amount

TABLE 3: HAVE YOU PAID A SURCHARGE IN THE PAST 2 YEARS WHEN YOU HAVE USED ANY OF THE FOLLOWING CARDS?	N	% OF 1359 RESPONDENTS*
Credit card*	1152	84.8
Debit card*	162	11.9
Neither	149	11.0
TOTAL (MULTIPLE RESPONSES ALLOWED FOR CARD ANSWERS)	**1463**	

A total of 1210 of the respondents in Table 3 said that they had paid a surcharge with either a credit card or debit card, or both.

of the surcharge actually equates to the cost to the supplier of the transaction. It is not transparent at all.
- The transaction would not accept the debit card, so I could not avoid the fees.
- The local small businesses don't charge the fee however big businesses like Telstra do???? Who makes a bigger profit???
- The charges are becoming ridiculous. The banks encouraged us to use plastic and now they make it expensive to do so. Woolworths have taken away the option to use credit and we now have extra charges. Surcharges are unfair; we are already paying interest on the money.
- Practice varies significantly from merchant to merchant.
- Only because I was not warned beforehand! I would have chosen a different payment option if I'd known
- Only at one petrol station, which I would not do again as I didn't read the sign before putting the nozzle into the car.
- Once, but I will get reimbursed as I was not told of the surcharge.
- On rare occasions, I have been asked to pay a surcharge. Also, it is often possible to get a small discount, equal to the surcharge, if cash is paid
- On both Amex and MasterCard (although majority of the time Amex and the surcharge is always more for Amex.
- Never asked, I thought such a charge was not allowed under the agreement retailers have with their bank.
- I generally avoid using credit card when there is a surcharge, but sometimes have no choice. It annoys me that a surcharge is levied – I would have thought the merchant fees were offset by reduced costs and risks to the retailer of carrying cash, and I like the extra consumer protection I get using a credit card.
- And am getting more annoyed daily at how this fee is being passed on.
- Aldi have a 1% surcharge. Also travel agents charge 1-3%, which is a lot if paying for flights and a hidden cost for consumers.
- $44! For a one-off purchase of built-in-robes. I was not impressed, as it felt like the money was for nothing. I could just as easily have used my keycard or cash if there had been sufficient warning. Was not happy.

What was establishment's name when you were last asked to pay a surcharge, what was the amount of the purchase, and what was the surcharge rate you were asked to pay?

Results are given for the top five companies mentioned by name (this total accounted for 30% of responses to the question). Where respondents mentioned multiple companies at once, only the first-mentioned was included.

Please note, data reflects respondents' recollection only (they were not required to refer to, or provide, records in order to answer).

TABLE 4: THINKING BACK TO THE LAST TIME YOU WERE ASKED TO PAY A SURCHARGE, WHICH CARD WERE YOU USING?	N	% OF RESPONDENTS*
Visa Credit Card	430	44.7
MasterCard Credit Card	245	25.5
American Express	186	19.3
Visa Debit Card	61	6.3
MasterCard Debit Card	15	1.6
EFTPOS	15	1.6
Diners Club Card	4	0.4
None of the above	2	0.2
Other	4	0.4
TOTAL	**962**	**100**

** Of the 1210 respondents who indicated that they had paid a surcharge (See Table 3) minus 248 invalid responses. Final sample size is 962.*

TABLE 4A: TOP FIVE COMPANIES THAT RESPONDENTS RECALLED AS BEING THE LAST PLACE A SURCHARGE WAS ASKED FOR	N
Telstra	113
Aldi	99
Qantas	72
Virgin Airlines	42
Caltex	35
TOTAL RESPONSES FOR TOP 5	**361**

Sample "Other" Responses for **Table 5**:
- Telephone payment.
- Requested by email to charge credit card a/c.
- Pre-arranged direct debit.
- Point of sale.
- Pay at parking machine.
- Mobile Cabcharge network.
- It's a regular payment, comes in the mail but it's paid automatically from my card.
- Fax acknowledgement.
- Direct debit.

Sample "Other" Responses for **Table 6**:
- Virgin claimed to have a bank-transfer option, but this option was not active at the time of purchase.
- There was another option, but it wasn't available on my computer.
- Their POLI system doesn't link to my bank account, so I can't use it.
- Only if amount is small enough to be comfortably payable by debit – limit approx $300; otherwise would.
- No fee when selecting credit but a $0.65 to use EFTPOS. Safeway and Big W no longer allow Visa debit.
- No ATM for my bank available in reasonable driving distance.
- Depends, book early with Qantas and BPay (free) is possible.
- Could have paid cash if I knew the charge amount and the removal guys had change.
- Complaint.
- By using the company's own product.

Sample "Another payment option" responses for Table 7:
- Transfer funds via internet banking.
- Poli (some weird bank transfer based system, but which isn't compatible with this computer).

TABLE 5: WAS THIS AN ONLINE OR OFFLINE TRANSACTION?	N	% OF RESPONDENTS*
Offline (eg. in person, by phone or mail)	764	63.1
Internet	382	31.6
Other	64	5.3
TOTAL	**1210**	**100**

** Of the 1210 respondents who indicated that they had paid a surcharge (See Table 3)*

TABLE 6: COULD THE FEE BE AVOIDED BY USING ANOTHER PAYMENT METHOD?	N	% OF RESPONDENTS*
Yes	924	76.4
No	124	10.2
Don't know	105	8.7
Other	57	4.7
TOTAL	**1210**	**100**

** Of the 1210 respondents who indicated that they had paid a surcharge (See Table 3)*

TABLE 7: IF THE FEE COULD BE AVOIDED, PLEASE DESCRIBE WHICH ALTERNATIVE PAYMENT METHOD YOU COULD USE TO AVOID THE FEE?	N	% OF 924 RESPONDENTS*
Cash	617	66.8
Debit card	263	28.5
Another payment option	261	28.2
Other credit	139	15.0
Cheque	118	12.8
TOTAL (MULTIPLE RESPONSES ALLOWED)	**1398**	

** Of the 924 respondents who had paid a surcharge and said that the fee could have been avoided by paying with another method (see Table 6).*

- Paypal.
- NIB Health Card using HICAPS.
- I think I would have to go to a post office or council offices.
- I think I could use cash or debit, but I had to go into a post office to make the transaction.
- I can't remember what they called it. But I could only pay by other option if I used internet explorer as my browser. Which I don't.
- Going to Telstra shop.
- Fuel card.
- Ezy debit.
- Direct debit.
- BPay.

Sample "Other" responses for Table 8:
- Yes, but they didn't accept Amex or Diners.
- Yes – only for those they accept.
- Only accepts MasterCard and Visa at all.
- For the cards that they accepted, yes.

TABLE 8: WAS THE SAME FEE APPLIED FOR ALL TYPES OF CREDIT CARDS?	N	% OF RESPONDENTS*
Yes	410	44.4
No	287	31.1
Don't know	205	22.2
Other	22	2.4
TOTAL	**924**	**100**

* *Of the 924 respondents who had paid a surcharge and said that the fee could have been avoided by paying with another method (see Table 6).*

TABLE 9: APPROXIMATELY HOW MANY TIMES HAVE YOU PAID A CREDIT CARD SURCHARGE IN THE LAST YEAR?	N	% OF RESPONDENTS*
Never	170	12.4
Once	135	9.8
Twice	158	11.5
3 times	170	12.4
4-5 times	277	20.2
6-10 times	165	12.0
More than 10 times	299	21.8
TOTAL	**1374**	**100**

* *Of the 1374 respondents comprising the base sample size for this section. In total 1204 of the respondents reported paying a surcharge at least once in the past year.*

TABLE 10: WHEN YOU WERE LAST ASKED TO PAY A CREDIT CARD SURCHARGE, WHAT DID YOU DO?	N	% OF RESPONDENTS*
Paid the surcharge with the intending card for purchase	801	64.3
Used another credit card with a lower (or zero) surcharge	150	12.0
Used a debit card, such as EFTPOS	144	11.6
Paid with cash	11	0.9
Cancelled the purchase	92	7.4
Paid with a cheque	48	3.9
TOTAL	**1246**	

* *Of the 1374 respondents comprising the base sample size for this section, minus 128 excluded for invalid responses. Final sample size 1246.*

TABLE 11: IN WHICH INDUSTRIES HAVE YOU SEEN SURCHARGES APPLIED FOR CREDIT OR DEBIT CARD PAYMENTS?	N	% OF 1204 RESPONDENTS*
Airlines	768	63.8
Telephone/Mobiles/Internet	504	41.9
Holiday Travel	436	36.2
Restaurant/Formal Dining	385	32.0
Utilities (eg. electricity, gas, water)	327	27.2
Taxi	318	26.4
Petrol	263	21.8
Groceries	221	18.4
Appliances	195	16.2
Council rates	190	15.8
Insurance	165	13.7
Clothing/Footwear	144	12.0
Sporting/Entertainment	142	11.8
Other Industry^	140	11.6
Take Away/Fast Food	99	8.2
Health/Medical Care	95	7.9
Education/Childcare	39	3.2
None of the Above	9	0.7
TOTAL (MULTIPLE RESPONSES ALLOWED)	**4440**	

**Of the 1204 respondents who said they had paid a surcharge at least once in the previous year (see Table 9)*

^Sample "Other" industries mentioned:

- *Wreckers*
- *Wine*
- *Vehicle purchase*
- *Strata levies*
- *Rental payments*
- *Purchasing from wholesalers*
- *Parking*
- *Lawyer companies*
- *It is usually a smaller type of business. Not usually a large organisation.*
- *Hotel accommodation*
- *Hairdresser and many small businesses*
- *Electrical and IT*
- *Duty-free shopping*
- *Councils – for property certificates*
- *Computer stores*
- *Child maintenance payments*
- *Car repair*
- *Car hire*
- *Building & construction products*
- *Body corporate fees*

TABLE 12: WHAT IS THE HIGHEST PERCENTAGE (%) SURCHARGE YOU HAVE SEEN?	N	% OF RESPONDENTS*
1%	104	8.7
2%	349	29.3
3%	349	29.3
4%	97	8.1
5%	125	10.5
6%	14	1.2
7%	11	0.9
8%	13	1.1
9%	3	0.3
10%	100	8.4
More than 10%	26	2.2
TOTAL	**1191**	**100**

**Of the 1204 respondents who said they had paid a surcharge at least once in the previous year (see Table 9), minus 13 excluded for invalid responses. Final sample size 1191.*

What was the name of the business charging the highest percentage (%)? Respondents were often not able to recall the business name, but more often could remember the industry. A total of 654 respondents were able to identify either a business name or the industry. The top five industries mentioned follow and together they account for 54% of responses. Please note, data reflects respondents' recollection only (they were not required to refer to, or provide, records in order to answer).

TABLE 12A: TOP FIVE INDUSTRIES THAT RESPONDENTS RECALL AS CHARGING THE HIGHEST % SURCHARGE THEY REMEMBER	N
Airlines	107
Taxis	89
Telephone/Mobiles/Internet	72
Petrol / Service Stations	46
Travel Agents / Services	36
TOTAL RESPONSES FOR TOP 5	**350**

TABLE 13: WHAT IS THE SECOND-HIGHEST PERCENTAGE (%) SURCHARGE YOU HAVE SEEN?	N	% OF RESPONDENTS*
1%	399	33.9
2%	463	39.4
3%	180	15.3
4%	57	4.8
5%	47	4.0
6%	3	0.3
7%	8	0.7
8%	5	0.4
9%	3	0.3
10%	4	0.3
More than 10%	7	0.6
TOTAL	**1176**	**100**

**Of the 1204 respondents who said they had paid a surcharge at least once in the previous year (see Table 9), minus 28 excluded for invalid responses or not seeing more than one surcharge. Final sample size 1176.*

TABLE 14: WHAT IS THE HIGHEST FLAT DOLLAR ($) SURCHARGE YOU HAVE SEEN?	N	% OF RESPONDENTS*
Less than $1	194	18.6
$2-$5	486	46.7
$6-$10	221	21.2
$11-$15	140	13.4
TOTAL	**1041**	**100**

**Of the 1204 respondents who said they had paid a surcharge at least once in the previous year (see Table 9), minus 163 excluded for invalid responses or because they stated they had never seen a flat dollar surcharge. Final sample size 1041.*

c) Respondents' understanding, reaction and action

For questions about respondents' knowledge about the operation of surcharges, and their opinions of the system, the entire sample of 1435 participants was used.

Sample "Other" responses for **Table 15**:

- Yes, it's legal but very poor customer service.
- Yes, if it is to cover the business costs of having the option.
- Yes, if advised prior to purchase.
- Yes, however it's impossible to know whether the surcharge actually reflects the merchant's costs to accept a card. I would also challenge the notion that accepting cash costs 'nothing' in comparison with card payment.
- Yes, but the amounts are clearly excessive and way beyond the cost to them of such an electronic transaction.
- Yes, as long as it is clearly pointed out to customers.
- Yes, but no more than they pay in fees to the banks.
- Yes, only for Amex and Diners because they charge up to 5%.
- Yes, I think it's legal, but I don't like it.
- Yes, I think it's legal as the banks charge the retailer.
- Yes, I think it is legal to recoup a surcharge cost, but not to charge more than this. Please ask less ambiguous questions.
- Yes, but not happy about it.
- Yes, but I strongly disagree with the practice.
- Yes, but I don't think it's good customer service.
- Within 1% is OK.
- While legal, I don't think it's ethical.
- They need to clearly disclose it prior to point of sale, so I can make the choice to go elsewhere if there is an option.
- They are only passing on the charge.
- The costs to the retailer for accepting these cards is greater, so I guess someone has to pay.
- Suspect it is legal, but certainly should be policed.
- Some small businesses have no option.
- Some of the charges don't necessarily reflect their cost. Also, for utilities, there aren't many payment options, so a little unfair. Almost have to pay them to make a bill payment.
- Should be illegal.
- Rip-off.
- Providing they tell you prior to purchase.
- Provided it's proportional to their charge (most surcharges are less than 1% excluding Amex/Diners for retailers etc.)
- Probably legal, but they shouldn't charge it, it is simply a cost of business.
- Probably – I expect it would be in the PDS.
- Presume so – often small businesses.
- Presumably if they inform you.
- Perhaps but the fee should be more like <1% and avoidable.
- Only if they display a sign indicating a surcharge applies.
- Only if it is the amount the bank charges.
- Obviously legal, but immoral.
- Not without advising before payment.
- Not sure. Understand that businesses have to pay for credit facilities, so need to recoup costs.

TABLE 15: DO YOU THINK IT IS LEGAL WHEN RETAILERS AND OTHER BUSINESSES CHARGE CUSTOMERS EXTRA WHEN THEY PAY WITH A CREDIT CARD?	N	% OF RESPONDENTS
Other	115	8.0
Yes	737	51.4
No	250	17.4
Don't know	333	23.2
TOTAL	**1435**	**100**

- Not a legality at this point as they can charge what they want for a 'service' but I object to paying this charge with no service benefit on top of other credit charges, i.e. not justifiable.
- No, especially if it costs them no more.
- No, when they charge more than 2%.
- Never thought about it, but assumed it was.
- Morally wrong.
- Might be legal, but they should not charge.
- May be legal, but I will avoid retailers charging extra.
- Legal, but not ethical.
- Legal – yes, ethical – no.
- Legal, but shouldn't be allowed.
- Legal, but not fair.
- It's legal, but you'd expect that, like supermarkets, surcharges are built into their pricing. If not, then go to standard pricing and surcharge for EFTPOS and credit card transactions and praise cash payers. They don't want that, though, as there's a margin in their surcharges...
- It would be more appropriate if they brought goods down for cash than to simply now surcharge on their existing costings, which include a shared buffer of their credit-card costs and costs remain the same for cash. I.e. Have the same surcharge %, but they should bring the cash rate down to reflect their saving of a fee that they use to absorb.
- It shouldn't be.
- It should not be allowed.
- It should be.
- It probably is legal, but I don't think it is right.
- It must be or they wouldn't do it!
- It must be but it is an absolute disgrace!
- It might be legal but it is unfair and excessive.
- It might be legal, but it is not ethical.
- It may be legal, but it doesn't feel right.
- It may be legal but it is not fair, they pushed us into using cards to make payments.
- It may be legal but I don't believe it is justified.
- It is legal but they shouldn't do it – it's a cost of doing business these days, they need to wear it.
- It is legal, but it is wrong.
- It is legal, but anti-social.
- It depends on whether another option is reasonably available.
- It depends on the service fee.
- If the bank (e.g. Amex) charge them more.
- If it's a small business, fair enough as their margins would be very tight.
- I used to think it was not allowed, but think the law changed a couple of years back.
- I understand retailers trying to recoup fees charged by banks, but don't accept the need for banks to charge them in the first place.
- I think they get charged from their bank, but, if this is not the case, then it is not legal.
- I think so, but I think it's wrong.
- I think it's legal, but it shouldn't be when over the internet when they offer no alternative.
- I think it is more immoral. Like when shopping for your groceries (at Aldi) you are generally purchasing a large amount and I expect to be able to charge it to my credit card without extra fees.
- I think it is legal, but not morally right.
- I think it is legal, but I don't think it is right.
- I realise that Amex is difficult for small business to pass on.
- I question the validity of it, though it may be legal to do it.
- I know they aren't allowed to do it in the UK, but they seem to be allowed to do it here.
- I know they are usually passing on the cost from a bank which owns the EFTPOS machine as they are bloody rip-offs.
- I don't think so, I know its legal to charge a fee since about 2003, if I remember correctly.
- I don't know, but I choose not to buy sometimes or pay differently.
- I don't like it, but I understand (except when you have no other choice on how to pay).
- I don't know if it is, but it shouldn't be.
- I don't know about legal, but the business gets charged for supplying the facility.
- I believe it's legal, but is it moral to charge more than what it costs?
- I believe it is legal, but is it legitimate given the circumstances and the price being charged?
- I assume it is legal otherwise surely they would not do it?
- Don't know but I think if they want to be able to offer credit card then they need to pay what it costs them to offer it.
- Do I like it: no. Is it legal: yes. Is it fair: maybe.
- Depends on business type.
- Depends if they have factored the fee into the ticketed price.
- But it is VERY annoying.
- Assume that it is legal.
- As long as it is clearly signed.

Sample "Other" responses for **Table 16**:

- Yes, as long as it is clearly pointed out to customers.
- Yes, if advised prior to purchase.
- Yes, but I don't think its good customer service.
- While legal I don't think it's ethical.
- Should be illegal.
- Rip off.
- Providing they tell you prior to purchase.
- Probably is, but it's hardly justified.
- Presumably if they inform you.
- Only if the retailer faces a charge from the bank (or upstream financial institution).
- Not when they give you no other choice of payment.
- Not sure, but would love to know as it is really a cash transaction.
- Not sure, because I don't know what the costs are on their end, if it's similar to a Visa card, then I guess so, if it's at a reduced rate the surcharge should be less.
- No – without offering an alternative, BPay, etc.
- Morally wrong.
- Might be legal, but again they should not charge.
- Legality is different to acceptable practice.
- Legal, but not ethical.
- It should not be allowed.
- It should be.
- It might be legal, but it is unfair and excessive.
- It might be legal, but it is not ethical.
- It is legal, but it is wrong.
- It depends on whether another option is reasonably available.
- Issue with security on debit cards.
- If the debit card is processed as an EFTPOS transaction (CHQ/SAV), there should be no surcharge, however processed through the "CREDIT" (MasterCard/Visa), there should be. Not 100% sure how the legislation lines this up.
- If it is legal, it shouldn't be because IT'S MY MONEY.
- I think it should be the same as a Cashcard.
- I think it is legal but not morally right.
- I don't think it should be.
- Depends what charges the bank is charging the retailer – if they are simply passing on the cost, then it's probably legal.
- Depends on how much they are charged by the banks.
- But not fair.
- Believe that it may be warranted, if under a certain dollar amount.
- As long as it is clearly signed.
- Again probably legal, however not right, they save money in getting cash pick-ups from the bank and are less likely to have money stolen.

Sample "Other" responses for **Table 17**:

- They pay to hire the credit-card machine and this is why they create the surcharge.
- The retailer pays to bank, but pockets the difference in what was charged to the consumer.
- The retailer pays a fee depending on the amount they put through on the credit cards.
- Retailers will get slugged by their EFTPOS/CC provider at an agreed % based on card type and transaction type, some resellers will receive small incentive based on transaction volume to encourage pushing said system.

TABLE 16: DO YOU THINK IT IS LEGAL WHEN RETAILERS AND OTHER BUSINESSES CHARGE CUSTOMERS EXTRA WHEN THEY PAY WITH A DEBIT CARD?	N	% OF RESPONDENTS
Other	54	3.8
Yes	284	19.8
No	646	45.0
Don't know	451	31.4
TOTAL	**1435**	**100**

- Retailer already pays a merchant fee for convenience of credit card facility, so surcharge goes into pocket.
- Generally the retailer pays a fee, unless it's like Woolworths etc., who get paid.
- Depends on who the retailer is (and how big they are).
- Depends on the type of credit card.
- Depends on the size of the retailer.
- Banks cover the charge for credit, but the shop may be charged for debit transactions – this is the explanation from the stores.

Sample "Other" responses for **Table 18**:

- We had a retail store and paid a very high amount, but knew that high-volume retailers were possibly paying nothing.
- Was 4% when I was in business in late 1980s.
- Varies with negotiation and volume between 0.5-3%.
- Varies on the deal the merchant gets with the financial institution.
- Varies according to size of business.
- Usually the rate that is charged.
- This depends on the bank merchant fee charged to the business. Businesses are only supposed to charge the retailer what the merchant bank charges them.
- Smaller – up to .5% larger they get paid.
- Small retailers will be between 1-2%, larger one less.
- Sliding scale dependant on transaction amount.
- Retailers probably receive discount incentives for turnover.
- Not as much as they charge.
- Less than 1%. Depends on volume of money, bargain power.
- It will vary, depending on the agreement between the retailer and the bank/provider.
- It varies according to volume.
- It depends on their transaction volume.
- It depends on the value of the throughput, 1% to 5%.
- It depends on the stores total turnover with provider.
- Retailer agreements vary considerably and fees can be negotiated according to volume of throughput.
- I think it varies with the value of the transaction and the relationship between the retailer and the card company. The bigger you are the less you pay.
- I believe it varies according to the number of transactions they process – more transactions means lower fees per transaction.
- For small/med businesses, it's 1%, for large ones like Coles etc. they get paid, don't they?
- For "big" retailers 0.5% for ordinary retailers 1%-2%.
- Fixed fee – maybe $0.50.
- Depends on their agreement with their bank.
- Depends on the type of card, i.e. Visa, Amex, Diners.
- Depends on the total of the purchase?
- Depends on the CC company, each charges their own rate between 2% - 5%.
- Depends on the $ value they put through.
- Depends on retailer size: 1-3%.

TABLE 17: WHEN A SHOP PROCESSES A CREDIT CARD TRANSACTION, HOW DO YOU THINK THE FEES FLOW BEHIND THE SCENES?	N	% OF RESPONDENTS
Other	19	1.3
The retailer PAYS a fee to its bank or the card scheme for each credit card transaction it processes	1205	84.0
The retailer RECEIVES a payment from the bank/card scheme each time the customer uses their credit card	49	3.4
Don't know	162	11.3
TOTAL	**1435**	**100**

TABLE 18: WHAT FIGURE DO YOU THINK IS THE CLOSEST TO THE AVERAGE COST RETAILERS PAY FOR EACH VISA/MASTERCARD TRANSACTION THEY PROCESS?	N	% OF RESPONDENTS
Other	74	5.2
Not applicable – retailers receive a payment for each transaction	16	1.1
No fee	48	3.3
1%	539	37.6
2%	440	30.7
5%	39	2.7
10%	1	0.1
Don't know	278	19.4
TOTAL	**1435**	**100**

- Depends on how many transactions they process per month, but say 2% at the highest.
- Depends mainly on turnover.
- Depends on number of yearly transactions.
- Average 3.5%.
- 1 to 5 %, depending on retailer.

Sample "Other" responses for **Table 19**:
- Was told they are rip-offs by a local retailer.
- Usually about 0.5-1% more than MasterCard/Visa.
- Unknown, but I would guess that it is higher than Visa or MasterCard.
- Think it high but don't know exactly.
- Selected retailers pay same as MasterCard or Visa, e.g. Flight Centre. Others pay 4-5%.
- Most will pay about 2.8%, big multi-nationals as low as 1.65%.
- Less than what they charge me!
- I don't know, but it is higher than most credit cards.
- I know. It is higher than an ordinary Visa card.
- Higher than for Visa/MasterCard.
- Don't know, but motels and others charge high surcharge for use.
- Don't know, but more than Visa or MasterCard.
- Bloody high – wouldn't have a personal Amex – expensive and not accepted everywhere.
- Amex and DINERS are 2.99 or 3% I can't remember which is which.
- Actually, I would have said 7 percent.
- 2% in addition to the above credit card rate.
- 2.8% for some merchants, 1.68% for others. Merchants receive offers based on transaction volume.

Sample "Other" responses for **Table 20**:
- Don't know, but most have a sign at checkout.
- Disclosure must be in writing – for example, signs in the shop. The signs should be placed at the entrance so the customer can make an informed decision BEFORE they start shopping.
- Check out is too late for items like petrol – needs to be on their forecourts advising. If I get it wrong, I will not return willingly to that merchant.
- Charging a surcharge should be illegal. The cost to the retailer should be a normal business cost incorporated in the retailer's margin.

Sample "Other" responses for **Table 21**:
- Will vary according to business agreement with card issuer.
- The shop keeps all of it. There is no contractual obligation to pass it on to the bank or Visa. The fee charged to the retailer is negotiated separately.
- Split fairly evenly between the first 3.
- I think all three keep a bit.
- Hopefully, no one is making a profit

TABLE 19: WHAT FIGURE DO YOU THINK IS CLOSEST TO THE AVERAGE COST RETAILERS PAY FOR EACH AMERICAN EXPRESS TRANSACTION THEY PROCESS?	N	% OF RESPONDENTS
Other	45	3.1
Not applicable – retailers receive a payment for each transaction	6	0.4
No fee	15	1.0
1%	70	4.9
2%	412	28.7
5%	464	32.3
10%	42	2.9
Don't know	381	26.6
TOTAL	1435	100

from the fee, just cover costs.

- Estimate shop keeps approx half.
- Depends on the shop's merchant rate.
- About 50/50 shop/bank.

Sample "Other" responses for **Table 22**:

- Visa.
- The company whose card is used.
- Part Visa, part Cabcharge, part taxi company.
- Hopefully, no-one is making a profit from the fee, just cover costs.
- Both the bank and the taxi company.
- As far as I am aware, it is illegal to charge more than the merchant bank fee to the business.

TABLE 20: WHICH OF THE FOLLOWING STATEMENTS DO YOU THINK IS CORRECT?	N	% OF RESPONDENTS
Shops must disclose any surcharge for credit card payments to consumers before the transaction goes through. Whether to display the fee in writing or disclose it verbally is at the shop's discretion.	782	54.5
Disclosure of surcharges must be both verbal and in writing.	234	16.3
Disclosure must be in writing – for example, signs in the shop.	212	14.8
Shops are not required to disclose surcharges verbally or in writing.	56	3.9
Disclosure must be verbal – for example, at the counter.	35	2.4
Other	5	0.3
Don't know	111	7.7
TOTAL	**1435**	**100**

TABLE 21: IMAGINE A MEDIUM-SIZED SHOP CHARGES CUSTOMERS A 5% SURCHARGE TO ACCEPT A VISA CREDIT CARD FOR PAYMENT. WHO DO YOU THINK KEEPS THE BIGGEST CUT OF THIS 5% FEE?	N	% OF RESPONDENTS
The shop	726	50.6
The bank that issued your Visa card – eg. ANZ (if it was a ANZ Visa card)	224	15.6
Visa	187	13.0
The shop's bank	152	10.6
Don't know	133	9.3
Other	13	0.9
TOTAL	**1435**	**100**

TABLE 22: IMAGINE A TAXI CHARGES CUSTOMERS A 10% SURCHARGE TO ACCEPT A VISA CREDIT CARD FOR PAYMENT. WHICH OF THE FOLLOWING ORGANISATIONS DO YOU THINK KEEPS THE BIGGEST CUT OF THIS 10% FEE?	N	% OF RESPONDENTS
The taxi company	648	45.2
Cabcharge/or another payment system in taxis	411	28.6
The consumer's bank that issued the Visa card – e.g. ANZ Bank if it was an ANZ Bank Visa card	100	7.0
The taxi company's bank	90	6.3
The taxi driver	44	3.1
Other	12	0.8
Don't know	130	9.1
TOTAL	**1435**	**100**

Sample "Other" responses for **Table 23**:

- Yes, provided that it is only on a demonstrable cost recovery basis; and it must always be discretionary on the part of the retailer.
- Yes, only to recoup the actual cost incurred as a result of the transaction, though (i.e. the charge to the shop by the card scheme).
- Yes, if they incur costs to process the transaction.
- Yes, given correct circumstances.
- Yes, but they should provide an opportunity to pay by other means to pay that does not incur extra fees. I don't believe that direct debiting of accounts is a suitable alternative.
- Yes, but only to the extent of the cost to them. Small business especially.
- Yes, as long as it's made absolutely clear before payment.
- Yes, provided it is widely publicised.
- Yes, if it is an extra cost they have to pay.
- Yes, if genuinely claiming an additional expense caused by the use of the credit card.
- Yes, but not higher than they are charged and no if they receive payments.
- Yes, if they are being charged a fee to accept payment through credit card.
- Thresholds should be developed to make it fair amongst consumers.
- They should pass on only the marginal cost of providing the service; they should not make a profit.
- They should not profit on the surcharge.
- They should just up the retail price to include all overheads.
- They should include in the price, and give 2% incentive to use an alternative payment method, i.e. cash or debit card.
- They should give discounts if paying by cash.
- They should be allowed to pass on what they disclose as long as there are alternatives.
- They should be able to charge the bank's fee – nothing more.
- The fee should be included in the price of the goods.
- Retailers should have a min purchase for fees to apply.
- Only to recoup their costs.
- Only to cover what it costs them.
- Only to cover the charges the bank put on them.
- Only to cover surcharges. I would prefer them disclose this value and give customers the choice to pay cash, rather than hide the surcharge and increase prices up for everyone.
- Only the exact amount that the card charge incurs.
- Only on Amex and Diners.
- Only if they inform the customers first.
- Only if they are passing on costs, not just because they want to.
- Only if it's a small business and they can't absorb the cost.
- Only if it to cover business costs.
- Only if it costs them more.
- Only if banking institution charges retailer or business.
- Only if all total prices are shown on labels i.e. with the surcharge & without the surcharge.
- Only enough to cover the costs of the credit card provider – not to make more money out of it.
- Only as much as the transaction costs them and no more.
- Not when they want my business.

TABLE 23: DO YOU THINK RETAILERS AND OTHER BUSINESSES SHOULD BE ALLOWED TO CHARGE CUSTOMERS EXTRA WHEN THEY PAY WITH A CREDIT CARD?	N	% OF RESPONDENTS
Yes	331	23.1
No	981	68.4
Other	123	8.6
TOTAL	**1435**	**100**

55

- Not unless there is a cost to them. If big business NO.
- Not knowing the reasons for this, I don't know.
- Not if they make it very hard to pay with other (free) methods.
- Not if it's via a debit card because there is no risk – if there's no money in the account you can't use it.
- Not for regular (e.g. monthly) bills as they get the benefit of being paid on time. Other businesses for one-off customers ok, as customers won't deal with them if they don't want to pay.
- No, that why Pay Cash, Pay Less is in the market.
- No, but the banks and companies should not charge the retailer, either.
- No more than costs.
- No, if that is the only method offered. No, if it is an internet purchase and they say you can pay cash (which can't happen over the internet).
- Minimal to cover costs only.
- Just scrap the fee, for goodness sake!
- I think it should be standardised across all retailers and businesses
- Its legal – but open to rorting, and they should offer EFTPOS as an alternative.
- It depends. If the shop is getting charged fees from the bank, they should be allowed to pass on those fees.
- It depends on how big the business is.
- Incorporate any costs into the price.
- If they incur a cost themselves.
- If they have to pay fees to the bank, it's ok.
- If they have to cover for the costs, they pay the credit card companies, yes.
- If they don't charge, it will be added to the cost of items.
- If they deem it necessary to benefit their financial gains.
- If they charge a premium for their product – no. If their price is low (for the item, minimal margin) – yes.
- If they are being charged by the bank, yes. Otherwise, no.
- If there is adequate warning and other payment methods available.
- If the retailer wants the business, then they should absorb that cost. Price the Items appropriately.
- If the business is being billed by the card company, then the cost of the credit should be transparent and declared, rather than being hidden in the cost of goods.
- If the bank charges a surcharge, it is fair that the shops pass a percentage of it on.
- If paying at the time of purchase, NO. If paying an account say 30 day terms, then Yes.
- If it's to only offset the true cost of the bank charges, then yes.
- If it is a genuine business cost then they should be able to pass it on.
- I would probably be happier if they built in these costs into their prices – and then gave a "discount" if you pay cash.
- I think they should only pass on the % being charged to them by Visa, MasterCard, Amex etc.
- I think that they should be able to pass on the costs that they will be incurring on the transaction, however, they should not be able to make additional profit because of the mode of payment.
- I think that retailers should not be charged extra for processing of credit card payments, so can understand why they pass on the surcharge, but disagree with it happening.
- I think it depends on the size of business; it is probably a good idea to incorporate it into their markup.
- I think for small business then maybe it's fair enough.
- I think both written and verbal explanation of surcharges should be required legally, I don't think it should be illegal to charge customers extra rather it is just very bad customer service.
- I simply don't know well whether this is justified.
- I don't think retailers or banks should profit from the situation.
- I don't know, because I don't know what fees they pay.
- Generally, no, but I think small businesses like corner stores may need to maintain profitability.
- Depends, if CC is the only way to pay, NO, otherwise begrudgingly yes.
- Depends upon their profit margins and the credit card fees.
- Depends on whether business has to pay a fee.
- Depends on the quantum of the merchant service fee.
- Depends on the nature of the service, and the amount of the purchase.
- Depends on the fee that they are charged – anything less than 4% should be absorbed in the overall margins.
- Depends on the circumstances. At work, we charge a surcharge if 30-day account customers take their 30 days & then want to pay by card. Credit cards should be used for on the spot purchases.
- Depends on business type.
- Depends on business profit margin.
- Depending on what they are charged by the banks.
- Customer should be charged what it costs the business.
- Cost recovery only.
- But not the world.
- As long as they offer a convenient alternative.
- As long as options are available, e.g. airline internet tickets are now almost always bought by credit card.
- Ambivalent – but I will avoid those shops or avoid paying the fee by using cash.
- Above a standard limit of $1000.
- A nominal amount is fair.
- A fee for using a card is similar to a discount for cash.

Sample "Other" responses for **Table 24**:

- Unless for work purposes. Which is where I generally pay the surcharge as my only method of payment is corporate credit card.
- Try to preplan to use other method, but pay surcharge if most convenient.
- Try to avoid the charge by another method of payment or go to another merchant who doesn't charge a surcharge for the same priced item.
- That depends on how much I want the goods, if it were feasible I'd cancel the transaction and find another merchant, if not I'd try to pay with a method the doesn't attract a surcharge, if that weren't possible I'd pay the surcharge.
- Personal: go elsewhere; business: just pay it.
- Pay with the credit card but never come back.
- Pay with another method if possible, else cancel the transaction.
- Pay the surcharge if low purchase amount, otherwise use another method or go elsewhere.
- Pay once, but not return.
- Pay it, but never use that business again – which is my current policy except for taxis (because they all do it) and Qantas (because I'm used to their poor service).
- Pay it at the time, but I wouldn't go back there.
- Pay cash on a high dollar transaction and credit card on a small one.
- Pay by another method depending on how many times I have done so that month (banks charge you if you go over a certain amount of EFTPOS transactions in a month).
- One or all of the actions from the above, depending on the item.
- Ok for small purchase, anything high I'd look else where.
- Would depend on the amount of surcharge.
- It depends on the size of the bill and the opportunity to get the same product elsewhere. If the bill is small and convenience is an issue and the surcharge is 1% or so I will pay. If the bill is large (e.g. $2000 for dishwasher at Winning appliances and the surcharge is high e.g. 2%, I will use another card. On one occasion when a luggage shop charged a surcharge, I went to another shop.
- It depends – if I have to fly or pay my phone bill, I will try and pay by some other means – if I am trying to buy something that is not really necessary, I will not proceed with the transaction and try somewhere else.
- If you've eaten the food and you're there in the restaurant with no cash and only your credit card, there's not much option.
- If unaware and no other means of payment, I would never use that place again.
- If for work, would have no choice, if personal, then avoid and complain.
- I'd pay it, but it would put me off returning.
- I would pay it in the first instance and attempt to avoid the retailer thereafter.

TABLE 24: IF A MERCHANT (EG. A SHOP OR RESTAURANT) APPLIED A 2% SURCHARGE FOR CREDIT CARD PAYMENTS, WHAT WOULD YOU MOST LIKELY DO?	N	% OF RESPONDENTS
Try to pay with a method that doesn't attract a surcharge (e.g. Cash or a debit card)	858	59.8
Go to another merchant who doesn't apply the surcharge	297	20.7
Pay the surcharge	198	13.8
Cancel/terminate the transaction	26	1.8
Other	56	3.9
TOTAL	**1435**	**100**

- For a restaurant, complete this transaction but never return. For a shop, depending on competition/alternatives, go elsewhere.
- Depends, I generally pay by Visa when they charge a surcharge for my Amex.
- Depends upon the value of the transaction.
- Depends on what my purchase is.
- Depends on what it is I am purchasing and whether it is possible to buy elsewhere easily without surcharge.
- Depends on the purchase. For some cards, the extra value of included purchase insurance, or travel insurance, or extended warranty may be worth it.
- Depends on the circumstances.
- Depends on the amount of the sale.
- Depends on how much I wanted the product/service.
- Depends on whether the goods I wanted are conveniently available from another merchant.
- Depends if it is a really good deal or worth it.
- Depends – use another method or negotiate it away.
- Complain if they did not disclose if before consuming goods.
- Compare fee inclusive charges.
- Be flexible. All of the above.
- Any one of the above options, depending on the final cost of the product including surcharge.

"Other" responses for **Table 25**:

- Too much leeway for fraud – standardise fees.
- Too confusing to have different fees for different cards maybe retailers should not accept, particular cards if they are not prepared to wear the transaction cost.
- They shouldn't apply surcharges for MasterCard/Visa.
- They should factor the surcharges into prices.
- They should build the fee into the price.
- The use of cards should be free to the merchant and buyer.
- The surcharge is just another way for the banks to generate additional rip off of bank customers.
- The merchant in many cases may need to recoup the insidious cost but the rates charged by the banks etc. are ridiculous.
- Surcharge be restricted to actual cost to retailer.
- Some transactions on a small commission basis might warrant a transaction fee. Otherwise, just build in into the cost of the product.
- Some cards such as Amex charge retailers large fees.
- Shops can compete but businesses like Telstra and Qantas also offer direct-deposit options.
- Prefer they don't charge any fees.
- Only Amex because of the high cost to the retailer.
- Not knowing the reasons for this, I don't know.
- My attitude varies with the size of the retailer.
- Many retailers do not accept my Amex card, so I use another card.
- In general, I would see the cost of a card transaction as part of the everyday costs to a merchant. We don't pay more on Sundays, in general, at shops the cost of labour is built in, so why not the cost of dealing with money?
- If the banks didn't charge the fees, the retailers wouldn't need to pass them on.
- I'm not sure. It's the retailers' decision.
- I wouldn't say I support it, but I can tolerate it if there are different charges being applied to the merchant.
- I would support it IF the shops HAVE to pay different fees for different cards. BUT this is a choice they make to ensure ease of payment and bring money to their business, so should they pass the fee on??
- I understand why, but think CC companies should standardise fees.
- I understand that Amex charges their retailers higher fees, but I don't like it.
- I think they load these costs into their margins anyway, so if I feel they are double-dipping.
- I only support it for Amex, as they are the only card I am consistently asked to pay surcharges on. Hopefully, this issue will result in less Amex purchases in which they, Amex will bring their charges more in-line with other credit cards.
- I know there are different charges to retailers for card types but I don't think they should charge at all.
- I don't think the banks should charge the retailers in the first place, they make plenty of money from the interest

TABLE 25: IF A RETAILER HAS DECIDED TO APPLY A SURCHARGE FOR CREDIT CARD PAYMENTS, HOW DO YOU FEEL ABOUT DIFFERENT SURCHARGES APPLYING FOR DIFFERENT TYPES OF CARDS, SUCH AS ONE FEE FOR AMEX, ANOTHER FOR VISA, ETC?	N	% OF RESPONDENTS
They shouldn't be applying any surcharges for card payments.	721	50.2
I support this, because shops have to pay different fees depending on what type of credit card I pay with.	518	36.1
I would prefer if the retailer had one fee for all types of credit cards	118	8.2
Other	46	3.2
Don't know	32	2.2
Total	1435	100

they charge their customers.

- I don't like it, but I do understand why they do it.
- I do support different fees depending on what the bank charges as opposed to the overall cost going onto the products or merchandise being sold… BUT I do struggle with WHY the banks are allowed to charge extra when we pay account fees and most or some people do pay interest on purchases..... so the first option with a big BUT to the banks.
- Don't mind if they pay different fees, but it might be in their interests not to apply fees at all.
- Don't care, as long as there is a method for free electronic payment.
- Different cards attract different surcharges because of the rewards attached.
- Credit cards are part of doing business – no surcharge should apply.
- At most they should only be able to recoup their cost.
- As Amex is a rip-off I don't own one of their cards.
- As above, surcharges should be allowed for in the price of the goods, and discounts offered if c/c not used, i.e. "The Good Guys".
- As above – I can understand why they may charge different amounts depending on their expenses, but disagree with surcharges being charged.

"Other" responses for **Table 26**:

- Without the actual costs to the merchant being displayed, it's hard to say what's fair. In any case, the notion that a cash payment costs the merchant 'nothing' is a fallacy!
- Whether its fair or not depends on what cost they are actually incurring.
- They should have a cash price and a visa card price advertised.
- The shop is losing customers due to lack of flexibility with payments.
- The shop is being ripped off by the BANKS.
- The shop is attempting to recover

TABLE 26: IMAGINE A SHOP HAS THE FOLLOWING SURCHARGES: 0.9% FOR VISA/MASTERCARD CREDIT CARDS, 1.9% FOR AMERICAN EXPRESS, NO FEE WHEN PAYING CASH OR EFTPOS. WHICH OF THE FOLLOWING DO YOU AGREE WITH MOST?	N	% OF RESPONDENTS
There should be no extra fee for cash or cards	726	50.6
This is generally a fair way to charge customers	436	30.4
The shop is ripping off customers (overcharging for credit card payments)	114	7.9
All credit cards should have the same fees	94	6.6
Other	65	4.5
TOTAL	**1435**	**100**

TABLE 27: WHICH OF THE FOLLOWING PAYMENT METHODS HAVE YOU USED IN THE PAST 12 MONTHS?	N	% OF 1435 RESPONDENTS
Bpay	1327	92.1
Pay anyone from your internet banking account	1057	73.4
Paypal	961	66.7
POLi	21	1.5
Paymate	10	0.7
NETELLER	32	2.2
Moneybookers	9	0.6
TOTAL (MULTIPLE RESPONSES ALLOWED)	**3417**	

some of its banking charges and do so fairly according to the varying levels of those costs.

- The rate has to be variable, as Amex charges more.
- The fee should only be the same as the merchant bank charges the retailer for a credit card transaction.
- The fee should be as required by the card with no margin for the shop. All card costs should be borne by the card entity.
- The banks are ripping off their customers including the shops.
- Surcharge on top of the bank's fee? Ripping the customers off.
- Sounds fine to me.
- Should not apply to debit cards.
- Shops wants to close the sale quickly, so they need to consider do they pay the cost or maybe lose the sale.
- Shop should factor card fees into their profit margin.
- Same fee for Visa/MasterCard credit cards, American Express etc. no fee when paying cash or EFTPOS.
- Pass on exact percentage each time.
- No surcharge, but only accept low merchant charged cards.
- No CC charge should be extra, it should be included in the shelf price.
- It's fair if the retailer is being charged by the bank.
- It is a cost of doing business and tax deductible for them.
- It depends on the amount necessary to recover the cost to the shop.
- If this accurately reflects the rates then fair enough.
- If business passing on charges is fair.
- I would be okay with this statement for small business; however, big business should be able to foot the bill themselves.
- I think as long as they advertise the fees clearly, then it is reasonable.
- I blame the banks for this rort.
- Given a (small/med) retailer pays for EFTPOS, I'm not sure why charges are only on credit cards.
- Fee set at cost of service for card transaction.
- Fair for cost-competitors, not fair for high-margin sales.
- Don't know, as I would use EFTPOS.
- Don't know.
- Do not know.
- Different fees charged by different credit card vendors.
- Depends on the amount the retailer is charged by its bank.
- Depends on impact on shop of form of payment.
- Customer service will show which shop survive.
- Could depend on the reward points the card gives.
- Charge in line with what it costs the shop for credit cards and no fee for cash or EFTPOS.
- Basic credit fees are part of business.
- Banks shouldn't charge shops.

APPENDIX III

CHOICE CREDIT CARD SURCHARGE DIARY - INSTRUCTIONS & METHODOLOGY

A diary of credit card activity was completed by 140 CHOICE members, tracking the incidence of credit card surcharges among consumers over two weeks.

CHOICE members were recruited via an online survey and required to keep a diary of their online and offline retail transactions for two weeks, and to note if a surcharge has been disclosed for using particular credit or debit cards.

They were asked to document their behaviour throughout each transaction and to report on their actions and reactions to each incident.

Participants were given the option of filling out the diary either in hard copy, or as an Excel spreadsheet.

a) Instructions to participants (electronic version)*see right p61*

b) Sample diary page for Completed Transactions

CREDIT CARD SURCHARGE DIARY

Member id: | email address

PAYMENTS MADE WITH CREDIT AND DEBIT CARDS

	Date of Transaction	Type of Establishment	Name of Establishment	Card Type	Where did you make the payment?	How much was the payment?
Example	11-Jul-10	Take Away/wFast Food	Pizza	Visa Credit	Telephone	$ 20.00
Payment 1						
Payment 2						
Payment 3						

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CHOICE CREDIT CARD SURCHARGE SURVEY - INSTRUCTIONS

Thank you for offering to participate in CHOICE's credit card surcharge diary research. Your participation is very important to us and the results will be used in a future CHOICE article. It will also help form a report commissioned by the NSW Office of Fair Trading on the charging of credit card surcharges.

Your survey responses are strictly confidential. The data from this research will be encrypted and stored on a secure server, with results to be grouped and reported in aggregate.

The instructions for filling in the 2 week diary are as follows:
For this diary we would like you to separate your credit card, debit card or EFTPOS transactions into 2 types. The first type is the **completed transactions** - these are transactions where you completed the payment without changing methods or cards for any reason. The second type is the **terminated or changed transactions** - these are transactions where you have either terminated the transaction or you have elected to change payment methods or the card used due to a surcharge being imposed.

1. Please fill in details of all of your completed credit, debit and EFTPOS card transactions in the worksheet labelled **"Completed Transactions".** Please enter all transactions regardless of whether a surcharge was paid or not (we also want to know which companies are not surcharging). Please enter one transaction per row. You may choose to enter the transactions on a daily or weekly basis, or at the end of the fortnight, whichever suits you.

2. Fill in the details of any terminated transactions or any transactions where you decided to change the payment method or card for the 2 week period in the sheet labelled **"Terminated Transactions".**

3. There are 2 types of answer boxes. The boxes with (please enter) require you to type an answer. For the remaining questions, click on the answer box and an arrow will appear, click on this arrow and it will reveal a drop down menu with options. Click on the option that is relevant to you. We have completed one payment as an example to show you how it works.

4. There is space to enter 60 completed transactions (payments made) and 30 terminated transactions (terminated payments). You may not need this many rows, so only complete the number of transactions you have experienced in the 2 week period and leave the remaining rows blank.

5. At the end of the 2 week period please email the excel sheet to us at **XXXXX** for data entry. **If at any time you wish to discontinue your involvement in this research please send in the information you have completed so far and let us know of your decision.**

6. If you have any questions about the survey procedures please email XXXXX. Alternatively, if your question is in relation to your CHOICE subscription please contact XXXXX.

Thank you for your participation.

Was there a surcharge for using this card?	What was the rate (% or $) of the surcharge (please enter)	Were you notified of the surcharge?	How were you notified of the surcharge?	Do you feel this notification was prominent enough?	When were you notified of the surcharge?	Do you feel the timing was adequate?	Any further comments? (please enter)
Yes (please continue)	$1	Only after asking Telephone	Online billing	No	Before payment	Yes	I had to ask about the fee and only then was I told

APPENDIX IV
CHOICE CREDIT CARD SURCHARGE DIARY - RESULTS

Key Points

Completed Transactions

- Overall, 7% of transactions that were completed by participants during the two-week period of record-keeping incurred a surcharge.
- While payments to telecommunication companies accounted for just 4% of all transactions, they comprised 23% of instances in which surcharges were noted. Similarly, only 3% of all completed transactions were for holiday travel, but this industry accounted for 13% of the surcharges recorded.
- In contrast, grocery purchases were the most common transaction overall, with 26% of all recorded transactions falling into this category. However, these purchases only accounted for 10% of surcharges.
- 45% of recorded surcharges came from online purchases, though this method accounted for only 17% of all completed transactions. 47% were incurred during in-person transactions and 8% during purchases completed over the telephone.
- In 12% of surcharging cases, customers did not recall being notified of the surcharge at all. Furthermore, in 26% of cases in which they were notified, they did not feel that the method of notification was prominent enough. This was true for 38% of transactions in which surcharge disclosure was via a printed bill, and for 30% of transactions in which disclosure was verbal.
- In 17% of surcharging incidences in which respondents were notified of the surcharge, customers felt the timing of the notification was inadequate. In 13% of cases in which notification occurred, the customer had been notified either while the payment was processing, or after payment confirmation.

Terminated Transactions

- Respondents recorded a total of 117 transactions that were terminated (did not proceed through to completion with the originally intended method of payment). In 33% of cases, the transaction was terminated because the customer was presented with a surcharge.
- Of those who terminated the transaction because of a surcharge, most (64%) proceeded by paying with a different credit card.

a) Data tables for ALL COMPLETED TRANSACTIONS (both those incurring a surcharge and those not)
In all cases, percentages are based on the total number of valid responses to the question (missing responses were excluded).

TABLE 1: TYPE OF PURCHASE – ALL COMPLETED TRANSACTIONS	N	% OF CASES
Groceries	626	26.2
Petrol	209	8.8
Health/Medical Care	194	8.1
Clothing/Footwear	146	6.1
Restaurant/Formal Dining	129	5.4
Sporting/Entertainment	106	4.4
Telephone/Mobiles/Internet	92	3.9
Holiday Travel	72	3.0
Utilities	61	2.6
Take Away/Fast Food	54	2.3
Insurance	49	2.1
Transport	49	2.1
Appliances	37	1.6
Education/Childcare	32	1.3
Taxi/Transport	28	1.2
None of the Above	502	21.0
TOTAL	**2386**	**100**

TABLE 2: CARD TYPE – ALL COMPLETED TRANSACTIONS	N	% OF CASES
Visa Credit	859	35.9
American Express	653	27.3
MasterCard Credit	586	24.5
Visa Debit	135	5.6
EFTPOS	134	5.6
MasterCard Debit	16	0.7
Diners Club	7	0.3
TOTAL	**2390**	**100**

TABLE 3: HOW DID YOU MAKE THE PAYMENT? *(E.G. IN PERSON, ONLINE) – ALL COMPLETED TRANSACTIONS*	N	% OF CASES
In person	1856	77.5
Internet	416	17.4
Telephone	102	4.3
Regular Mail	20	.8
TOTAL	**2394**	**100**

TABLE 4: WAS THERE A SURCHARGE FOR USING THIS CARD? – *ALL COMPLETED TRANSACTIONS*	N	% OF CASES
Yes (please continue)	169	7.0
No (end this line here)	2220	91.9
Don't know (end this line here)	26	1.1
TOTAL	**2415**	**100**

TABLE 4A: SURCHARGE BY INDUSTRY – ALL COMPLETED TRANSACTIONS

WAS THERE A SURCHARGE?

Industry	Yes (industry % of surcharges)	No (industry % of no surcharges)	Don't know (industry % unsure)	Total (industry % of all transactions)
Telephone/Mobiles/Internet	22.6	2.3	11.5	3.9
Holiday Travel	13.1	2.2	3.8	3.0
Groceries	10.1	27.6	11.5	26.2
Transport	8.3	1.5	7.7	2.1
Utilities	7.7	2.2		2.6
Taxi/Transport	6.0	0.8		1.2
Restaurant/Formal Dining	4.2	5.5	7.7	5.4
Take Away/Fast Food	3.6	2.1	7.7	2.3
Petrol	3.0	9.3	3.8	8.8
Education/Childcare	2.4	1.3		1.3
Health/Medical Care	1.8	8.7	3.8	8.1
Appliances	1.2	1.6	3.8	1.6
Sporting/Entertainment	1.2	4.6	15.4	4.4
Clothing/Footwear	0.6	6.6	3.8	6.1
Insurance	0.6	2.1	3.8	2.1
None of the Above	13.7	21.7	15.4	21.0
TOTAL	**100**	**100**	**100**	**100**

Industries in which the percentage of transactions incurring a surcharge was higher than its percentage of overall transactions are in blue.

TABLE 4B: SURCHARGE BY CARD – ALL COMPLETED TRANSACTIONS

WAS THERE A SURCHARGE FOR USING THIS CARD?

Card	Yes (card % of surcharges)	No (card % of no surcharges)	Don't know (card % of unsure)	Overall (card % of all transactions)
Visa Credit	35.7	35.7	57.7	35.9
American Express	35.1	27.0	7.7	27.3
MasterCard Credit	23.8	24.5	30.8	24.5
EFTPOS	3.6	5.8	3.8	5.6
Visa Debit	1.8	6.0	0	5.6
MasterCard Debit	0	0.7	0	0.7
Diners Club	0	0.3	0	0.3
TOTAL	**100**	**100**	**100**	**100**

Cards for which the percentage of transactions incurring a surcharge was higher than its percentage of overall transactions are in blue.

TABLE 4C: SURCHARGE BY METHOD OF PURCHASE – ALL COMPLETED TRANSACTIONS

WAS THERE A SURCHARGE?

Method of Purchase	Yes (method % of surcharges)	No (method % of surcharges)	Don't know (method % of surcharges)	Overall
In person	47.0	80.3	42.3	77.5
Internet	44.6	15.1	34.6	17.4
Telephone	8.3	3.9	11.5	4.3
Regular Mail	0	0.8	11.5	0.8
TOTAL	**100**	**100**	**100**	**100**

Methods for which the percentage of transactions incurring a surcharge was higher than its percentage of overall transactions are in blue.

b)Data tables for COMPLETED TRANSACTIONS incurring a surcharge only

In all cases, percentages are based on the total number of participants validly responding to the question (missing responses were excluded).

TABLE 5: TYPE OF PURCHASE – COMPLETED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
Telephone/Mobiles/Internet	38	22.6
Holiday Travel	22	13.1
Groceries	17	10.1
Transport	14	8.3
Utilities	13	7.7
Taxi/Transport	10	6.0
Restaurant/Formal Dining	7	4.2
Take Away/Fast Food	6	3.6
Petrol	5	3.0
Education/Childcare	4	2.4
Health/Medical Care	3	1.8
Appliances	2	1.2
Sporting/Entertainment	2	1.2
Clothing/Footwear	1	.6
Insurance	1	.6
None of the Above	23	13.7
TOTAL	**168**	**100**

TABLE 6: CARD TYPE – COMPLETED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
Visa Credit	60	35.7
American Express	59	35.1
MasterCard Credit	40	23.8
EFTPOS	6	3.6
Visa Debit	3	1.8
TOTAL	**168**	**100**

TABLE 7: HOW DID YOU MAKE THE PAYMENT? (E.G. IN PERSON, ONLINE) – COMPLETED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
In person	79	47.0
Internet	75	44.6
Telephone	14	8.3
TOTAL	**168**	**100**

TABLE 8: WHAT WAS THE AMOUNT OF THE SURCHARGE? – COMPLETED SURCHARGE TRANSACTIONS ONLY	MEAN*	N	STD. DEVIATION
Groceries	1%	15	.0041
Holiday Travel	3%	22	.0220
Taxi/Transport *(includes general Transport category)*	5%	23	.0387
Telephone/Mobiles/Internet	1%	33	.0076
Other ^	2%	53	.0162
TOTAL	**3%**	**146**	**.0247**

** Note that values represent participants' memory of the surcharge only and are dependent on their accurate recollection and recording of transaction. Respondents were not required to refer to, or to provide, documentation of the value.*

^ Only industries with more than 10 responses for this question are shown – remaining categories have been collapsed into the "Other" category.

TABLE 9: WERE YOU NOTIFIED OF THE SURCHARGE? (IN AMOUNT OR PERCENT) – COMPLETED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
Yes	137	84.0
No	20	12.3
Only after asking	2	1.2
Don't remember	4	2.5
TOTAL	**163**	**100**

TABLE 10: HOW WERE YOU NOTIFIED OF THE SURCHARGE? – COMPLETED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
Verbal	40	29.2
Signage	17	12.4
Text (printed bill)	32	23.4
Text (online payment)	38	27.7
Other (explain in comments)	10	7.3
TOTAL	**137**	**100**

** of those who said they had been notified or were notified after asking.*

TABLE 11: DO YOU FEEL THIS METHOD WAS PROMINENT ENOUGH? – COMPLETED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
Yes	99	72.8
No	35	25.7
N/A	2	1.5
TOTAL	**136**	**100**

** of those who said they had been notified or were notified after asking.*

TABLE 11A: PROMINENCE BY METHOD OF DISCLOSURE – COMPLETED SURCHARGE TRANSACTIONS ONLY

DO YOU FEEL THIS METHOD WAS PROMINENT ENOUGH?				
	Yes	No	N/A	Total %
How were you notified of the surcharge?	(% of method)	(% of method)	(% of method)	
Verbal	70	30	0	100
Signage	88	12	0	100
Text (printed bill)	56	38	6	100
Text (online payment)	78	22	0	100
Other (explain in comments)	90	10	0	100
N/A	73	26	1	100
TOTAL	**70**	**30**	**0**	**100**

** of those who said they had been notified or were notified after asking.*

TABLE 12: WHEN WERE YOU NOTIFIED OF THE SURCHARGE? – COMPLETED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
Before payment	116	86.6
While payment was processing	11	8.2
After payment confirmation	7	5.2
TOTAL	**134**	**100**

** of those who said they had been notified or were notified after asking.*

TABLE 13: DO YOU FEEL THE TIMING WAS ADEQUATE? – COMPLETED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
Yes	106	80.3
No	23	17.4
N/A	3	2.3
TOTAL	**132**	**100**

** of those who said they had been notified or were notified after asking.*

c) Data tables for ALL TERMINATED TRANSACTIONS

TABLE 14: TYPE OF PURCHASE - ALL TERMINATED TRANSACTIONS	N	% OF CASES
Groceries	18	15.9
Health/Medical Care	17	15.0
Restaurant/Formal Dining	11	9.7
Utilities	10	8.8
Holiday Travel	8	7.1
Telephone/Mobiles/Internet	6	5.3
Appliances	5	4.4
Insurance	3	2.7
Petrol	3	2.7
Sporting/Entertainment	3	2.7
Clothing/Footwear	2	1.8
Transport	2	1.8
Education/Childcare	1	0.9
None of the Above	24	21.2
Not specified	4	3.5
TOTAL	**117**	**100**

TABLE 15: WAS THERE A SURCHARGE FOR USING THIS CARD? – ALL TERMINATED TRANSACTIONS	N	% OF CASES
Yes (please continue)	41	35.0
No (end this line here)	59	50.4
Don't know (end this line here)	10	8.5
Not specified	7	6.0
TOTAL	**117**	**100**

TABLE 16: WHY DID YOU TERMINATE THE TRANSACTION? - ALL TERMINATED TRANSACTIONS	N	% OF CASES
Surcharge	39	33.3
Other	56	47.9
Not specified	22	18.8
TOTAL	**117**	**100**

d) Data tables for TERMINATED TRANSACTIONS incurring a surcharge only

In all cases, percentages are based on the total number of participants validly responding to the question (missing responses were excluded).

TABLE 17: INTENDED CARD TYPE – TERMINATED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
MasterCard Credit	6	14.6
Visa Credit	5	12.2
American Express	30	73.2
TOTAL	**41**	**100**

TABLE 18: HOW DID YOU INTEND TO MAKE THE PAYMENT? – TERMINATED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
In person	23	57.5
Internet	17	42.5
TOTAL	**40**	**100**

TABLE 19: WERE YOU NOTIFIED OF THE SURCHARGE? – TERMINATED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
Yes	34	87.2
No	1	2.6
Only after asking	4	10.3
TOTAL	**39**	**100.0**

TABLE 20: HOW WERE YOU NOTIFIED OF THE SURCHARGE? – TERMINATED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES*
Verbal	9	32.1
Signage	6	21.4
Text (printed bill)	5	17.9
Text (online payment)	7	25.0
Other (explain in comments)	1	3.6
Total	28	100.0

** of those who said they had been notified or were notified after asking.*

TABLE 21: DO YOU FEEL THIS METHOD WAS PROMINENT ENOUGH? – TERMINATED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES*
Yes	28	73.7
No	9	23.7
N/A	1	2.6
Total	38	100.0

** of those who said they had been notified or were notified after asking.*

TABLE 22: WHEN WERE YOU NOTIFIED OF THE SURCHARGE? – TERMINATED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES*
Before payment	37	97.4
While payment was processing	1	2.6
TOTAL	**38**	**100**

** of those who said they had been notified or were notified after asking.*

TABLE 23: DO YOU FEEL THE TIMING WAS ADEQUATE? – TERMINATED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES*
Yes	31	83.8
No	6	16.2
TOTAL	**37**	**100**

** of those who said they had been notified or were notified after asking.*

e) Data tables for TERMINATED TRANSACTIONS terminated because of a surcharge only

TABLE 24: DID YOU CHANGE PAYMENT METHODS AND IF SO WHAT DID YOU CHANGE TO? – TERMINATED SURCHARGE TRANSACTIONS ONLY	N	% OF CASES
Yes - Different credit card	23	63.9
Yes - ATM card	3	8.3
Yes - Cash	2	5.6
Yes - Other	6	16.7
No - Cancelled transaction	2	5.6
TOTAL	**36**	**100**

f) Open-ended comments for ALL COMPLETED TRANSACTIONS

- A sign displays that a surcharge may be charged, but I am not charged.
- A sign displays that a surcharge may be charged, but I am not charged.
- All cards have fees.
- Automatic payment.
- Automatic weekly payment. Didn't know about surcharge when setting up but was on invoice. Will be changing to direct debit.
- Blamed Amex.
- Blamed the federal gov't.
- BPay charge by my credit union.
- Can BPay from a savings account to avoid the charge, but not from a credit card.
- Check-out staff informed me and then the EFTPOS terminal flashed with "accept surcharge" even before I could confirm payment amount.
- Clearly able to choose before processing starts.
- Computer parts: surcharge noted in pricelists, online and verbally before transaction: surcharge seems to be typical for independent computer retailers; I chose to pay because of the insurance I get with the card in case of damage/loss of items.
- Could have been advised of surcharge before payment process started.
- Credit cards handy if you have to make unexpected transactions.
- Direct debit from my credit card.
- Excessive surcharge.
- Fee is on next bill and you will have to keep track so not overcharged.
- First advised several months ago when surcharge was introduced. Advice is printed on every bill.
- Had no idea until invoice/receipt received in mail.
- Had no idea until payment completed.
- Hate paying for using credit card when they get their money on time.
- I do not feel it is warranted.
- I don't have a choice, really.
- I feel the fee is unjustified.
- I get notified every time.
- I had organised the holiday via email, but it had to be paid the same day, I could have gone into their office to pay cash, but I would have lost time from work.
- I hate this one as there is a surcharge, regardless of what form of payment you select.
- I was aware that Aldi charged a surcharge and I accepted that, even though I was not informed.
- I would have paid cash had I known.
- If I used Amex, the conversion fee would be higher.
- It should be printed on the bill.
- Just a total rip-off by Cabcharge.
- Like to use Amex for points, but have to sign for each trans (not pin).
- Many firms charge for Amex but not for M/Card -so you use M/card in these circumstances.
- Misleading pricing ¬– everyone pays hotel bills by credit card, so why not include in the room rate?
- My thoughts are that these type of online transactions to secure bookings and avoid queuing at the venue and credit card surcharges go hand in hand.
- No big worry.
- No choice other than to pay by Credit card-wanted to use Amex.
- No competition at airport.
- No direct credit card fee, but you pay extra to pay by the month.
- No notification.
- Non-direct debit admin fee and BPay charge by my credit union.
- Not warranted.
- Noticed difference between bill and CC transaction amount, then asked.
- Only applied to transaction <$10.
- Only other option of paying is direct deposit.
- Only when I noticed that the price was $1 more per ticket did I go back and find the surcharge mentioned -- but the amount was not mentioned.

- Purchase regularly at this location. No fees.
- Question whether I'll go back.
- Safeway does not offer credit choice anymore if you have a credit/debit card.
- Saw variation in total on my Visa account.
- Shopping here regularly I now know of the charge, so it is my choice to use credit.
- Should have been told immediately.
- Should not be warranted.
- Small notation on bill about surcharge – fee is added to next bill!!
- Stated was that fare included surcharges and then next line it then added that credit card would attract a fee of $7.70. So I feel it was deceptive.
- Surcharge to be stated before fare booked.
- Telstra rip-off for online payment.
- The bill stated that a credit card fee (as a % of the amount paid) "may" be charged, and to refer to the company's website for current processing fees. The only mention of a credit card fee on the website was only shown under the "POSTbillpay" section.
- The only opportunity to avoid the surcharge is by using the 'POLI' system. Unfortunately, this only works on Windows computers, not on Macs.
- There is no choice but to pay the charge.
- There was a surcharge for Amex and Diners – just a sign on a bowser.
- They changed their policy a few months ago and I didn't know until I saw the charge on my next bill.
- They offer alternatives.
- This fee is not charged at Caltex Goulburn but the cost of petrol is higher.
- This fee was excessive.
- This is an automatic debit. I was advised of the fee before it was introduced.
- This is small local shop and I support the surcharge
- Told before swiping the CC surcharge, no surcharge on EFT or cash.
- Totally ripped off in a small town with only one drycleaner. Oh, I wish for another so competition starts.
- Used MasterCard (lower charge).
- Used Star card as there was a charge on all cards.
- Usually the operator mentions before processing the card.
- Was not advised of fee when boss away, am not advised to pay fee.
- Was not advised of a fee.
- Was told some time ago that this would occur.
- Was told that it was because of bank fees placed on company.
- We only have credit on the card no debit facility.
- Will only accept M/card or Visa

g) Open-ended comments for ALL TERMINATED TRANSACTIONS

- AGL did not take Amex.
- Amex not accepted.
- AMEX not accepted.
- Amex not accepted – Visa used.
- AMEX wasn't accepted.
- Card not accepted.
- Card not accepted.
- Chemist advised. Amex too expensive.
- Chose MasterCard that had no surcharge.
- Dan Murphy's/Woolworths no longer take 'credit' as an option.
- Do not take Amex.
- Don't accept Amex.
- Don't usually carry a lot of cash, so was annoying and would have spent more using a card.
- EFT from savings account instead.
- I am disappointed with Woolworths for not allowing credit cards.
- I asked whether they took Amex because many don't. I was then informed there would be 2% surcharge, so I changed to MasterCard on which there was no surcharge.
- I don't think the amount reflects the correct costs.
- I was happy enough to use another card
- Inconvenience for having to use alternate method of payment.
- It says "may incur a processing fee", so had to check website to confirm.
- It's disappointing when a govt puts a surcharge on a bill.
- No Amex.
- No option to pay Amex online via ANZ.
- Not only was there a surcharge, but compulsory Premium Reduction Waver Insurance (at an extra $21/day), if you pay with Amex. Surely this is not legal!
- Not surprised, as have had similar experiences.
- Surcharge excessive (would have accepted 1%).
- They are getting Amex soon.
- This is the first time they've charged a fee.
- Used Visa.
- Visa credit had a surcharge of 2%.
- Visa used.
- Would not take Amex because of their charge.

EXHIBIT H

A Variation to the Surcharging Standards: A Consultation Document

DECEMBER 2011

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1. Introduction

The Bank initiated a public consultation on potential changes to the Standards relating to merchant surcharging of MasterCard and Visa credit and Visa Debit transactions in June. The Standards, which came into force in 2003 and 2007 respectively, ensure that card schemes cannot prevent merchants from applying a fee or surcharge for the acceptance of the cards of those schemes. While the Standards currently prohibit any scheme or participant restrictions on merchant surcharging, the proposals outlined in June would give card schemes the capacity to limit the level of surcharges, so that merchants could not recover an amount significantly in excess of the cost of acceptance. This would represent a relaxation of the Standards, but would continue to emphasise the right of merchants to recover fully their card acceptance costs, something the Bank believes is critical to the efficiency of the Australian payments system.

In light of the views expressed in consultation and developments in surcharging practices in recent years, the Payments System Board considers that there is a case for varying the Standards, by allowing the schemes to limit surcharges to a reasonable cost of acceptance, while at the same time ensuring the schemes' rules cannot prevent full cost recovery by merchants. The Board believes that the proposed variation is in the public interest and would improve the efficiency of the payments system by providing better price signals to cardholders and increasing the level of comfort with surcharging among both consumers and merchants.

This document outlines the views presented during the consultation process, presents some additional relevant information obtained by the Bank, and sets out the conclusions reached by the Payments System Board as a result. In light of the Board's conclusions, it seeks views from interested parties on the specific form of the variation to the Standards proposed by the Board.

Section 2 of the document provides background on surcharging practices in Australia and the current Standards. Section 3 discusses the various views from consultation and the Board's consideration of those views, while Section 4 sets out the various options for imposing some limit on surcharges, including the Board's preferred approach. Section 5 discusses the elements of the proposed variation to the Standards and Section 6 provides details of the next steps in the process.

2. Background

In 2003, the Reserve Bank began implementing reforms to the credit and debit card systems in Australia. These reforms are intended to improve the efficiency of the payments system and to promote competition. As part of these reforms, the Payments System Board imposed standards that required the removal of the schemes' no-surcharge rules that had previously prevented merchants from surcharging for credit card and scheme debit card transactions: *Standard No. 2, Merchant Pricing for Credit Card Purchases;* and *The 'Honour All Cards' Rule in the Visa Debit and the Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System.* These Standards became effective from 1 January 2003 for the MasterCard and Visa credit card systems and from 1 January 2007 for the Visa Debit system. American Express, Diners Club and MasterCard (for the Debit MasterCard system) provided voluntary undertakings to remove their equivalent rules.

The removal of the no-surcharge rules was expected to have a number of benefits for the efficiency of the payments system. First, it was expected to improve price signals to cardholders about the relative costs of different payment methods. This was clearly stated in the Gazette notice that accompanied the first of the Standards:

> … the price signals facing consumers choosing between different payment instruments would lead to a more efficient allocation of resources in the payments system, in the public interest.[1]

Second, the ability to surcharge provides a negotiating tool for merchants who might use the threat of surcharging to negotiate lower fees. Third, with the ability to surcharge, merchants no longer need to build the costs of accepting card payments into the overall prices of their goods and services; hence, customers who choose alternative payment methods are no longer subsidising credit card users. The Payments System Board is satisfied that surcharging has been successful in achieving these benefits and by reviewing the Standards it is seeking to ensure that this continues to be the case.

The Standards

The prohibition on no-surcharge rules is stated in the Standards as:

> Neither the rules of the Scheme nor any participant in the Scheme shall prohibit a merchant from charging a credit cardholder any fee or surcharge for a credit card transaction.[2]

1 Gazette notice to *Standard No. 2, Merchant Pricing for Credit Card Purchases.*

2 Paragraph 8 of *Standard No. 2, Merchant Pricing for Credit Card Purchases*. Paragraph 8 of the Standard titled *The 'Honour All Cards' Rule in the Visa Debit and the Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System* is worded similarly.

This wording is quite open-ended; it provides merchants the freedom to set surcharges without constraint. That is, there is little that the card schemes can do to directly restrain surcharges, even where they are clearly well above acceptance costs.

The Board was of the view that this level of discretion for merchants was appropriate at the time the Standards were first put in place. The environment then was one where surcharging was thought likely to emerge slowly and was, therefore, unlikely to be used to recover more than the cost of card acceptance. In part, this was because there had been a strong expectation by cardholders, built up over many years, that surcharges would not apply.

Nonetheless, paragraph 9 of each of the Standards expressly provides that agreements between merchants and acquirers to limit the size of any surcharge to the fees incurred by the merchant would not be inconsistent with the Standards:

> Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a credit cardholder will be limited to the fees incurred by the merchant in respect of a credit card transaction.[3]

The intention was that this provision would provide merchants with a tool to bargain down merchant service fees.

Together, these elements of the Standards imply an expectation that surcharges would generally be in line with acceptance costs, but that it would be open to merchants to apply higher surcharges and equally open to acquirers to attempt to bargain surcharges down to the fees incurred. It has become apparent over time, however, that paragraph 9 – the provision allowing agreement to limit surcharges to the fees incurred – has had limited use, and has therefore been ineffective. This is because acquirers for the four-party card schemes (as opposed to the schemes themselves) do not have an incentive to limit merchant surcharges in exchange for reducing merchant service fees.

The Current Review of the No-surcharge Standards

Despite the Board's view that the surcharging reforms have been successful and have provided significant public benefit, the efficient allocation of resources relies on the effectiveness of the price mechanism – in this case, the extent to which surcharging practices reflect the cost of acceptance of alternative payment methods. Over the past few years the Board has become concerned that in some instances surcharging has developed in a way that potentially compromises price signals and reduces the effectiveness of the reforms. In particular, the Board has been concerned about cases where surcharges appear to be well in excess of acceptance costs (sometimes referred to as 'excessive' surcharging) and an apparent increased tendency for surcharges to be 'blended' across card schemes (often at a rate above the cost of acceptance of the lower-cost card). These practices are inefficient because they can cause consumers to underutilise a particular payment method. For instance, when the costs of card acceptance differ across card schemes and the merchant applies a blended surcharge, the consumer may have an incentive to use the higher-cost card more intensively than would be the case if the surcharges reflected the cost of acceptance for each card product. This is particularly the case if higher merchant fees are being used to fund more generous reward schemes. If the blended surcharge is at a level above the cost of acceptance of the lower-cost card, the lower-cost card is also likely to be underutilised

3 *Standard No. 2, Merchant Pricing for Credit Card Purchases*. Paragraph 9 of the Standard titled *The 'Honour All Cards' Rule in the Visa Debit and the Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System* is similarly worded.

relative to other payment methods, not just the higher-cost card. A potential flow-on effect from this is that such practices dull the incentive for the card schemes to compete down their effective costs to merchants.

The Board considered some of these issues as part of the 2007/08 review of the card payment reforms. It concluded that the Standards had provided substantial benefits through the improvement of price signals to cardholders, but nonetheless considered whether there was a case to modify the Standards to allow scheme rules to limit the size of any surcharge imposed by merchants. At that time, the Board assessed that cases of merchants imposing high surcharges appeared to be isolated, and the merchants doing so tended to be those with market power. It was considered that the isolated cases provided insufficient grounds to allow the schemes to impose restrictions on all merchants.

As noted in the June 2011 Consultation Document, the Board now believes that these cases are more widespread and has therefore sought views on modification of the Standards.

3. Consultation

The Consultation Process

At its May 2011 meeting, the Payments System Board decided to conduct a public consultation on potential modifications to the Standards. The Bank released the document, *Review of Card Surcharging: A Consultation Document,* in June 2011, seeking the views of interested parties on seven interrelated questions:

i. Is there a case for modifying the Standards to allow schemes to limit surcharges?

ii. Is a surcharge cap best implemented by the Board setting a transparent and specific permissible cap that is specified in the Standards, and may then be imposed in scheme rules? Or, should the Standards allow scheme rules to limit surcharges to an amount that is either reasonably related, or equal, to each particular merchant's cost of card acceptance?

iii. Should there be some level of tolerance allowed around any surcharge cap?

iv. Is the merchant service fee an appropriate measure of the cost of card acceptance (that can be applied consistently across all merchants)?

v. Should the no-surcharge Standards clarify that, notwithstanding any surcharging cap, scheme rules cannot prohibit merchants from applying a surcharge that is either a blended rate for each card scheme or the cost of accepting each card *within* a card scheme? Are there alternative ways to allow for differential surcharging?

vi. Should the no-surcharge Standards require acquirers to pass on information about the merchant's cost of acceptance for each different card type if it is requested by the merchant? And, for those on 'interchange-plus' pricing, should the no-surcharge Standards require acquirers to pass on information about the weighted-average merchant service fee if it is requested by the merchant?

vii. Is there a case for disclosure of the cost of card acceptance by merchants? Or, would it be sufficient for the Bank to collect and publish more detailed data on merchant service fees, such as the range and average of merchant service fees across merchant categories for each card scheme?

In total, 51 submissions were received, including from financial institutions, merchants, card schemes, a consumer group and private citizens, most of which are published on the Reserve Bank's website. Around 25 parties took up the invitation to discuss their submissions with the Bank. The main points made in response to the questions in the Consultation Document are discussed below.

Issues Raised During Consultation

Is there a case to modify the Standards to limit surcharges?

A number of submissions from merchants and financial institutions suggested that the Bank had not demonstrated that there is sufficient market failure to justify further modification to the Standards. These submissions suggested that excessive surcharging remains limited to a few merchants with market power. Some of these submissions questioned the veracity of the survey data presented by the Bank in its Consultation Document, arguing that both the gap between average surcharges and merchant service fees, and the rising trend in surcharge levels shown by the data might not be representative. Given that many of these submissions suggested that the cases of excessive surcharging that exist are a reflection of anti-competitive behaviour, they proposed that the issues are best investigated by the Australian Competition and Consumer Commission (ACCC) or the Australian Securities and Investment Commission (ASIC). Other suggestions put forward in place of regulatory intervention were self-regulatory or market-based solutions, such as industry codes. Some submissions also expressed a view that modifying the Standards to allow for limits on surcharges may have limited effect in certain industries or for certain transaction types.

By contrast, submissions from the four-party card schemes, a consumer group, an acquirer and some private citizens expressed support for a limit to be placed on surcharges, agreeing that excessive surcharging is becoming more commonplace, potentially undermining the Bank's previous reforms. Many submissions also raised concerns about surcharging for card transactions where there are few genuine payment alternatives, such as for online purchases. Several parties suggested that merchants that only accept card payments (or do not offer genuine alternatives) should not be allowed to surcharge.

Implementation of a cap on surcharges

The Consultation Document proposed two potential modifications to allow for some limit to be imposed on surcharges. These were:

- the Board setting a transparent and specific permissible cap in the Standards that could be adopted in scheme rules
- the Standards allowing scheme rules to limit surcharges to an amount that is either reasonably related, or equal, to each particular merchant's cost of card acceptance.

Nearly all submissions were opposed to the Bank setting a specific fixed cap, arguing that such a cap would inevitably be too high in many circumstances and too low in others. Many also saw potential for a cap of this type to become the norm for surcharging, even for merchants that have lower acceptance costs and might otherwise have adopted a lower or even no surcharge. Instead, most submissions preferred surcharges to be limited to an amount that is 'reasonably related' to the cost of acceptance. There were divergent views, however, about what constitutes the cost of acceptance. A number of submissions suggested that the merchant service fee is the most appropriate indicator of costs, although the majority of submissions indicated that the merchant service fee does not adequately reflect all the costs of accepting card payments. For example, other related costs of accepting card payments that were noted included: charge backs; terminal rental fees; fraud compliance; gateway fees; and terminal modifications. Accordingly, many submissions indicated that, depending on how a cap is implemented, there should be some level of tolerance to capture other related costs of card acceptance.

Most submissions were broadly in support of merchants choosing how to apply surcharges and the majority of submissions were supportive of merchants being able to differentially surcharge *across* card schemes. In particular, the four-party schemes were opposed to merchants applying blended surcharges across schemes where a price differential exists, citing the significant differences in the cost of card acceptance between different card schemes. However, one merchant argued that blended surcharging is a legitimate strategy employed by merchants, with the current arrangements reflecting competition between the card schemes. During consultation, some parties also suggested that the Bank should not promote or restrict any specific model of surcharging.

By contrast, many submissions questioned the benefit of clarifying the ability of merchants to surcharge differentially *within* a card scheme. In particular, some submissions pointed out that differentiating between card types within a scheme in real time would be a difficult technical challenge, both at the point of sale and for card-not-present transactions. Other submissions, including merchants, also cited the confusion for consumers that surcharging beyond a few different rates would cause.

Views on the most appropriate body to implement, monitor and enforce a cap on surcharges were mixed. While a number of submissions agreed that the card schemes are best placed to implement and monitor such rules, others recommended that another body, such as the Bank, should take on the role. Other parties interpreted the issues raised in the Consultation Document as relating to consumer protection and therefore suggested that the ACCC and ASIC should be involved in developing a solution.

Disclosure of merchant service fees by acquirers and merchants

A number of submissions supported measures to require acquirers to provide better information to merchants about their costs of card acceptance, though several submissions indicated that merchants are already able to obtain this information if they request it. By contrast, nearly all submissions were strongly opposed to any requirements for disclosure of merchant service fees at the point of sale, citing the fact that merchant-acquirer agreements are subject to commercial confidentiality. A related argument was that the merchant service fee might form part of a wider set of prices offered by a financial institution to merchants, so disclosing only one price might not provide an accurate picture of the competitive landscape. Some also argued that disclosure of individual merchant service fees would make acquirers reluctant to negotiate fees with merchants.

Finally, the parties that commented were generally supportive of the Bank collecting and publishing more detailed data on merchant service fees. Suggestions on the additional data that could be published included: scheme debit and eftpos merchant service fees; merchant service fees across different industries; and data on surcharge amounts.

Discussion

The Board has carefully considered the views put to it during consultation. It acknowledges in particular that the views were mixed as to whether excessive surcharging has become sufficiently widespread to warrant modification of the Standards. While the Bank believes that the costs of modifying the Standards would be relatively low and therefore that a modification could provide a net public benefit even if the incidence of excessive surcharging were relatively low, it has nonetheless sought additional data to those presented in the June 2011 Consultation Document in order to aid this discussion. Specifically, it has obtained confidential data from several acquirers on the distribution of merchant service fees for credit cards across their entire merchant books. This distributional information provides an indication of the different merchant service fees paid by a range of merchants and is therefore a richer dataset than the average merchant service fee data that the Bank regularly obtains and publishes. The Bank has also identified a cross-section of advertised surcharges in a range of industries. Based on this information, observed surcharging practices do not appear to reflect the distribution of merchant service fees. For instance, it is not uncommon to find merchants of many different types applying *ad valorem* surcharges at levels that are significantly greater than would be implied by the distribution of merchant service fees.[4]

The Board also carefully considered the views expressed about whether the Reserve Bank is the appropriate body to respond to concerns about the surcharging practices discussed above. It is important to note that the Board's concerns relate to the efficiency of the payments system, for which the Board has a clear mandate, not to consumer protection. The Board's concerns therefore, reflect a judgement that these surcharging practices are potentially distorting price signals and payment patterns and that addressing them will help to ensure that the Standards continue to achieve their original aims. In light of this, the Board recognises that a modification to the Standards to allow scheme rules to impose some limit on surcharges may not address the public's concerns about all surcharging practices. A modification will, however, address inefficiencies that have arisen, in line with the Board's legislative mandate.

The Board also notes the views expressed by some that it should not be the card schemes that impose limits on surcharges. The Board, however, believes that this is the most practical approach to addressing the issue, given that the proposed amendment relaxes the Standards to simply restore some element of the powers that the schemes previously held through scheme rules. The Reserve Bank does not itself have powers over merchant pricing.

It is clear that there is some concern among consumers that surcharges are being imposed in circumstances where they feel they have few alternatives to using a scheme card. This is often the case for online payments, particularly where there is a desire for the payment to be confirmed in real time. Certain industries where some form of bond or deposit is required, such as the car rental and hotel industries, also rely disproportionately on scheme card payments. This issue is related to the *Australian Consumer Law,* which requires that any fee or charge (including a card surcharge) that is unavoidable be incorporated into the advertised price. However, in the cases that have been brought to the Bank's attention, at least one alternative payment method is available without a surcharge. The Bank has observed that in some cases the alternative (non-surcharged) payment methods offered are relatively uncommon or not available to customers of many financial institutions. Nonetheless, the Bank does not believe that preventing surcharging for online payments, as some have suggested, would lead to efficient outcomes. For instance, this would inhibit the ability of any emerging payment system with lower acceptance costs to compete, given that those lower costs could not be signalled to consumers if surcharging were prevented. The Bank would nonetheless like to see merchants that surcharge scheme products offer genuine payment alternatives.

The consultation also touched on the potential for greater differential surcharging within schemes, for instance applying a higher surcharge for premium cards than standard cards. While such a practice could potentially serve to constrain the high interchange fees that are evident in some card categories, the Bank acknowledges

4 For example, *ad valorem* surcharges above the level of merchant service fees that are paid by the vast majority of merchants are common among merchants in the following industries: accommodation and travel; entertainment, leisure and recreation; hospitality; professional services; rental, hiring and transport; restaurants, dining and takeaway; retail; taxis; and telecommunications and internet. Apart from the airline industry, flat-fee surcharging is not common. The distribution of the Bank's cross-section of surcharges is consistent with distributional data on surcharges provided to the Bank confidentially by East & Partners. The average surcharge for MasterCard and Visa credit card transactions from the cross-section of advertised surcharges collected by the Bank is also in line with the average from East & Partners' sample of 1.9 per cent.

that merchants generally would like to avoid the complexity of such an approach. Indeed, the merchant service fees charged to many merchants do not differentiate between card types, even though the mix of cards may influence the level of fees charged over time. The Bank has contemplated the possibility that acquirers could be compelled to provide more information on the mix of transactions to merchants in order to help them understand their costs, but is satisfied this information is available on request. It nonetheless believes there is a case to make it clear in any modified Standards that schemes and acquirers cannot prevent differential surcharging within a scheme.

Finally, the Board sees some benefits in greater transparency of merchant service fees to give consumers greater comfort that the levels of surcharges they face are reasonable. However, given the widespread opposition to the proposal that merchants disclose their merchant service fees, the Board does not anticipate pursuing this particular option further. The Board believes that the modifications to the Standards proposed in this paper have the potential to give consumers greater comfort with the level of surcharges without this change. There was nonetheless widespread support for the Bank publishing more detailed information on merchant service fees at an aggregate level. The Bank will engage with acquirers to determine the most appropriate approach to doing so.

The Board has considered the views expressed in consultation on specific approaches to modifying the Standards. Its consideration of these views is incorporated in the discussion of the policy options in Section 4.

4. Policy Options

The Board has weighed the options regarding modification of the Standards at two levels. First, it has considered whether modification of the Standards to allow schemes to place a limit on surcharges is in the public interest, and second, it has considered the form that any modification should take. These questions are dealt with separately below.

Is there a Case to Modify the Standards?

The Board remains of the view that the benefits of the removal of no-surcharge rules have been substantial, reflecting the improved price signals that have been provided to cardholders and the resulting improvements to the overall efficiency in the payments system. This transmission of more accurate price signals to consumers is also an effective discipline on acceptance costs, which should, over the long term, reduce upward pressure on interchange fees. The Board, however, remains concerned that surcharges in excess of the cost of card acceptance, and the blending of surcharges for cards with differing acceptance costs (particularly at rates above the acceptance cost of the lower-cost card), are reducing the effectiveness of the earlier surcharging reforms. The Board is aware that, under the current wording of the Standards, the industry is prevented from addressing even the more extreme cases on its own. While the original intent was for the Standards to provide a mechanism for surcharges to be limited to the fees incurred by the merchant for a card transaction, should both parties agree, over time it has become evident that this provision has not been as effective as originally intended.

Following the consultation and further work by the Bank, the Board considers that surcharging is now sufficiently common, and surcharging above the cost of acceptance sufficiently widespread, that an unconstrained capacity for surcharging may no longer be appropriate. The Board is of the view that relaxing the Standards to allow schemes to limit surcharges would provide a number of public benefits. It is likely to generate more efficient price signals than if the Standards were left unchanged and the inefficient surcharging practices that have developed over recent years continued. In addition, whereas consumers currently have little capacity to assess whether a surcharge is reasonable, the ability for schemes to enforce surcharge limits if needed is likely to provide consumers with greater confidence that surcharges are in line with merchants' cost of accepting cards. This is likely to result in increased acceptance of surcharging by consumers and merchants and, therefore, has the potential to further increase the incidence of surcharging and improve price signals to consumers.

The Board has weighed the expected benefits from modifying the Standards against a number of potential drawbacks that have been noted during consultation. First, it has been suggested that a modification to the Standards may constrain merchant bargaining power. When the surcharging reforms were first put in place, the Board sought to place as many bargaining tools in the hands of merchants as possible, given the public's presumption that merchants would not surcharge. The Board's assessment is that surcharging is now sufficiently common, and surcharging above the cost of acceptance sufficiently widespread, that an unconstrained capacity for surcharging is no longer appropriate. In any case, it is not clear that giving the schemes the ability to limit surcharges will have a significant effect on merchants' negotiating power; while merchants have indicated that the threat of surcharging has enabled them to negotiate lower merchant service fees, it is unlikely that the threat of surcharging well above the cost of acceptance is significantly more effective than the threat of surcharging alone.

A second potential drawback of modifying the Standards is that the schemes may either seek to apply the revised Standards in a way that makes it more difficult for merchants to surcharge, or apply restrictions aggressively across the whole merchant base, resulting in high compliance costs. The Board is of the view that an appropriately worded Standard would reinforce the rights of merchants to recover their card acceptance costs. This is discussed further below and in Section 5. The Board also believes that the schemes and acquirers will jointly have an incentive to find an appropriate balance between managing excessive surcharging and ensuring that compliance costs are not unnecessarily high.

The Board has also considered the possibility that excessive surcharging could be addressed and price signals improved without varying the Standards. Under this approach, the Reserve Bank would make a public statement clarifying that the intent of the Standards is for merchants to pass through an amount to consumers that reflects the cost of card acceptance. The Reserve Bank may also provide some specific guidance that it is expected that card surcharges would be no more than a certain percentage of the transaction value, potentially differentiated between the three-party and four-party schemes reflecting differences in acceptance costs.

The effect of such a statement may be to set expectations about acceptable surcharge levels, both for merchants and consumers. In this way it may cause consumers to question higher surcharges and place pressure both on merchants that already impose surcharges that are excessive and on those that may consider doing so in the future.

This approach has the advantage over the status quo that it potentially provides at least some constraint on the surcharging practices that have concerned the Board, and does so at low cost. On the other hand, moral suasion alone might not be sufficient to change the behaviour of some merchants – particularly those with some market power. Some merchants may, therefore, require an element of compulsion to bring surcharges into line with card acceptance costs.

A statement that identified a specific surcharge level that might be considered reasonable could also potentially suffer from concerns about those levels becoming the norm for surcharges and would not account for the large differences in acceptance costs among merchants (see discussion under Option 1 below).

On balance, the Board is of the view that relaxing the Standards to allow scheme rules to impose some limit on surcharges will result in the most efficient outcomes and is in the public interest. The options for varying the Standards are considered below.

Options for Varying the Standards

In weighing the options to modify the Standards, the Board considered the advantages and disadvantages of being more prescriptive in its approach relative to providing a little more flexibility to schemes in setting surcharge limits. It considered three options: setting a specific permissible cap itself; allowing surcharge limits to be set in line with merchant service fees or some function of the interchange fee; and allowing surcharges to be limited to a reasonable cost of card acceptance.

Option 1: Specific permissible surcharge limit

Under this option, the Board would determine a specific permissible surcharge limit, possibly expressed as a percentage of the transaction value, for the designated MasterCard and Visa credit card systems, and the Visa Debit system.[5] This would be the *lowest* limit that scheme rules could choose to impose; that is, scheme rules could limit the surcharge that a merchant could apply, but could not prevent the merchant from applying a surcharge up to the limit determined by the Board.

As set out in the June 2011 Consultation Document, this option has the appeal of being transparent and makes monitoring of compliance relatively straightforward. The practical difficulty with this approach, however, is that the Board would be required to determine an appropriate level for the surcharge limit across all merchant types and sizes. Inevitably, for some merchants the limit would be higher than the cost of acceptance and may encourage merchants to simply set surcharges at the limit determined. For other merchants the limit may be too low and may therefore prevent them from recovering their costs and providing appropriate price signals to cardholders. A fixed permissible limit for surcharges would also be unresponsive to competitive pressures that might influence average merchant service fees over time.

As discussed in Section 3, nearly all submissions to the initial consultation were opposed to this option for these reasons.

Option 2: Surcharge limit equal to the cost of card acceptance

A second option is to modify the Standards to allow scheme rules to limit surcharges to the merchant's cost of card acceptance, and for this cost to be defined clearly as part of the Standards. As discussed in the June 2011 Consultation Document, this option raises the difficulty of determining the appropriate cost of acceptance, particularly if a wide range of other costs, such as annual fees, terminal rental or other transaction fees are to be included along with the merchant service fee. While one approach might be to only include 'other' costs that are charged by the acquirer, there are also a range of legitimate costs for card transactions that, for some merchants, may not be charged by their acquirer. For example, while some merchants rent their terminals from their acquirer and incur terminal rental fees, others invest directly in terminals themselves; if only costs charged by the acquirer are included, merchants that rent their terminals from their acquirer would be able to impose higher surcharges than those that own them. Similarly, in the case of online transactions, some merchants use a payment gateway, which may differ from the merchant acquirer, to process their card transactions. In addition, 'other' costs may not always be entirely attributable to acceptance of a particular card; terminals, for example, may process many types of payment methods and the costs would therefore need to be apportioned accordingly.

Given these difficulties, a simple and consistent approach across all merchants under this option would be to define the cost of acceptance as the merchant service fee. The main benefit of this approach over Option 1 is that surcharge limits would vary with the cost of card acceptance for each individual merchant and so would send more appropriate price signals to cardholders. Therefore, concerns about setting a limit too high or too low would be reduced. The June 2011 Consultation Document also suggested that under this option some

5 For this, and the other options considered below, the American Express, Diners Club and Debit MasterCard systems would be expected to modify their relevant voluntary undertakings accordingly.

sort of tolerance around the cost of card acceptance could be expressly allowed for in any revised Standards, such as for rounding purposes.

The Board recognises, however, that a number of arguments have been made against this approach. One is that acquirers have the ability to alter the mix of fees included in the merchant service fee, which would have a direct effect on the amount any given merchant would be able to surcharge. For example, acquirers may have an incentive to include a wider range of costs in the merchant service fee in order to attract the business of merchants that wish to impose higher surcharges. Second, the merchant service fee may not adequately reflect all the costs of accepting card payments, with some variation in these other costs across industries. And third, merchant service fees are commercial-in-confidence between the merchant and its acquirer, which means it would be difficult for the four-party schemes (and the public) to monitor merchant compliance with the surcharge limit.

A variant of this option, suggested during consultation, is to allow scheme rules to set a surcharge limit as a specified function of the interchange fee – for instance a multiple of the interchange fee or the interchange fee plus a set margin. The key benefit of this approach over using the merchant service fee is that interchange fees are more transparent, with fees for individual card and transaction types published and the weighted average of fees for each four-party scheme capped at 0.5 per cent of the transaction value by the Reserve Bank. This means that it would be relatively easy for the schemes and consumers to monitor merchant compliance with the surcharge limit. It would also eliminate the possibility, discussed above, that acquirers might seek to incorporate a wider range of costs in the merchant service fee to attract merchants that wish to impose higher surcharges. Another benefit of this approach is that it may be more effective in placing downward pressure on interchange fees by creating a direct link between these fees and surcharges; schemes would need to balance the desire to set higher interchange fees with the likelihood of facing higher surcharges.

The principal drawback of this approach is that it would not reflect genuine differences in card acceptance costs where they are not related to interchange fees and so would suffer some of the same drawbacks as Option 1.

Option 3: Limit surcharges to a reasonable cost of acceptance of cards

A third option is to allow the schemes to set limits that are a little more flexible. The proposal considered here is to allow a scheme's rules to limit surcharges to a reasonable cost of acceptance of cards of that scheme. A reasonable cost of acceptance would not be defined, but would include, at a minimum, the merchant service fee. As noted in some submissions to the consultation, an approach that provides some degree of tolerance in the setting of surcharges has been adopted in New Zealand and parts of Europe.

The key advantage of this option is that it provides the flexibility to consider the different costs that may be faced by different merchants and industries. In this way, it is likely to generate more efficient outcomes to the extent that it enables surcharges to reflect better the cost of acceptance across a wide range of different types of merchants.

A potential drawback of this approach, though, is that it may take longer to establish new surcharging behaviours as schemes and merchants determine what is 'reasonable' on a case-by-case basis.

The Board's Preferred Option

After considering the various options in light of the developments in surcharging practices over recent years, the Board is of the view that the benefits of varying the Standards to allow schemes to limit the level of surcharges outweigh the costs. In particular, such a variation would be in the public interest because it would allow the card schemes to address cases where merchants are clearly charging more than is justified for card acceptance, a practice that may distort price signals and result in inefficiencies in the relative use of payment methods. Nonetheless, an appropriate variation of the Standards would continue to allow merchants to pass on the legitimate costs of accepting cards.

On balance, the Board is of the view that Option 3 – allowing a limit based on the reasonable cost of card acceptance – would be the most effective way to relax the Standards. The Board believes that this is the approach that is likely to result in the most efficient outcomes; by not being too prescriptive, it will enable surcharges to best reflect the actual costs of card acceptance faced by each individual merchant.

The Board wishes to stress that this approach is aimed at improving the efficiency of the payments system and may not necessarily address all surcharging practices that are viewed by the public as being of concern. This approach does not, for instance, prevent surcharging in circumstances where there are only limited payment alternatives available. It does, however, provide the capacity for the schemes to ensure that the surcharges collected in these circumstances reflect card acceptance costs.

5. Draft Variation to the Standards

The Board proposes to vary the Standards titled *Standard No. 2, Merchant Pricing for Credit Card Purchases* and *The 'Honour All Cards' Rule in the Visa Debit and Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System*. The proposed variations are marked in the Draft Standards, as set out in Attachments 1 and 2.

The variations relax the current Standards to allow scheme rules to impose a limit on surcharge levels. Specifically, the variations provide that neither the rules of a designated card scheme nor any participant in the scheme may prohibit a merchant from recovering part or all of the reasonable cost of acceptance by the merchant charging fees or surcharges to credit cardholders. The effect of the variation is that scheme rules may limit surcharges to a reasonable cost of acceptance, but are not able to prevent merchants from fully recovering their costs. The varied Standards also provide that the merchant cannot be prohibited from applying different surcharges for different card types, either across card schemes or within a card scheme. That is, as is the case under the current Standards, the merchant can choose to differentially surcharge, including within a card scheme, if desired. While the Board recognises that there are practical constraints to applying differential surcharging within a scheme, the Board wishes to make it clear that merchants should not be prevented by schemes or acquirers from doing so.

The Board also recognises that this variation does not explicitly prohibit the practice of blended surcharging across card schemes. However, given that the variation allows scheme rules to limit surcharges to the cost of acceptance, under such rules any blended surcharge would be limited to the lowest cost of card acceptance, ensuring that blended surcharging is not also associated with excessive surcharging for lower-cost card schemes. Further, to the extent that blended surcharges are set at the cost of acceptance of the lower-cost scheme, the variation is likely to discourage the practice of blended surcharging because the merchant will not be recovering its acceptance costs overall.

Given that under the Draft Standards schemes will have the ability to impose a limit on surcharges through their rules, the provisions that currently allow a merchant to voluntarily agree with its acquirer to limit the size of any surcharge to the fees incurred by the merchant will be redundant. The variation to the Standards will therefore remove this provision.

Paragraph 10 of each of the Draft Standards defines the merchant's cost of acceptance to include, but not necessarily be limited to, the applicable merchant service fee. The cost can be determined by reference to:

i. the cost to the merchant of the particular card transaction;

ii. the average cost to the merchant of acceptance of all credit cards (Visa Debit cards, for the Visa Debit Standard) of all types issued under the scheme; or

iii. the average cost to the merchant of acceptance of a subset of credit cards (Visa Debit cards, for the Visa Debit Standard).

The effect of this clarification is that the merchant will still be able to recover its costs of card acceptance from a cardholder in any way it chooses. That is, merchants may choose to recover their costs of card acceptance by applying: a different surcharge for each different card type; a single surcharge rate for all credit cards (or Visa Debit cards, for the Visa Debit Standard) for a particular scheme; or some combination, such as one rate for 'standard' card transactions and another rate for 'premium' card transactions. Merchants may also apply a surcharge on either an *ad valorem* or a flat-fee basis.

6. Next Steps

The Board invites comments on the specific form of the proposed variations to the Standards for the designated MasterCard and Visa credit card systems and the Visa Debit system. Given that the current paper reflects the output of a public consultation on the case for a variation of the Standards, this issue will not be considered as part of the current consultation.

Formal written submissions should be provided by no later than 10 February 2012 and should be sent to:

Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

or

pysubmissions@rba.gov.au.

Submissions provided by email should be contained in a separate document, in PDF, Word or equivalent format.

In the normal course of events, submissions will be posted on the Reserve Bank's website and those making submissions will be provided with an opportunity to discuss their submission with the Bank.

Attachment 1

Draft Standard No. 2

Merchant Pricing for Credit Card Purchases

Objective

The objective of this Standard is to promote:

(i) *efficiency; and*

(ii) *competition*

in the Australian payments system by providing merchants the freedom to make a reasonable charge according to the means of payment.

Amended and restated Standard

1. This Standard was gazetted on 27 August 2002 and amended on [ ] to read as set out above and below.

Application

~~1.~~ 2. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.

~~2.~~ 3. This Standard applies to the credit card system operated within Australia known as [ ] designated on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, and referred to ~~as follows~~ in this Standard as the Scheme.

~~3.~~ 4. In this Standard:

an 'acquirer' is a participant in the Scheme in Australia that provides services to a merchant to allow the merchant to accept a credit card;

'credit card' means a card issued under the rules of the Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

'credit card transaction' or 'transaction' means a transaction in Australia between a credit card holder and a merchant involving the purchase of goods or services using a credit card;

'merchant' means a merchant in Australia that accepts a credit card for payment for goods or services;

'merchant service fee' means a transaction-based fee charged to a merchant for acquiring credit card transactions from that merchant whether collected on an *ad valorem* or flat-fee basis, or charged as a blended rate across all credit card types or on an interchange plus acquirer margin basis or any other basis;

'rules of the Scheme' mean the constitution, rules, by-laws, procedures and instruments of the Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in the Scheme in Australia consider themselves bound;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

~~4.~~ 5. Each participant in the Scheme must do all things necessary on its part to ensure compliance with this Standard.

~~5.~~ 6. If any part of this Standard is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.

~~6.~~ 7. This Standard is to be interpreted:

- in accordance with its objective; and
- by looking beyond form to substance.

~~7.~~ 8. This Standard ~~comes~~ originally came into force on 1 January 2003. This Standard as amended and restated comes into force on [ ].

Merchant pricing

~~8.~~ 9. Neither the rules of the Scheme nor any participant in the Scheme shall prohibit ~~a merchant from charging a credit cardholder any fee or surcharge for a credit card transaction~~:

(i) a merchant from recovering part or all of the reasonable cost of acceptance of credit cards issued under the Scheme by the merchant charging fees or surcharges to credit card holders; or

(ii) a merchant, in recovering part or all of the reasonable cost of acceptance of credit cards issued under the Scheme, from applying different fees or surcharges to credit card holders for different card types either within the Scheme or across card schemes.

~~9. Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a credit cardholder will be limited to the fees incurred by the merchant in respect of a credit card transaction.~~

10. For the purposes of paragraph 9, the merchant's cost of acceptance of credit cards issued under the Scheme may, for the purpose of determination of a fee or surcharge, be determined by reference to:

(i) the cost to the merchant of the credit card transaction in relation to which the fee or surcharge is to be levied;

(ii) the average cost to the merchant of acceptance of all credit cards of all types issued under the Scheme; or

(iii) the average cost to the merchant of acceptance of a subset of credit cards issued under the Scheme, which includes the type of credit card in relation to which the fee or surcharge is to be levied, and includes, but is not necessarily limited to, in the case of (i), the applicable merchant service fee and, in the case of (ii) and (iii), all applicable merchant service fees.

Transparency

~~10.~~ 11. Each acquirer must notify, in writing, each merchant to whom the acquirer provides services of the provisions of this Standard (as amended) as soon as practicable after this Standard (as amended) comes into force.

Attachment 2

Draft Standard

The 'Honour All Cards' Rule in the Visa Debit and Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System

Objective

The objective of this Standard is to ensure that the rules of the Visa Debit system and the Visa credit card system promote:

(i) *efficiency; and*

(ii) *competition*

in the Australian payments system.

Amended and restated Standard

1. This Standard was gazetted on 7 July 2006 and amended on [ ] to read as set out above and below.

Application

~~1.~~ 2. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.

~~2.~~ 3. This Standard applies to the payment system operated within Australia known as Visa Debit, which was designated as a payment system on 23 February 2004, and to the Visa credit card system operated within Australia which was designated as a payment system on 12 April 2001 (together referred to as the 'Scheme').

~~3.~~ 4. In this Standard:

an 'acquirer' is a participant in the Visa Debit system in Australia that provides services to a merchant to allow that merchant to accept a Visa Debit card;

'merchant' means a merchant in Australia that accepts a Visa Debit card or Visa credit card for payment for goods or services;

'merchant service fee' means a transaction-based fee charged to a merchant for acquiring Visa Debit card transactions from that merchant whether collected on an *ad valorem* or flat-fee basis, or charged as a blended rate with Visa credit cards or on an interchange plus acquirer margin basis or any other basis;

'rules of the Scheme' means the constitution, rules, by-laws, procedures and instruments of the Visa Debit system and of the Visa credit card system as applied in Australia respectively, and any other arrangement relating to the Scheme by which participants consider themselves bound;

'Visa credit card' means a card issued by a participant in Australia in the Visa credit card system, under the rules of the Scheme, that allows the cardholder to make payments to merchants for goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

'Visa credit card transaction' means a transaction in Australia between a Visa credit card holder and a merchant involving the purchase of goods or services using a Visa credit card;

'Visa Debit card' means a card issued by a participant in Australia in the Visa Debit system, under the rules of the Scheme, that allows the cardholder to make payments to merchants for goods or services by accessing a deposit account held at an authorised deposit-taking institution;

'Visa Debit card transaction' means a transaction in Australia between a Visa Debit card holder and a merchant involving the purchase of goods or services using a Visa Debit card;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

~~4.~~ 5. Each participant in the Visa Debit system and the Visa credit card system must do all things necessary on its part to ensure compliance with this Standard.

~~5.~~ 6. If any part of this Standard is invalid, the Standard is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.

~~6.~~ 7. This Standard is to be interpreted:

- in accordance with its objective; and
- by looking beyond form to substance.

~~7.~~ 8. This Standard ~~comes~~ originally came into force on 1 January 2007. This Standard as amended and restated comes into force on [ ].

Merchant pricing

~~8.~~ 9. Neither the rules of the Scheme, nor any participant in the Visa Debit system, shall prohibit ~~a merchant from charging a Visa Debit cardholder any fee or surcharge for a Visa Debit card transaction~~:

(i) a merchant from recovering part or all of the reasonable cost of acceptance of Visa Debit cards issued under the Scheme by the merchant charging fees or surcharges to Visa Debit card holders; or

(ii) a merchant, in recovering part or all of the reasonable cost of acceptance of Visa Debit cards issued under the Scheme, from applying different fees or surcharges to Visa Debit card holders for different card types either within the Scheme or across card schemes.

~~9.~~ ~~Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a Visa Debit cardholder will be limited to the fees incurred by the merchant in respect of a Visa Debit card transaction.~~

10. For the purposes of paragraph 9, the merchant's cost of acceptance of Visa Debit cards issued under the Scheme may, for the purpose of determination of a fee or surcharge, be determined by reference to:

(i) the cost to the merchant of the Visa Debit card transaction in relation to which the fee or surcharge is to be levied;

(ii) the average cost to the merchant of acceptance of all Visa Debit cards of all types issued under the Scheme; or

(iii) the average cost to the merchant of acceptance of a subset of Visa Debit cards issued under the Scheme which includes the type of credit card in relation to which the fee or surcharge is to be levied,

and includes, but is not necessarily limited to, in the case of (i), the applicable merchant service fee and, in the case of (ii) and (iii), all applicable merchant service fees.

Honouring cards

~~10.~~ 11. Neither the rules of the Scheme, nor any participant in the Visa Debit system, or the Visa credit card system, may require a merchant to accept Visa Debit cards as a condition of the merchant accepting Visa credit cards. Likewise, neither the rules of the Scheme, nor any participant in the Visa Debit system or the Visa credit card system, may require a merchant to accept Visa credit cards as a condition of the merchant accepting Visa Debit cards.

Transparency

~~11.~~ 12. (i) All Visa Debit cards issued after 1 January 2007 must be visually identified as debit cards. By 31 December 2009, all Visa Debit cards on issue must be visually identified as Visa Debit cards.

(ii) From 1 January 2007, all Visa Debit cards issued in Australia must be issued with a Bank Identification Number (BIN) that allows them to be electronically identified as Visa Debit cards.

(iii) On request, acquirers must provide to merchants for which they acquire Visa Debit and credit card transactions, BINs that would permit the merchant to identify separately Visa Debit and Visa credit card transactions electronically.

(iv) Each acquirer must notify merchants to which it provides acquiring services of the provisions of this Standard (as amended) as soon as practicable after this Standard (as amended) comes into force. ~~This requirement must be met by 31 December 2007.~~

EXHIBIT I

REFORM OF AUSTRALIA'S PAYMENTS SYSTEM

PRELIMINARY CONCLUSIONS OF THE 2007/08 REVIEW

APRIL 2008

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Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review

1. Introduction

This document sets out the Payments System Board's preliminary conclusions of its review of the regulation of Australia's card payment systems. It is the product of a process that commenced with the publication of an Issues Paper in May 2007 and has involved a large number of submissions and extensive consultation with industry participants, including a conference in November 2007. The document discusses the main options considered and the Board's preferred course of action.

The origin of the Review was a commitment made by the Payments System Board when it released its final reforms for the credit card systems in 2002. The Review has been wide ranging, and has covered all the reforms to the card-based payment systems in Australia. The Board thanks all those who made submissions and took time to meet with the Bank's staff as part of the Review.

The structure of this document is as follows. Section 2 sets out the Board's mandate and objectives, and Section 3 provides details on the current regulatory landscape. Section 4 then summarises the consultation process and the various views raised by industry participants. The Board's assessment of the main issues is set out in Section 5, while Section 6 discusses the various options regarding interchange fees, including the Board's preferred approach. The main conclusions of the Review are then summarised in Section 7, while Section 8 provides details of the next steps in the process.

The conclusions set out in this document are preliminary. The Board is seeking submissions on these conclusions and on the analysis set out below. Further details are provided in Section 8. The final conclusions of the Review will be published in late August/early September 2008.

2. The Payments System Board's Mandate and Objectives

The Payments System Board's responsibilities stem from the Financial System Inquiry, whose findings and recommendations were released in 1997.[1] The Inquiry found that, while earlier deregulation had improved competition and efficiency in Australia's payments system, further gains were possible. To that end, it recommended the establishment of the Payments System Board at the Reserve Bank with the responsibility and powers to promote greater competition, efficiency and stability in the payments system. The Government accepted those recommendations and established the Payments System Board in 1998. The Board's responsibilities are set out in the *Reserve Bank Act 1959*. The Act requires the Board to determine the Bank's payments system policy so as to best contribute to: controlling risk in the financial system; promoting

1 *Financial System Inquiry (1997),* Final Report, *March.*

the efficiency of the payments system; and promoting competition in the market for payment services, consistent with the overall stability of the financial system.

At the time the Board was established, the Government also provided the Bank with specific powers to regulate payment systems in order to implement the Board's policies. The most relevant powers in the context of the card payment reforms are those set out in the *Payment Systems (Regulation) Act 1998*. Under this Act, the Bank has the power to designate payment systems and to set standards and access regimes in designated systems. The Act also sets out the matters that the Bank must take into account when using these powers, including the desirability of payment systems: being financially safe for use by participants, efficient and competitive; and not materially causing or contributing to increased risk to the financial system.

The Bank's reforms to the card payment systems have aimed to improve the efficiency of the overall payments system and to promote competition. In particular, they have sought to: increase the transparency of the system; remove or modify restrictions that hinder competitive forces; liberalise access arrangements; and promote price signals to consumers that are conducive to the efficient evolution of the payments system. These reforms are discussed in the following section.

3. The Current Regulatory Landscape

3.1 The origin of the reforms

The current regulatory landscape has its origins in the findings of *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* (the Joint Study) undertaken by the Bank and the Australian Competition and Consumer Commission (ACCC) and published in October 2000. The Joint Study emphasised both the substitutability of individual payment instruments, and the need for a system-wide approach. It found that credit card interchange fees had contributed to many holders of credit cards facing negative effective prices for credit card transactions, while interchange fees in the EFTPOS system contributed to many people facing positive effective prices for EFTPOS transactions. This higher price for EFTPOS transactions was despite the EFTPOS system having substantially lower operating costs per transaction than the credit card system. The Joint Study also concluded that the case for an interchange fee in debit card systems on the grounds of balancing issuers' and acquirers' costs (as advocated by the card schemes) was not strong.

In the years following the publication of the Joint Study, the Board introduced a number of reforms to address the issues identified. Although the Joint Study highlighted the interrelationship between the various card payment systems, these reforms have been sequential, rather than simultaneous. This reflects a variety of factors, including legal considerations and the Board's willingness to allow industry to explore solutions before regulatory solutions are considered.

The first reforms were those to the credit card system. In March 2000, an independent investigation by the ACCC concluded that the collective setting of interchange fees in the credit card schemes was in breach of the price-fixing provisions of the *Trade Practices Act 1974*. The ACCC advised the credit card schemes and their members that they should seek authorisation of the interchange fee agreements or cease collective setting of these fees. After a year of discussions with the banks, the ACCC concluded that the authorisation process was unlikely to meet its concerns about competition and efficiency and, in March 2001, asked the Bank to consider using its powers to address the issue of interchange fees.

After consultation, the Payments System Board formed the view that it would be in the public interest to bring the credit card schemes under the Bank's regulatory oversight. As a result, in April 2001, the Bankcard, MasterCard and Visa credit card systems were designated under the *Payment Systems (Regulation) Act* after it became clear that the Board's concerns were unlikely to be addressed voluntarily by the schemes. The Bank then commenced a process of consultation on potential standards and access regimes. These reforms were finalised in August 2002 and came into effect during 2003 and 2004.

After the reforms were finalised, MasterCard and Visa launched legal challenges to the Bank's powers to designate the credit card systems and impose standards and access regimes. The case was heard in 2003 in the Federal Court, with the decision, released in September 2003, finding in favour of the Bank on all grounds.

Reform of the debit card systems followed some time later. Following the Joint Study, the Bank's discussions with industry participants suggested that there was a reasonable probability that interchange fees in the EFTPOS system would be reduced without the need for regulation. Indeed, in February 2003 a group of industry participants agreed to set interchange fees in the EFTPOS system to zero, and sought ACCC authorisation for the proposal. The ACCC eventually approved the proposal, although the approval was subsequently overturned by the Australian Competition Tribunal (ACT) following an appeal by a group of merchants. After the ACT's decision, the Board judged that the prospect for further industry-based reform was limited, and it designated the EFTPOS system in September 2004. This designation was then challenged unsuccessfully in the Federal Court by the same group of merchants that had challenged the earlier industry agreement.

Given the strong potential substitutability between EFTPOS and scheme debit, the Board viewed it as important that changes to these systems occur at the same time. The Board designated the Visa Debit system in February 2004 and, once the industry reform proposal for EFTPOS had failed, proceeded to consider interchange fees in the two systems together.[2] In February 2005, the Bank released a consultation document, setting out the proposed reforms in the EFTPOS and scheme debit systems. Following consultation, the reforms were finalised in April 2006. The interchange fee Standards and the EFTPOS Access Regime came into effect in 2006, while the honour-all-cards Standard came into effect in January 2007. MasterCard agreed to implement equivalent reforms for its debit card system with voluntary undertakings rather than the Bank imposing standards.

3.2 The reforms

The Board's reforms to the card-based payment systems have been in three broad areas: the removal of various restrictions on merchants imposed by the card schemes; the regulation of interchange fees; and the introduction of more liberal access arrangements. The reforms are summarised in Table 1 and more detail is provided in the sub-sections below.

2 *At that time, Visa Debit was the only scheme debit system in operation in Australia. MasterCard's debit product was not launched in Australia until November 2005.*

3.2.1 Merchant restrictions

In its early work, the Board identified a number of restrictions on merchants that were detrimental to efficiency and competition in the payments system. These included rules that:

- prevented merchants from surcharging for credit card and scheme debit card transactions (the no-surcharge rule);
- required a merchant to accept a scheme's debit card if it accepted its credit card and *vice versa* (the honour-all-cards rule); and
- prevented merchants from steering customers to other forms of payment (the no-steering rule).

The Board concluded that the no-surcharge rule masked the price signals to cardholders about relative costs of different payment methods and limited the ability of merchants to put downward pressure on interchange fees by threatening to charge the customer for using a credit card. It also contributed to the subsidisation of credit card users by all other customers, as merchants charged a uniform price to all consumers regardless of the payment method used, with this uniform price needing to cover the relatively high costs of credit card acceptance.

MasterCard and Visa declined to voluntarily remove their no-surcharge rules and, as a result, the Bank imposed standards requiring the removal of these rules from 1 January 2003. American Express and Diners Club voluntarily agreed to remove their equivalent rules.

Table 1: Payments System Reforms - as at April 2008

Standards	
Interchange fees	
Credit cards	Weighted-average interchange fees in the MasterCard and Visa schemes must not exceed 0.50 per cent of the value of transactions.
	MasterCard and Visa must publish their actual credit card interchange fees.
Visa Debit	The weighted-average interchange fee for Visa Debit transactions must not exceed 12 cents per transaction.
	Visa must publish its actual debit card interchange fees.
EFTPOS	EFTPOS interchange fees for transactions that do not involve a cash-out component must be between 4 and 5 cents per transaction.
Merchant restrictions	
Honour-all-cards	Visa is not permitted to require a merchant to accept Visa Debit cards as a condition of accepting Visa credit cards, or *vice versa*.
	Visa Debit cards must be visually and electronically identifiable as debit cards, and acquirers must provide merchants with information required to electronically distinguish Visa Debit and Visa credit card transactions.
Surcharges	The card schemes must not prohibit a merchant from imposing a surcharge for MasterCard or Visa credit card transactions, or for Visa Debit card transactions.

Access Regimes	
Credit cards and Visa Debit	Schemes must treat applications for membership from Specialist Credit Card Institutions on the same basis as those from traditional authorised deposit-taking institutions (ADIs).
	A participant in the MasterCard or Visa credit card schemes, or the Visa Debit system, must not be penalised by the scheme based on the level of its card issuing activity relative to its acquiring activity, or *vice versa*.
	Schemes must make available the criteria for assessing applications to participate in the MasterCard credit card system, or the Visa credit or debit card systems. The schemes must: assess applications in a timely manner; provide applicants with an estimate of the time it will take to assess an application; and provide reasons for rejected applications.
EFTPOS	The price of establishing a standard direct connection with another participant must not exceed a benchmark published by the Reserve Bank, currently \$78 000 (ex GST).
	An existing acquirer (issuer) cannot require a new issuer (acquirer) to pay (accept) a less favourable interchange fee than any other issuer (acquirer) connected to the acquirer (issuer).
Voluntary Undertakings	
American Express and Diners Club	American Express and Diners Club have provided the Bank with written undertakings to remove restrictions in their credit and/or charge card schemes preventing merchants from charging any fee or surcharge for the use of a card.
American Express	American Express has provided the Bank with a commitment to modify provisions in its merchant contracts that would otherwise prevent a merchant from 'steering' a customer's choice of payment instrument. Also, in the event that American Express introduces a debit card in Australia, the merchant agreements and pricing for that product will be separate to those for credit and charge cards.
MasterCard	MasterCard has provided the Bank with a written undertaking to voluntarily comply with the Visa Debit interchange Standard and the honour-all-cards Standard as they apply to credit and debit card transactions, as well as the Standard on surcharging as it applies to debit card transactions.
Other	
EFTPOS Access Code	Under the EFTPOS Access Code developed by the Australian Payments Clearing Association, new and existing EFTPOS participants have specific rights to establish direct connections with other participants within a set time frame.
Scheme data	Since August 2005 the Bank has published aggregated data on the average merchant fee for each of the schemes as well as data on market shares.

The honour-all-cards rule in the MasterCard and Visa schemes had two distinct aspects: one relating to honouring all issuers and the other to honouring all products. The Board recognised the merits of the honour all *issuers* aspect of the rule, but concluded that the honour all *products* aspect was not in the public interest. It concluded that the tying of credit and debit card acceptance adversely affected competition, particularly between EFTPOS and scheme debit, by forcing merchants to accept a payment method they might not otherwise accept, at a price they might not otherwise pay.

Visa declined to modify voluntarily its honour-all-cards rule and, as a result, the Bank imposed a standard requiring that the rule be modified in the Visa system to allow merchants to make separate acceptance decisions for Visa credit and debit cards from 1 January 2007. In contrast, MasterCard provided a written undertaking to voluntarily comply with this Standard. Similarly, while American Express does not issue a debit product in Australia, it has agreed to voluntarily comply with the Standard if it introduces debit or pre-paid products in the future.

Finally, the no-steering rule prevented merchants that accepted American Express cards from encouraging customers to use another method of payment (equivalent rules did not exist in the Diners Club, MasterCard and Visa schemes). Again, the Board saw this rule as inappropriately restricting competition and, after discussions, American Express agreed to remove the rule.

3.2.2 Interchange fees

When the Board first considered the regulation of the credit card system in 2001, it considered whether just requiring the removal of the no-surcharge rule would be sufficient to establish price signals that better promoted competition and efficiency in the payments system. Although recognising that removing the no-surcharge rule would be a positive step, the Board was not convinced that surcharging would become sufficiently commonplace within a reasonable time to materially alter the price signals facing most cardholders. A particular concern was that surcharging was likely to develop only slowly given the strong expectation by cardholders that no surcharges would apply – an expectation built up over a number of decades in which the schemes prohibited the practice. The Board therefore came to the conclusion that both the removal of the no-surcharge rule *and* a reduction in the difference between interchange fees in the various systems were necessary to establish more appropriate price signals to cardholders.

Reflecting this view, the Board introduced a number of regulations to reduce interchange fees in the card payment systems and move them closer together. These reductions were achieved by the imposition of standards which capped the level of average interchange fees in the various systems.

The *credit card interchange fee Standard* specifies a benchmark, calculated by reference to issuers' costs, and requires that the weighted-average interchange fee of each scheme be no higher than the benchmark at specific points in time. Under the original Standards, the benchmarks differed slightly across the schemes, reflecting differences in issuers' costs. Following concerns by some industry participants that the scheme with the highest benchmark had a competitive advantage, a revised Standard was released in November 2005 after consultation with industry. Under this revised Standard, the same benchmark applies in both the MasterCard and Visa systems. That benchmark is currently 0.50 per cent of the value of a transaction.

The *EFTPOS interchange fee Standard* sets both a floor and a cap on interchange fees for EFTPOS transactions without a cash-out component. This approach reflects the bilateral nature of the EFTPOS system in which interchange fees are negotiated between each of the direct connectors in the system. The Board was concerned that these bilateral negotiations could be used to frustrate access or limit competition, with existing participants potentially offering arrangements to new participants on less attractive terms than were established with other existing participants. The cap is set as the average cost to an acquirer of authorisation and processing a transaction – currently $0.05 per transaction. The floor is 80 per cent of the cap – currently $0.04 per transaction.

The *Visa Debit interchange fee Standard* requires the weighted-average interchange fee in the Visa Debit system to be no higher than a benchmark set as the average cost to an issuer of processing and authorisation, expressed as cents per transaction. MasterCard's undertaking requires its debit interchange fees to meet the same benchmark. The benchmark is currently $0.12 per transaction.

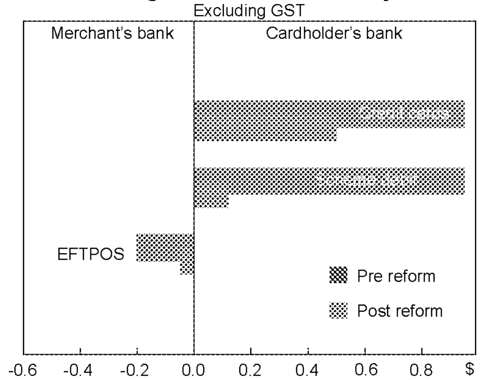
While the interchange fee Standards use costs to calculate the benchmarks, at a conceptual level the Board does not see interchange fees as a way for acquirers to compensate issuers (or *vice versa*) for specific costs. Rather, the Standards have been based on costs as a way of establishing transparent benchmarks that meet the legal requirement of a 'standard'.

The implementation of the set of interchange standards has resulted in lower levels of interchange fees and a smaller differential between the fees in the various systems (Graph 1). Interchange fees for credit card transactions have halved while those on scheme debit have fallen by a larger amount. Further, the difference in interchange fees between the EFTPOS and scheme debit systems has declined from around $1.15 on a $100 transaction prior to the reforms to around $0.17 currently.

Graph 1

Interchange Fees on a $100 Payment*

Excluding GST



* The post-reform data show the benchmark for each system.
Source: RBA

3.2.3 *Access*

In order to promote competition in the payments system, the Board has also introduced a number of reforms to access arrangements.

In the credit card system, the effect of the previous access rules was to restrict membership of MasterCard and Visa to authorised deposit-taking institutions (ADIs) supervised by the Australian Prudential Regulation Authority (APRA). The credit card schemes argued that this was necessary for both their own protection and that of their members. While the Bank accepted the need for some entry criteria, it concluded that the then existing criteria were unnecessarily restrictive. It also concluded that the scheme rules that prevented institutions acting as acquirers only, or levied penalties on institutions that were significant net acquirers, unduly restricted competition.

Given that the schemes did not address these issues voluntarily, the Bank imposed access regimes on both the MasterCard and Visa credit card schemes. In doing so, it worked closely with APRA, which established a new class of supervised institutions known as Specialist Credit Card Institutions. The Access Regimes require the schemes to treat applications for membership from these specialist institutions on the same basis as those from the traditional ADIs, and prevent the schemes from imposing penalties on institutions on the basis of their issuing or acquiring volumes. Given the linkages between the credit and debit card schemes operated by Visa, and the structure of Visa's rules, it was also necessary for the Bank to impose a corresponding Access Regime on the Visa Debit system.

The Bank also concluded that access arrangements for the EFTPOS system were more restrictive than necessary, largely reflecting the bilateral nature of the system. While potential entrants could either negotiate access through an existing participant (which may also be a competitor) or establish their own direct links, existing participants were under no obligation to establish the necessary connections on reasonable terms and conditions, or to do so within a reasonable timeframe.

Following prompting by the Bank and the ACCC, industry participants spent considerable time developing an EFTPOS Access Code to improve access arrangements. Under the Access Code, which was adopted in September 2006, existing participants have agreed to procedures and timetables under which they will negotiate and establish connections with new participants. The Access Code also imposes a cap on the price that current participants can charge for new connections. This cap is set in the EFTPOS Access Regime imposed by the Bank and is the lowest cost of connection from a survey of direct connectors undertaken by the Australian Payments Clearing Association (APCA) in 2004 – it is currently $78 000. The EFTPOS Access Regime also limits the ability of existing participants to use negotiations over interchange fees to impede competition by imposing 'no discrimination' requirements on existing participants.

4. The Review and Consultation

4.1 The scope of the Review

The origin of this Review is a commitment made by the Payments System Board when it released its final reforms for the credit card systems in 2002 that it would review the reforms in five years. The Review is, however, more wide ranging than was envisaged at that time, and covers all the reforms discussed in the preceding section. This wider scope reflects the interconnections between the various reforms, and the Board's view that the individual reforms are best viewed and assessed as part of a package, rather than on a stand-alone basis. Throughout the reform process, the Board's focus has very much been on the payments system as a whole, not just on the operation of individual payment systems within the overall system.

As important inputs to the Review, the Bank undertook extensive projects on the costs and use of payment instruments in Australia. The study on costs extended the work of the Joint Study by examining the end-to-end costs of a number of different payment instruments, including cards and cash. The study of payment patterns involved a survey of consumers on their use of various payment methods and an analysis of data supplied by financial institutions and merchants. The results of these studies were presented at the Payments System Review Conference in November 2007.

The Review is intentionally forward looking. While the Board has considered the effects of the reforms to date in detail, its main focus has been on how best to establish a set of arrangements that are conducive to ongoing strong competition in the Australian payments system and the efficient evolution of the system over the longer term.

4.2 The consultation process

The Board has been keen to ensure that the Review is as open and transparent as possible, and the Bank has consulted widely with interested parties.

The first step in the consultation process was in September 2006, with the Bank seeking submissions from interested parties on the scope and process of the Review. Most submissions called for the Review to be broad in nature and to cover all the Bank's reforms, not just those relating to the credit card system. This is reflected in the broad scope of the Review.

The second step was the publication of *Reform of Australia's Payments System: Issues for the 2007/08 Review* in May 2007 (the Issues Paper). This paper provided a summary of recent developments in card payment systems and sought industry feedback on three interrelated questions:

(i) what have been the effects of the reforms to date?

(ii) what is the case for ongoing regulation of interchange fees, access arrangements and scheme rules, and what are the practical alternatives to the current regulatory approach? and

(iii) if the current regulatory approach is retained, what changes, if any, should be made to the standards and access regimes?

In total, 27 submissions were received by the Bank and these are published on the Bank's website; Appendix 1 provides a list of those who made submissions. Twenty parties took up the invitation to discuss their submissions with the Bank. The Bank has also held a significant number of other related meetings with industry participants, including consumer groups.

The third step was the Payments System Review Conference in November 2007, held jointly by the Bank and the Centre for Business and Public Policy at the Melbourne Business School. Around 90 participants were invited, representing financial institutions, merchants, card schemes, industry associations, consultants and academia. All members of the Payments System Board attended. The first part of the conference involved a discussion of two commissioned papers and the results of the Reserve Bank's studies of the use and cost of payment instruments. The second part took the form of an open forum discussing the reforms to the card payment systems, particularly the issues of interchange fee regulation, innovation and access. The conference proceedings are published separately and available on the Bank's website.

4.3 Views expressed during consultation

The Board has found the consultation process very helpful, although in a number of areas the views expressed have been diametrically opposed to one another. In part, these divergent views reflect the fact that the reforms have had quite different effects on the various parties. While it is difficult to accurately represent individual positions without reference to the complete submissions, in general the stances of the key stakeholders on the direction of policy can be characterised as follows:

- large financial institutions supported the relaxation of interchange fee regulation and potentially moving to a self-regulatory arrangement, but argued that the no-surcharge and honour-all-cards Standards should be retained;
- smaller financial institutions had concerns about the impact of interchange regulation on scheme debit and about the honour-all-cards Standard;
- merchants broadly supported the reforms and argued strongly for a move to zero interchange for all card payment systems; and
- the regulated card schemes argued for the removal of all regulations, although one indicated that it could accept an approach in which the no-surcharge and honour-all-cards Standards remained in place in their current form if interchange fee regulation were removed.

Given the strongly held positions there was little explicit support for the *status quo*.

The three sub-sections below set out the main points made in response to the questions in the Issues Paper.

4.3.1 The effects of the reforms

The consultation process revealed a general agreement on a number of effects of the reforms. These included: a substantial reduction in merchant service fees; a significant change in relative prices facing cardholders for credit cards and debit cards; an improvement in the competitive position of merchants; and a significant increase in the prevalence of surcharging for credit card payments, although the majority of merchants still do not levy a surcharge. In a number of other respects, views on the effects of the reforms were more varied.

On the removal of the no-surcharge rule, a number of parties, including the banks, argued that merchants' capacity to surcharge had increased competitive pressure on interchange and merchant service fees. Better price signals to consumers also resulted when merchants chose to surcharge. In contrast, others argued that, despite improving competition at the margin, surcharging is not yet sufficiently widespread for it to have had a substantial effect. In this context, it was noted that the capacity of merchants to surcharge varied. For instance, it was argued that both retailers with market power and billers are in a better position to surcharge than are many merchants in the retail sector where payments are made at the point of sale. It was also argued that surcharging is sometimes excessive and that there has been substantial damage to scheme brands.

Similarly, there were various views on the benefits of the modification of the honour-all-cards rule. Merchants generally argued that modification of the rule had been beneficial in providing the freedom to choose which cards they accept and, thereby, control costs. Against this, the schemes argued that the removal of the rule had provided no benefits to consumers and, if anything, had increased the potential for confusion. As a result, the change had caused damage to their brands. It was also noted that because the majority of merchants currently receive blended pricing – with a single merchant fee for all scheme card transactions – there is little incentive for most merchants to differentiate between cards and, thus, the modification of the rule has had limited effect.

Submissions put forward a variety of views about the effects of the reforms on individual payment systems. The four-party card schemes argued that the absence of regulation of three-party schemes provided a competitive advantage to these schemes. The fact that merchant service fees for the three-party schemes have declined by less than those for the four-party schemes was cited by some as evidence of this. The three-party schemes disputed this conclusion, noting that there had been a minimal shift in market share to three-party schemes, and that surcharging has had a particularly detrimental effect on their businesses because their surcharges tend to be higher. Furthermore, the decline in merchant service fees for the three-party schemes was argued to be evidence that these schemes have come under competitive pressure.

In relation to competition between the regulated card schemes, some submissions argued that the common interchange fee benchmark limits the ability of these schemes to compete effectively for issuers. Furthermore, it was argued that the backward-looking nature of the weights used in the compliance calculation can provide a competitive advantage where a scheme chooses to apply a high interchange fee to a card category in which it has relatively few cards on issue.

Submissions on the effects of the reforms on financial institutions highlighted the perceived disproportionate effects on smaller institutions. Some argued that the honour-all-cards Standard had a significant effect on smaller financial institutions which typically offer a more limited range of payment products than larger institutions, and rely more heavily on scheme debit products for which interchange fees have declined significantly.

4.3.2 The case for ongoing regulation and alternatives

Submissions tended to focus on the case for relaxing or removing regulation and specific regulatory approaches. The issue that attracted most attention was the regulation of interchange fees. As with other aspects of the reforms, a variety of views were expressed.

Some submissions arguing for a removal of interchange regulation stated that consumers are worse off as a result of the reforms. In support, these submissions cited the rise in annual fees on credit cards, reductions in the value of loyalty programs and surcharges. They also typically argued that merchants have not reduced their prices in response to lower interchange fees, but have instead increased their profits.

In addition, a number of other arguments were raised, including the following:

- the regulations have added significant cost, complexity and uncertainty to financial institutions' businesses;
- it is difficult to implement competitively neutral interchange regulation, both among card systems and against other platforms;

- participants will inevitably find ways around the regulations, leading to the prospect of further distortions and/or further regulation; and
- the regulations have impeded innovation, with effort being diverted to managing interchange fees rather than developing new products.

A number of submissions argued that the increase in competition in the market over recent years means that interchange regulation can be removed or relaxed, or that additional changes could further increase competition sufficiently to allow this to occur. A common argument in favour of this approach was that the combination of regulations on the no-surcharge and honour-all-cards rules means that there is now sufficient competition in the market to address the Board's concerns about the setting of interchange fees. Merchants disagreed with this argument. They argued that despite the removal of the no-surcharge and honour-all-cards rules, regulation is still necessary to ensure interchange fees do not rise substantially. In their view, the competitive forces on interchange fees remain very weak.

In the Issues Paper, the Bank asked specifically whether the no-surcharge Standard alone could address its concerns over interchange fees. The large banks, in particular, suggested that this Standard had sufficiently changed the competitive environment to allow interchange regulation to be removed. In contrast, merchants argued that, while the abolition of the no-surcharge rule has been beneficial, surcharging is not yet sufficiently widespread for there to be confidence that surcharging is effective in constraining interchange fees.

Financial institutions generally supported some form of self-regulation taking the place of formal regulation, although for some (typically smaller) institutions, support was contingent on how representative the governance of those self-regulatory arrangements would be. In contrast, the merchants argued against self-regulation, and even some supporters of self-regulation said that they could not see it working for interchange fees. There was greater support, however, for self-regulation with respect to technical standards, payment system rules and access, encouraging competition and coordinating innovation.

The main self-regulatory proposal was put by APCA, which envisages a self-regulatory body working in conjunction with the Bank. At this stage, however, details on how such a body might work are still being developed by industry, and no specific model has been put to the Bank.

Another factor identified as having a bearing on the prospects for successful relaxation of regulation is the capacity of the EFTPOS system to provide effective competition to scheme products. Some submissions, including from representatives of the banking industry, argued that competition from EFTPOS had the potential to exert competitive pressure on fees, but that changes to EFTPOS governance arrangements would be required for it to do so. At the same time, some banks indicated a reluctance to spend money on marketing or innovation with respect to EFTPOS, arguing that returns on investment from scheme products were significantly greater than for EFTPOS.

Some submissions also raised the possibility that competition in acquiring could be prompted by requiring three-party schemes to open up acquiring of their cards. Another option raised was allowing merchants, rather than cardholders, to choose the network over which a card transaction is processed.

While interchange regulation drew the most comment, the schemes' submissions argued for the removal of all regulation, including the no-surcharge and honour-all-cards Standards. These submissions cited the benefits of a prohibition on surcharging in terms of ensuring consistency of cardholder treatment regardless of payment choice, as well as protecting cardholders from price gouging by merchants with market power. In addition, some submissions suggested that surcharging inappropriately limited the ability of card systems to use pricing structures to promote network growth and/or provide incentives to engage in cost-reducing practices.

The schemes and the smaller financial institutions argued for the removal of regulations governing honour-all-cards rules. The schemes argued that honour-all-cards rules enhance convenience and competition by reducing search costs to cardholders, and facilitate greater competition among issuers and acquirers. As significant issuers of scheme debit cards, the smaller financial institutions emphasised the detrimental effect of the honour-all-cards Standard on their competitive position.

4.3.3 Changes to the Standards and Access Regimes

The issues addressed under this question included: whether interchange fees should be reduced further, perhaps to zero; the transparency of scheme fees; and a number of technical issues related to the operation of existing regulation.

Merchant submissions advocated a further reduction in interchange fees. Their preference was for these fees to be set to zero (or equivalently abolished), with one submission arguing that, if this did not occur, the costs of the interest-free period and of fraud prevention should be removed from the benchmark calculations for the credit card schemes.

Financial institutions and the card schemes opposed moving to zero interchange, arguing that interchange fees play an ongoing part in developing and maintaining a card system.

Some submissions approached this question from an analytical perspective. One argued that interchange fees are not essential to the operation of card systems and are unlikely to be set efficiently by the schemes. A second argued that econometric evidence supported the 'neutrality hypothesis' – that interchange fees have no long-run effect on merchants' and consumers' choices when surcharging is possible. Interchange fees could, therefore, be set at any level, including zero. It was also noted, however, that there are costs of imposing regulation and if a cap is imposed, it should be done in a way that minimises regulatory costs.

A number of parties suggested that the interchange differential between scheme debit and EFTPOS is putting EFTPOS at a competitive disadvantage, especially by failing to provide issuers with the incentive to invest in the EFTPOS system. As such, consistency in the setting of debit card interchange fees would put EFTPOS and scheme debit on a more even footing.

Comments were also provided on the way in which interchange benchmarks are set, with a number of calls for greater consistency between payment instruments. Comments included the following:

- the current credit card methodology should be applied to all card payment systems;
- fraud costs and the cost of the interest-free period should be removed from the credit card benchmark;

- fraud costs should be included in the scheme debit benchmark;
- the methodology should take account of relevant costs of both issuers and acquirers; and
- a cost-based approach is a prerequisite for the survival of new entrants that are only issuers or acquirers because these organisations do not have the capacity for cross-subsidisation between issuing and acquiring functions.

A number of submissions also commented on the current exclusion of cash-out transactions from the EFTPOS interchange fee Standard. Several argued that these transactions should be treated the same as EFTPOS purchases. Among other things, it was argued that the different treatment of cash-out transactions was complicating negotiations over EFTPOS access. Other submissions emphasised that EFTPOS cash-out transactions should receive regulatory treatment that is consistent with ATM transactions.

There were also a small number of submissions suggesting the need to review compliance aspects of the interchange Standards. One submission argued that, if interchange regulation is retained, common weights should be used for determining the schemes' weighted-average interchange fees for comparison with the benchmark. It argued that this would remove schemes' capacity to exploit differing compositions of card portfolios to gain market share in particular segments. Another submission raised concerns that the regulated schemes are exploiting the period between compliance calculations in a way that allows weighted-average interchange fees to rise between compliance dates.

A number of submissions expressed concern that scheme fees could be used in a manner similar to interchange fees – that is, to raise revenue from acquirers and merchants to pay to issuers and cardholders. These submissions called for structural changes to generate competition over scheme fees (for example, allowing acquirers to choose which network routes transactions to issuers) or to subject these fees to greater scrutiny.

The main issues prompting comment other than interchange regulation related to the honour-all-cards and no-surcharge Standards. Some submissions supported further modifications to the honour-all-cards Standard as a way of further improving the competitive environment. One suggestion was to extend the Standard to cover all categories of card with a different interchange fee, rather than simply debit and credit cards as covered currently.

Other submissions expressed concern that an extension of the honour-all-cards Standard would lead to high levels of confusion among consumers, particularly foreign visitors.

A number of parties raised the possibility of imposing a cap on any surcharge imposed by merchants, or requiring that surcharges bear a reasonable relationship to the cost of accepting a card. In particular, it was argued that such a cap could help limit the brand damage that can occur as a result of merchants surcharging excessively.

5. The Board's Assessment

This section sets out the Board's views on the major issues raised in the consultation process. First, it discusses the Board's assessment of the competitive forces acting on interchange fees, and in particular, why it is that close oversight of retail payments is warranted. Second, it discusses the main effects of the reforms. And third, it discusses the Board's proposed course of action in a number of areas. The options for interchange fees are discussed separately in the following section.

5.1 A central issue: the competitive forces acting on interchange fees

A central issue confronting the Review is the extent of the competitive forces acting on interchange fees. From the time of the Joint Study, the Board's view has been that the normal forces of competition have not acted effectively on interchange fees, and that the resulting configuration of fees was not conducive to the efficient evolution of the system. As noted above, during the consultation process a number of parties argued that, due to the Bank's reforms, the competitive environment is very different to that applying five years ago and that interchange regulation could now be removed. In contrast, others argued that because of the structure of the market, it was very difficult, if not impossible, to have confidence that competition could ever lead to an efficient configuration of interchange fees.

Following a careful consideration of this issue, the Board remains of the view that, in the absence of regulatory oversight, there is a significant risk that interchange fees in some systems will be set at levels that are too high from the point of view of the efficiency of the system. The main reason for this is that merchants find it difficult to exert sufficient downward pressure on interchange fees, largely as a result of the structure of incentives that they face. In essence, merchants face a co-ordination problem, and as a result are willing to pay more, in aggregate, for some payment methods than the aggregate benefit that they receive from accepting those methods. This difficulty is most apparent in the credit card system but, in principle, can arise in other payment systems as well.

While each merchant that accepts credit cards obviously judges the net benefit of doing so to be positive (otherwise it would not accept credit cards), the aggregate benefit to the merchant community of acceptance need not exceed the aggregate cost of acceptance. This is because part of the benefit that an individual merchant perceives from accepting cards is that of 'stealing' business from other merchants. But merchants cannot collectively steal business from themselves; one business's gain is another's loss. Further, the Board does not accept the idea that in the long run, credit card acceptance by merchants significantly increases the aggregate value of spending (although it is likely to bring forward some spending).

In a sense, merchants are in a game akin to the 'prisoner's dilemma': they would be better off if they could collectively agree on the terms of credit card acceptance, paying no more than their collective benefit, but instead they act individually and, as a result, can in aggregate potentially pay more for credit card acceptance than the benefit they receive.

Historically, merchants' ability to exert competitive pressure on interchange fees has been further diluted by scheme rules and a lack of transparency of interchange fees. In particular, the no-surcharge and honour-all-cards rules reduced the ability of merchants to put downward pressure on interchange fees by either threatening to impose a surcharge, or refusing acceptance of some cards with high interchange fees. The lack of transparency also made it difficult for merchants to know exactly what interchange fees were being paid on different transactions.

The Board's main concern about high interchange fees arises from the potential for these fees to distort payment patterns. In particular, a payment system with high interchange fees can effectively subsidise consumers to use that system, even if doing so generates a loss of welfare for society as a whole. In the Australian context, the cash, direct entry and cheque systems do not have interchange fees and there is no simple means by which such fees might be implemented in these systems. This puts these systems at a potential disadvantage.

Of more concern has been the structure of the EFTPOS debit card system, and in particular the existing governance and organisational structure of this system. The current arrangements have meant that, following the establishment of the system in the 1980s, it has been very difficult for industry participants to change the long-established interchange fees. Given that these fees were set up to be paid from the issuer to the acquirer (the reverse direction to almost all other interchange fees in the world), the EFTPOS system has been at a significant disadvantage to the credit card system. The result has been a set of price signals to consumers that have encouraged credit card use at the expense of debit card use.

It is important to note that the Board's concerns in this area have nothing to do with the level of credit card debt and do not reflect a view that 'debit is better than credit'. Rather they reflect a judgement that the structure of interchange fees in the Australian payments system has distorted payment patterns in Australia.

While the Board recognises that there may be a case for interchange fees in some payment systems, it has not been presented with any convincing evidence to suggest that the various externalities that might justify these fees are sufficiently different in the debit and credit card systems to justify substantially different fees in these systems.

The Board's central conclusion here is that merchants, as a group, will pay more for credit card acceptance than the benefit they receive, introducing a distortion into the system. Historically, this distortion has been amplified by the various scheme rules that have restricted merchants' choices. The Bank's reforms have required that these restrictions be removed, but they have not completely overcome the source of the distortion. Given this assessment, the Board's deliberations in this area have focussed on two broad issues:

(i) whether more can be done to give merchants greater influence over the levels at which interchange fees are set by encouraging, or requiring, further changes to scheme rules or the structure of the system; and

(ii) whether, in the long run, regulation of interchange fees will more effectively overcome the underlying distortion than other approaches.

These issues are taken up further below.

5.2 The effects of the reforms

As part of the Review, the Board has considered the broad effects of the reforms and the various views expressed through the consultation process. The following discusses the Board's assessment of the main effects of the reforms.

5.2.1 Price signals and payment patterns

In the Board's judgement, the reforms have met a key objective of improving the price signals that consumers face when choosing between use of credit and debit cards. In particular, the relative prices that consumers face for credit and debit transactions more closely reflect relative costs than was the case prior to the reforms. While the Board recognises that efficiency does not necessarily require an exact alignment of costs and prices in the various systems, its assessment is that the relative prices that consumers now face are a substantial improvement compared to those that existed prior to the reforms.

An important part of the Review has been a re-examination of the costs of the various payment instruments. This work has confirmed that the resource costs of credit card transactions are higher than for EFTPOS transactions for both financial institutions and merchants. In terms of the payment functionality, the cost of an average-sized credit card transaction is around $0.46 higher than for an average-sized EFTPOS transaction.[3] The fraud costs associated with credit cards are higher than on EFTPOS transactions – due to signature authorisation and the ability to use credit cards in remote environments – and there are higher costs associated with maintaining an international scheme. Merchants also incur higher costs mainly because credit card transactions take longer to process at the point of sale than do EFTPOS transactions.

The changes in price signals that have occurred reflect both changes in interchange fees and the introduction of surcharging on credit card transactions. Lower interchange fees in the MasterCard and Visa credit card systems have resulted in a reduction in the value of reward points and higher annual fees, increasing the effective price of credit card transactions facing many consumers. For example, the effective price of a $100 transaction where the credit card balance is paid off by the due date has increased from around -$1.30 prior to the reforms (reflecting the value of the interest-free credit and reward points) to around -$1.10 currently.[4]

Surcharging has also led to a significant rise in the effective price of some credit card transactions. Since the beginning of 2003, when the no-surcharge rule was removed, the number of merchants surcharging has risen substantially (Graph 2). At the end of 2007, around 23 per cent of very large merchants imposed a surcharge; for small or very small merchants, the percentage was closer to 10 per cent.[5] Although the size of the surcharge varies across merchants, the average surcharge imposed is currently around 1 per cent for MasterCard and Visa transactions, and around 2 per cent for American Express and Diners Club transactions.[6] At these levels, the

3 *Including the costs related to the credit and reward functionality of credit cards, the differential is around $1.33 on average, half of which is due to the cost of credit collections and write-offs with credit cards. These calculations are based on costs for the average transaction size for each payment method. Using a consistent transaction size of $50, which is around the median for credit card and EFTPOS payments, the average cost of the payment functionality of a credit card transaction is around $0.35 higher than for an EFTPOS transaction. See Schwartz C, J Fabo, O Bailey and L Carter (2008), 'Payment Costs in Australia',* Payments System Review Conference, *Reserve Bank of Australia and Melbourne Business School, Sydney, pp 88-138.*

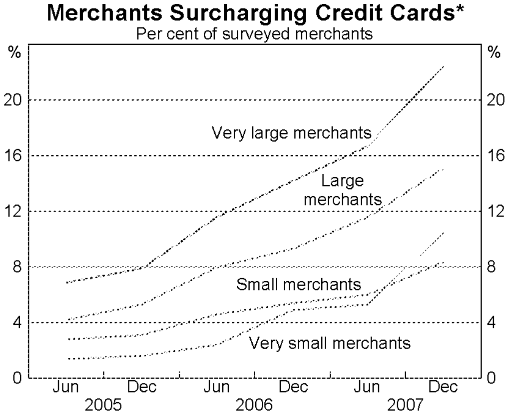
4 *These calculations abstract from changes in the general level of interest rates over time. The other component of these calculations, namely the length of the interest-free period, is directly controlled by issuers and on average has not changed significantly since 2003.*

5 *East & Partners (2007),* Australian Merchant Acquiring and Cards Markets: Special question placement report prepared for the Reserve Bank of Australia, *December.*

6 *East & Partners (2007).*

Graph 2

Merchants Surcharging Credit Cards*



* Very large merchants are those with annual turnover greater than $340 million, large merchants $20 million to $340 million, small merchants $5 million to $20 million and very small merchants $1 million to $5 million.

Source: East & Partners Pty Ltd

effective price of a MasterCard or Visa credit card transaction on which a surcharge is imposed and the balance is paid off in time is close to zero. For consumers who do not pay the balance by the due date, the effective price of a credit card transaction on which a surcharge is imposed is clearly positive.

For EFTPOS transactions, prior to the reforms most banks provided a certain number of fee-free transactions after which a charge of around $0.50 was levied. In contrast, most financial institutions now offer customers 'all you can eat' accounts, which offer unlimited fee-free transactions (usually electronic) for a fixed monthly account-keeping fee. While this change reflects a number of factors, the reduction in EFTPOS interchange fees from around $0.20 a transaction to $0.05 a transaction has made it more viable for institutions to offer accounts that do not have EFTPOS transaction fees.

While it is difficult to estimate precisely what effect these changes in price signals have had on payment patterns in Australia, the available evidence strongly supports the idea that relative prices matter to consumers' choice of payment instrument.

Confidential data from one card scheme indicate that when surcharges are imposed on a particular type of card, use of that card declines substantially. Where merchants have imposed a surcharge on one scheme only, or imposed a higher surcharge on one scheme than another, there have been large shifts in payment patterns away from the scheme with higher surcharges.

Similarly, data from the survey of individuals' payment patterns undertaken by the Bank as part of the Review indicate that those consumers that face a higher price for credit card transactions tend to use credit cards less than those that face a negative price. In particular, according to the survey results, credit card 'transactors' (who face a negative price) undertook around 22 per cent of their transactions on credit cards, while 'revolvers' (who face a positive price) undertook only around 12 per cent of their transactions on credit cards.[7] Conversely, revolvers are more likely to use a debit card for payments, while nearly 40 per cent of transactors did not use a debit card for any payments during the two-week survey period. The survey also indicated that credit and debit cards are used extensively for a wide range of transactions in the $25 to $200 range, suggesting significant substitution possibilities for some consumers.

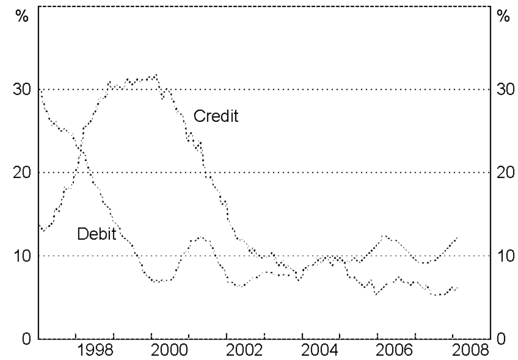
7 *Emery D, T West and D Massey (2008), 'Household Payment Patterns in Australia',* Payments System Review Conference, *Reserve Bank of Australia and Melbourne Business School, Sydney, pp 139-176.*

Aggregate data also show a slowing in growth of the number of credit card transactions over the past few years, while growth in the number of debit card transactions has increased (Graph 3).

Graph 3

Number of Card Payments

Year-on-year growth



Source: RBA

5.2.2 The effect on welfare

A number of submissions have argued that the reforms, particularly those to interchange fees, have reduced aggregate welfare, citing, among other things, the higher costs that credit card holders pay for credit cards. The Board does not accept this argument.

While the reforms have clearly affected different groups differently, the Board's assessment is that the effect on overall welfare has been positive. In assessing the aggregate benefits it is important to recognise that simply altering the size of the transfers between different participants in the payments system has only a limited direct effect on overall welfare, although it obviously affects the groups involved. The major benefits to the Australian economy accrue not through changing the size of these transfers, but through the improved allocative efficiency resulting from more appropriate price signals, and an increase in the contestability of markets.

While it is relatively straightforward to measure the change in the transfers between different groups, measuring the overall benefits is inherently difficult, partly because it cannot be known precisely what would have happened in the absence of the reforms. One approach is to use the principle of revealed preference, which suggests that if consumers use a particular payment instrument at a given price, they must receive a benefit at least equal to that price. Further, if the price increases then it can be inferred that those consumers that stop using the payment instrument receive a benefit less than the new price.

Using this principle, together with some assumptions about the change in the use of the various instruments, some indicative measures of welfare gain can be produced. If, for example, it is assumed that the number of credit card transactions was around 5 per cent lower over the past year than would have otherwise been the case (with these transactions migrating to the EFTPOS system), the welfare gain could be in the order of \$100–\$150 million per annum.

An alternative assumption might be that in the absence of the reforms, the EFTPOS system would have gradually withered, with transactions migrating to the international card schemes. Based on the cost data collected as part of this Review, this would have resulted in an increase in annual costs to the economy of around \$300 million. To the extent that a number of EFTPOS users valued EFTPOS transactions more highly than scheme card transactions, the net benefit to society from the reforms would have been higher still.

The Board's overall assessment is that the welfare gains from the reforms are likely to have been substantial. Not only has the change in payment patterns *relative to what would have occurred in the absence of the reforms* resulted in lower costs, but there has also likely been an increase in welfare from consumers using a payment instrument from which they derive higher benefits. An estimate of the welfare gain of some hundreds of millions of dollars per annum would not be inconsistent with the available data.

5.2.3 Competitive position of the three-party schemes

One criticism of the credit card interchange fee regulations is that they have given a competitive advantage to American Express and Diners Club. While the Board has adopted a different approach to American Express and Diners Club than to the four-party schemes, this reflects differences in the structure of the schemes.[8] The Board does not accept the idea that the different approaches have given American Express and Diners Club a competitive advantage.

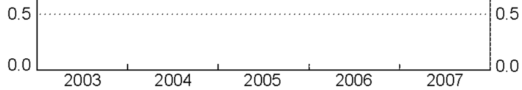
While neither American Express nor Diners Club has been designated under the *Payment Systems (Regulation) Act*, both agreed to voluntarily comply with the no-surcharge Standard. American Express also agreed to remove its no-steering provisions. These changes have had significant effects on the schemes. This is partly because they have higher merchant service fees than the four-party schemes which has meant that surcharges are more likely to be imposed, and where they are imposed, they tend to be relatively large. As noted earlier, survey data suggest that for those merchants that surcharge, the average surcharge for a transaction on a MasterCard or Visa card is around 1 per cent while for American Express and Diners Club cards it is around 2 per cent. Moreover, confidential evidence provided to the Bank by one card scheme indicates that where such differential surcharging has been applied it has had a marked effect on the use of the various cards.

Merchant service fees charged by both American Express and Diners Club have been under downward pressure as merchants have reviewed their acceptance of these cards given the increase in their relative costs compared to MasterCard and Visa cards. Since the reforms were introduced, average merchant service fees for American Express and Diners Club transactions have fallen from 2.44 per cent to 2.16 per cent (Graph 4). This decline is around half that of the four-party schemes and has occurred a little more slowly than the Bank originally expected. But at the same time, surcharging appears to be more prevalent for American Express and Diners Club than for MasterCard and Visa, suggesting that the three-

Graph 4

Merchant Service Fees

Per cent of transaction values acquired



Source: RBA

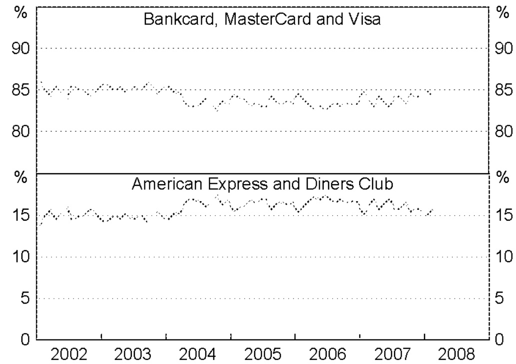
8 *For a discussion of why different approaches were adopted see: Reserve Bank of Australia (2002),* Reform of Credit Card Schemes in Australia: IV Final Reforms and Regulation Impact Statement, *August, p 2; and Reserve Bank of Australia (2005),* Media Release No. 2005-02, *'Payments System Reform', 24 February.*

party schemes have been prepared to preserve higher merchant fees at the expense of more surcharging.

Graph 5

Market Shares of Card Schemes

By value of purchases



Source: RBA

The available evidence on market shares of the three-party schemes does not suggest that these schemes have enjoyed a competitive advantage. While the combined market share of American Express and Diners Club did increase by 2 percentage points in 2004, coinciding with the issuance of American Express cards by two major banks and an arrangement between Diners Club and another major bank, over the past two years their market share has been broadly stable and has actually declined a little recently. Over the three months to February 2008, the market share of the three-party schemes was only around 1 percentage point higher than over the same period five years earlier, prior to the reforms (Graph 5).

5.2.4 Competitive pressure on interchange fees

Evidence on the effect of the Bank's reforms on the competitive pressures on interchange fees is mixed. On the one hand, the modification of the honour-all-cards rule has resulted in a lowering of scheme debit interchange fees for some merchants, and the increased prevalence of surcharging has raised the prospect that future increases in interchange fees would be resisted by merchants. On the other hand, average interchange fees are still pushing up against the benchmarks, suggesting that upward pressure on these fees remains.

Increased competitive pressures flowing from the modification of the honour-all-cards rule have been evident mainly in the lowering of interchange fees on scheme debit products, at least for large merchants. Industry participants suggest that this outcome is partly attributable to the ability of these merchants to decline acceptance of scheme debit cards if the fees are too high. This ability reflects both the changes to the honour-all-cards rule and the existence of an alternative debit card system which the merchants can rely on if they decline to accept scheme debit.

In contrast, there is little evidence to suggest that surcharging has put direct downward pressure on interchange fees in the four-party schemes. However, in the Board's view, the increased willingness of merchants to surcharge suggests that, looking forward, the threat of surcharging could reduce the upward pressure on interchange fees. This would be consistent with the experience of the three-party schemes discussed above.

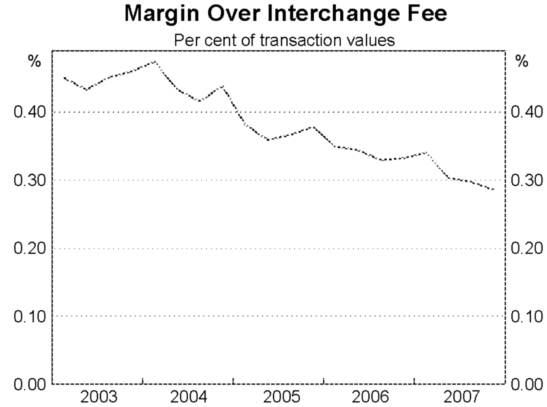
Notwithstanding these factors, the benchmarks set by the Board are binding and there is no suggestion that competitive pressure is leading to average interchange fees being set *below* the relevant benchmarks. Indeed, confidential data provided to the Bank suggest that average interchange fees are currently above the relevant benchmarks. Although large merchants have had some success in bargaining down interchange fees, these lower fees have tended to be offset by higher interchange fees for other categories of transactions, in particular interchange fees faced by smaller retailers. This experience suggests that despite some increased competitive pressures at the margin, the more important factor keeping interchange fees low is the regulatory caps.

5.2.5 Competition in acquiring

The reforms appear to have contributed to increased competition in acquiring. This is suggested by a significant decline in the margin between average merchant service fees and average interchange fees. The margin for the four-party credit cards has fallen from 0.45 per cent of the transaction value in the September quarter of 2003 to 0.29 per cent of the transaction value in the December quarter 2007. For EFTPOS, it has fallen from $0.18 per transaction in the September quarter of 2006 to $0.13 per transaction at the end of 2007 (Graphs 6 and 7).

Graph 6

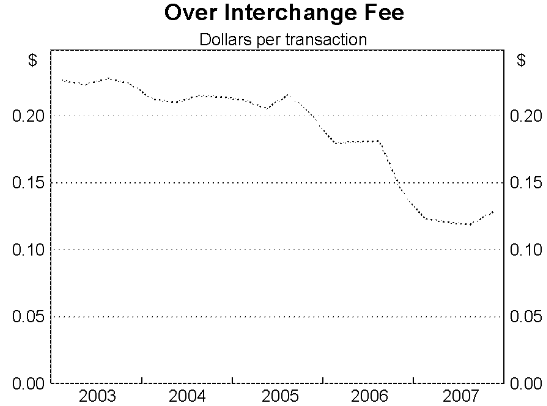
Credit Card Merchant Service Fee Margin Over Interchange Fee



Source: RBA

Graph 7

EFTPOS Merchant Service Fee Margin Over Interchange Fee



Source: RBA

In part this decline can be attributed to the increased focus that the Bank's reforms have brought to payments system issues, and the increased transparency that has resulted from the reform process. Merchants now understand more about the costs being incurred by acquirers and are in a better position to negotiate with acquirers. The access reforms may have also contributed to the lower margins (see Section 5.2.8 below).

5.2.6 Merchant pass-through of savings

One issue that has attracted considerable attention since the reforms were introduced is whether the cost savings that merchants have received from lower merchant service fees have been passed on to consumers in the form of lower prices for goods and services than would have otherwise been the case. The schemes argue that there has been no, or little, pass-through, while the merchants argue that the cost savings have been passed through. The Bank's estimate is that over the past year, these cost savings have amounted to around $1.1 billion.

No concrete evidence has been presented to the Board regarding the pass-through of these savings, although this is not surprising as the effect is difficult to isolate. The Bank had previously estimated that the cost savings would be likely to lead to the CPI being around 0.1 to 0.2 percentage points lower than would otherwise be the case over the longer term (all else constant). It is very difficult to detect this against a background where other costs are changing by much larger amounts and the CPI is increasing by around 2½ per cent per year on average.

Despite the difficulties of measurement, the Board's judgement remains that the bulk of these savings have been, or will eventually be, passed through into savings to consumers. This judgement is consistent with standard economic analysis which suggests that, ultimately, changes in business costs are reflected in the prices that businesses charge. A similar conclusion was reached by the House of Representatives Standing Committee on Economics, Finance and Public Administration when it considered the Bank's payments system reforms in 2006.[9]

5.2.7 Innovation

Another issue that has attracted considerable attention is the effect of the reforms on innovation in the payments system. In particular, some industry participants have argued that the introduction of chip and PIN on credit cards has been delayed in Australia because of the reduction in credit card interchange fees. The Board does not agree with this position.

Many industry participants have noted that, until recently, there has been only a weak business case for the introduction of chip and PIN on credit cards. This primarily reflects the fact that fraud rates in Australia have been very low. Data collated by APCA indicate that, over the year to June 2007, fraud on credit and charge cards amounted to around 39 cents per $1 000 transacted, around the same as in previous years. This is very low compared with overseas jurisdictions in which chip and PIN have been implemented, most notably the United Kingdom. Given this low rate of fraud, few industry participants have seen a strong case to incur the substantial expenditure required to implement these technologies.

In addition, in the Board's view it is unlikely that the level of interchange fees paid to issuers is an important determinant of investment in chip and PIN technology. Confidential information provided to the Bank in 2003 showed that around 80 per cent of the expenditure required to upgrade the Australian system to chip technology would be borne by acquirers. Raising interchange fees paid by acquirers would not seem to be consistent with encouraging those same acquirers to undertake significant additional capital expenditure. Furthermore, countries with higher interchange fees than Australia, most notably the United States, have not upgraded to chip and PIN.

No concrete evidence has been presented to the Board to suggest that innovation has been slowed by the reforms, although a number of general claims have been made. Some industry participants have argued that the reforms have actually promoted innovation, by making the market more contestable, although again few concrete examples have been provided.

9 *House of Representatives Standing Committee on Economics, Finance and Public Administration (2006),* Review of the Reserve Bank of Australia and Payments System Board Annual Reports 2005*, Canberra, June.*

The Board's general conclusion in this area is that the reforms have had little effect on the pace of innovation, either negatively or positively. The Board does, however, recognise that regulatory uncertainty and the regulatory environment can affect the pace of innovation, and this is discussed further in Section 6.

One related issue that the Board has drawn attention to on a number of occasions is the governance arrangements that apply to Australia's bilateral payment systems. As has been argued previously, the current arrangements are not always conducive to innovation, and the Board urges the industry to examine these structures as a matter of priority.

5.2.8 Access

The access reforms have made it easier for new participants to enter the payments system, although further progress is required. Two new acquirers and one new issuer have been authorised by APRA as Specialist Credit Card Institutions. In addition, there have been a number of cards issued under co-branding arrangements with established issuers; for example, rather than joining the schemes in their own right, a number of large retailers have chosen to partner with financial institutions to issue cards on their behalf.

The EFTPOS Access Regime has improved access at the margin for new entrants but the bilateral architecture of this system still makes access to this system difficult. Since its establishment in September 2006, there have been two applications for access under the APCA Access Code. In both these cases, however, access was ultimately negotiated outside the Code, suggesting that, while the provisions might not be used, the Access Code and Regime have provided a negotiating backstop for new entrants.

The experience of recent years has demonstrated that the ability to compete in one payment system is often conditional on being able to obtain access to another system. When a merchant is choosing an acquirer, it typically wants a firm that is able to acquire all its card transactions, requiring access to all the credit card and debit card systems. In the absence of more comprehensive access reform than has currently been undertaken, particularly to Australia's bilateral payment systems, access will remain relatively difficult, although substantially easier than was previously the case.

5.2.9 The use of cash

Over recent years, a criticism of the Bank's reforms is that they have not addressed what some see as a significant distortion in the payments system, namely the heavy use of cash. Some industry participants have gone further and argued that the reduction in interchange fees has promoted the use of cash, and that this has harmed the overall efficiency of the payments system. The Board's judgement is that the evidence does not support these views.

The Bank's research on payment patterns in Australia showed that cash is the most commonly used payment method, accounting for around 70 per cent of transactions by individuals.[10] It is used particularly extensively for small transactions, accounting for nearly all transactions under $10 and three-quarters of transactions between $11 and $25. Importantly, information

10 *Emery D, T West and D Massey (2008), 'Household Payment Patterns in Australia',* Payments System Review Conference, *Reserve Bank of Australia and Melbourne Business School, Sydney, pp 139-176.*

on the cost of various payment instruments shows that for these low-value transactions, cash has a lower average cost than other payment methods.[11] This is partly explained by the fact that small cash payments have faster tender time than electronic payments, and that a single cash withdrawal can support multiple cash transactions in contrast to the electronic payment systems which require use of the electronic infrastructure each time a payment is made.

In addition, there are no restrictive practices in the provision of cash. Banks supply cash to individuals and merchants in a competitive market place and, while it is true that the costs of producing cash are not explicitly charged to the users of cash, the effect of this is more than offset by the interest forgone in holding cash. Indeed, in many cases, given the interest forgone and charges on foreign ATM withdrawals, cash represents a more expensive payment instrument for consumers than either debit or credit cards.

Despite this higher effective price, cash is used frequently, presumably reflecting the benefits that individuals derive from cash payments. Foremost amongst these are the quicker tender time and, to a lesser extent, the anonymity of cash payments. Perhaps at some point in the future an alternative low-cost payment instrument will emerge that can offer these same benefits. To date, however, the various schemes that have been proposed or trialled have not been able to gain sufficient merchant or cardholder acceptance. And, importantly, the costs have either been too high or the functionality too limited compared with cash.

The Board's assessment, therefore, is that there is no major distortion in the payments system that encourages or discourages the use of cash. For the low-value transactions for which cash is predominantly used, it is a low-cost, efficient payment instrument.

5.3 Major policy issues

This section discusses the Board's main conclusions about the various standards and access regimes introduced over recent years and, in particular, whether these standards and access regimes should be retained, and if so, whether they should be modified. It also discusses some further suggestions for reform.

5.3.1 Interchange fees

As noted above, the Board's judgement is that there are strong public policy grounds for continued close regulatory oversight of interchange fees in card payment systems. The nature of the incentives facing merchants means that there is a significant risk that, in the absence of such oversight, interchange fees will be set at levels that distort payment patterns. The likelihood of this outcome is increased by the current governance arrangements in the EFTPOS system which limit the capability of the EFTPOS system to be an effective competitor to the international card schemes.

The Board does not, however, view interchange fees as undesirable in all circumstances. While it remains unconvinced that interchange fees are needed in mature systems, it can see an argument for interchange fees in emerging systems or, potentially, in systems that are being upgraded. In the start-up phase, a payment system may find that it cannot attract consumers to

11 *Schwartz C, J Fabo, O Bailey and L Carter (2008), 'Payment Costs in Australia',* Payments System Review Conference, *Reserve Bank of Australia and Melbourne Business School, Sydney, pp 88-138.*

use the system without subsidising use. An interchange fee may assist in establishing a payment network and realising the benefits to the economy. Once the system is established, however, there seems to be less reason to maintain the fees at their original level.

This assessment rules out the Board stepping back completely and unconditionally from the regulations introduced over recent years. The issue facing the Board, therefore, is how to best build on the progress that has been made in improving the competitive environment and in establishing less distortionary interchange fees. Looking forward, the Board has considered three broad options with respect to interchange fees. These are discussed in Section 6.

5.3.2 The no-surcharge Standard

The Board sees no case for allowing the schemes to reintroduce the no-surcharge rule. Given that the schemes have argued strongly against the no-surcharge Standard, it is the Board's expectation that if the Standard were removed the schemes would seek to re-establish the rule. The Board is, however, prepared to consider removing the Standard if the schemes provided an enforceable undertaking that they would alter their rules to allow surcharging.

In the Board's view, the benefit of the no-surcharge Standard has been substantial. It has improved price signals to consumers and, in time, might be expected to add to the downward pressure on interchange fees. The schemes' no-surcharge rules had long restricted merchants from passing on the costs of card acceptance to cardholders, and had reinforced the underlying distortion discussed in Section 5.1.

While the Board is proposing to retain the Standard, it has considered modifying the Standard to place a cap on the size of any surcharge imposed by merchants. This reflects concerns expressed through the consultation process that surcharging is being exploited by firms with market power. The Board's assessment, however, is that the case for such a cap is relatively weak, and it is not persuaded that the isolated examples of high surcharges are sufficient grounds to reimpose restrictions on merchant pricing for all merchants. The imposition of a cap would limit merchant flexibility and potentially remove a negotiating tool for merchants who might agree to limit the amount of their surcharge in exchange for a lower merchant service fee.

While surcharging might make more transparent any market power that already exists, it is a symptom not a cause: if a firm has market power, a limit on the surcharge is unlikely to affect the overall price charged by that firm. Furthermore, the evidence does not support the idea that surcharging is only used by firms with market power, with firms across a wide range of industries levying surcharges. By imposing a surcharge, some firms operating in very competitive markets are able to offer cardholders the choice of paying by credit card, without all their customers having to cover the higher costs of credit card acceptance. Finally, a confidential submission by one of the schemes provided the results of a survey that indicates that surcharges tend to be set with reference to merchant service fees.

5.3.3 The honour-all-cards Standard

The Board does not see a case to allow schemes to reinstate their earlier version of the honour-all-cards rule. The evidence to date suggests that the modification of the rule has, at the margin, been of benefit in exerting downward pressure on some interchange fees, and this benefit is expected to increase through time. As with the no-surcharge Standard, the Board is prepared to consider removing the Standard imposed on the Visa scheme if Visa provided an enforceable undertaking that it would alter its rules (MasterCard has already provided such an undertaking).

Since the introduction of the honour-all-cards Standard in 2007, there have been signs that some merchants have used their new freedom to negotiate lower interchange fees in the scheme debit systems. In particular, both schemes have introduced interchange fees for scheme debit transactions undertaken at large merchants significantly below the 12 cent cap.

This result is encouraging and in line with the Board's expectations at the time the Standard was introduced. It indicates that providing large merchants with more freedom on the conditions under which they take cards can result in more competitive pressure on the interchange fees applying to those merchants.

While the Board is proposing to maintain the Standard (and the associated Undertaking), it has considered modifications to address concerns raised during consultation about the treatment of scheme pre-paid cards. When the Board looked at pre-paid cards in 2006, it decided not to regulate interchange fees for these cards (which were, at the time, not in wide use) but did signal an expectation that interchange fees should be set broadly in conformity with those for scheme debit cards. Furthermore, it indicated that if a pre-paid card was introduced with features substantially different from a scheme debit card, merchants should not be required to accept that card.

Since then there has been an increase in the issuance of scheme pre-paid cards and the feedback through the consultation process is that the lack of an explicit reference to pre-paid cards in the Standard and Undertaking is causing confusion. Some industry participants have argued that the Standard and associated Undertaking should be modified to explicitly acknowledge that merchants are not required to accept pre-paid cards as a condition of accepting any other scheme card.

The forced acceptance of pre-paid cards is inconsistent with the general approach that the Board has taken. It has the potential to make it more difficult for other, non-scheme pre-paid cards to compete, and allows the schemes to tie the interchange fee to that applying to scheme debit. Given the potential for pre-paid cards to become a significant part of the payments system in the future, the Board sees a strong case for merchants being allowed to make independent acceptance decisions about this form of card. This could be achieved by the schemes voluntarily removing any rules that tie acceptance. In the event this did not occur, the Board would consider designation of the pre-paid schemes and regulation.

A further issue raised in the context of honour-all-cards rules is that one scheme has offered a discounted interchange fee to some merchants on the condition that they accept all the scheme's cards. Although not technically in breach of the honour-all-cards Standard or Undertaking, the requirement introduces a substantial penalty for a qualifying merchant who chooses not to accept all cards. In the Board's view, this is inconsistent with the spirit of the Standard and the principles that the Board discussed when it first introduced the honour-all-cards Standard.

Although the practice currently only applies to large merchants, it is possible that it could be extended more broadly, reintroducing a *de facto* honour-all-cards rule. For the same reasons that the Board viewed the original introduction of the honour-all-cards Standard to be in the public interest, it is of the view that this practice detracts from competition and efficiency by limiting merchant choice and, therefore, merchants' ability to impose downward pressure on interchange fees. The Board's preliminary conclusion is that the Standard and associated Undertaking by MasterCard should be modified to address this issue. Such a change would take place regardless of the final option chosen on interchange regulation.

Finally, the Board has considered whether a further modification of the rule to allow separate acceptance decisions for any product that has a separate interchange fee would promote competition and efficiency in the payments system. Its conclusion on this issue is discussed in the following section, given that the Board's proposed approach depends upon the direction taken with respect to interchange fee regulation.

5.3.4 Access Regimes

As noted in Section 3, a number of reforms to access have improved the ability of new entrants to compete in the card payment systems. The Board is proposing to retain all the existing access regimes.

Difficulties, however, remain particularly with payment systems built around bilateral technical links and business relationships. Even in the EFTPOS system where access reform has been helpful, access remains more difficult than is desirable.

The technology on which the bilateral payment systems are based is relatively old and is likely to need to be updated in the not too distant future. The Board is aware that there are alternative technologies available for exchanging payment messages, some of which do not require separate connections to all participants. Indeed, some of these new technologies only require entrants to establish a single technical connection in order to participate fully in a payment system. The Board has no specific views on the appropriate technology going forward and has no plans to impose an access regime or standards to implement a particular solution. It does, however, encourage the industry to consider seriously these new technologies and to assess which ones would provide the most open, transparent and cost-effective options for access by new entrants.

There is a minor issue related to the wording of the Visa Debit Access Regime that the Board will take the opportunity to modify at the same time as any changes related to the Review. This modification relates to the definition of a Specialist Credit Card Institution. The current definition includes an entity that proposes to engage in debit card issuing but does not otherwise conduct banking business. Such an entity could not exist because debit card issuing requires the taking of deposits. The change in the Access Regime will remove this anomaly but will have no practical effect.

5.3.5 Bypass rules

MasterCard and Visa have both advised the Bank that there are no rules in Australia that prohibit the bypass of the scheme processor. This is supported by the fact that two large merchants in Australia have bypass arrangements in place whereby they utilise their own switches to send credit card transactions directly to the issuer, rather than through an acquirer and the scheme switch.

The Board is not aware of anything in the scheme rules that would prevent an independent switch from providing a similar service to smaller merchants that do not have their own switch. Also, there seems no reason why an acquirer could not choose to send its transactions to the issuer through an independent switch. In both cases, competition would be enhanced.

Although there are apparently no restrictions on this activity, there would seem to be some benefit in the schemes making a clear statement on the criteria that alternative switches need to meet. Such a requirement would seem to impose little cost on the schemes and would increase the transparency of the relevant requirements.

5.3.6 Merchant choice of scheme

One issue that was raised a number of times at the Payments System Review Conference was whether *merchants* should be able to choose the network through which a transaction is processed. Under such an arrangement, rather than the cardholder pre-selecting the network by presenting, say, a Visa branded card, the merchant would choose whether the transaction was processed through the MasterCard or Visa network. In theory, this would exert pressure on interchange fees and scheme fees because the merchant would tend to select the cheaper network.

Such a change would be expected to have a very significant effect on the competitive dynamics in the payments system. Instead of competing for consumers partly on the basis of reward programs (or equivalently competing for issuers by offering the highest interchange fees), the schemes would have an incentive to compete for merchants on the basis of who could offer their payment services at the lowest cost. Such an outcome could well achieve an efficient level of interchange fees because the current market failure – arising from the difficulty that merchants have in refusing credit card acceptance because of business stealing incentives – could be largely overcome by the competition between schemes for merchant business.

Despite the potential advantages of such an arrangement, in practice it would require very significant structural modifications to the existing system. On the issuing side, it would be likely to require credit cards to be issued with both MasterCard and Visa brands. While multifunction cards already exist in Australia in the form of EFTPOS and credit cards, co-branded MasterCard/Visa cards do not exist anywhere around the world, and would require significant system changes. There would also need to be significant changes on the acquiring side, including possibly to terminals.

On balance, while the Board's view is that such changes could have a profound effect on competition, there is not a strong case to require a move in this direction through regulation. It would require costly adjustments in existing systems and may well have significant unintended consequences for the future development of card-based payment systems in Australia.

5.3.7 Transparency of fees

A number of industry participants have expressed a concern that, in an attempt to circumvent the interchange regulations, the payment schemes might raise scheme fees to acquirers (and hence the cost of credit card acceptance to merchants) as a way of generating revenue which could ultimately be rebated to issuers. Concerns about these fees have been heightened by the general lack of transparency to merchants about their magnitude and how they are set. These fees have a number of dimensions, but they are mainly 'brand' fees and fees for the processing of transactions. The main concerns relate to the former, given that it is difficult for acquirers to avoid brand fees. In contrast, if the processing fees were increased significantly, bypass arrangements might be expected to become more common (see above).

The Board can see considerable merit in greater transparency surrounding these fees. This is consistent with its approach in other areas, where transparency is seen as a way of strengthening competitive forces. At the same time, the Board recognises that there is a degree of commercial sensitivity about some of these fees, and has considered how best to increase transparency without forcing schemes to publish information which is legitimately confidential. The Board proposes, therefore, that at a minimum, information on average scheme fees paid by issuers and acquirers should be publicly available. There may also be a case for schemes to publish the average compulsory scheme fee paid by acquirers (that is, fees that cannot be avoided by on-us transactions or using a third-party processor).

In addition to transparency of scheme fees, the Board also sees merit in the schemes publishing their weighted-average interchange fee on a quarterly basis. Again this could be required through regulation if the schemes were not prepared to publish this information voluntarily.

6. Options Regarding Interchange Fees

6.1 The options

As noted above, the Board sees strong public policy grounds for continued close regulatory oversight of card payment systems. The most contentious issue has been, and remains, the regulation of interchange fees. Looking forward, the Board has considered three broad options regarding these fees.

The first is to maintain the *status quo*. Under this option, the broad features of the current interchange regulations would be maintained, including the current caps on interchange fees, although modifications would be made to enhance the functioning of the existing regulations. The second option is to further reduce the allowable levels of interchange fees in the credit card system and to further narrow the difference in interchange fees between the debit card systems. The third option is to step back from the regulation of interchange fees on the condition that further changes are made by industry participants to enhance the competitive environment. The three options are set out and discussed below.

Option 1: Status quo

The first option is to retain the current credit and debit card interchange Standards, largely unchanged. This would mean that:

- the weighted-average interchange fee in the MasterCard and Visa credit card systems would continue to be capped at around 0.5 per cent;
- the weighted-average interchange fee in the MasterCard and Visa debit card systems would continue to be capped at around 12 cents; and
- interchange fees in the EFTPOS system (paid to the acquirer) would continue to be between 4 and 5 cents.

If this option were adopted a number of technical changes, aimed at improving the functioning of the existing regulations, would also be considered. These include:

- the removal of the requirement to conduct cost studies every three years;
- requiring that the weighted-average interchange fees be below the relevant benchmarks once a year, rather than once every three years (or when interchange fees are varied) as is currently the case; and
- removing the exemption of cash-out EFTPOS transactions from the EFTPOS interchange fee Standard.

These modifications are discussed in Appendix 2.

Option 2: Reduce interchange fees further

The second option is to retain interchange regulation, but reduce interchange fees further. This option is consistent with the direction that the Board indicated when the original credit card regulations were finalised in 2002. At that time, the Board stated that the reduction in credit card interchange fees (from around 0.95 per cent to around 0.55 per cent) was the first step towards lower interchange fees in Australia.[12] This option would also eliminate the existing difference in the average interchange fees in the debit card systems in Australia. If this option were adopted, the Board would also consider the technical changes to the Standards noted under Option 1.

If a common average interchange fee is to be established in the various debit card systems, the Board has considered two broad possibilities. The first is to set interchange fees in these systems to zero. The second is to cap interchange fees with a low, but common, benchmark, with fees flowing from acquirers to issuers in both the EFTPOS and scheme debit systems. There are arguments in favour of both approaches.

International experience suggests that debit card systems do not need interchange fees to operate effectively. Moreover, most other payment systems in Australia that draw on transaction accounts do not have interchange fees. This suggests a common fee of zero would be feasible and consistent with existing practice in other payment systems. On the other hand, setting a small positive benchmark for the weighted-average fees would allow the schemes some flexibility in setting different fees for different types of transactions. At the margin this may be useful, and could potentially allow the schemes to use interchange fees in a way that promotes innovation in the system. On balance, the Board considers this latter approach preferable with, perhaps, a benchmark of around 5 cents capping the weighted-average fee in the various debit card systems.

In considering interchange fees in the credit card systems, the Board assessed the case for setting interchange fees to zero, or at levels similar to those in the debit card systems. While it remains unconvinced of the need for significantly higher interchange fees for credit card systems than for debit card systems, it does recognise that there are some plausible arguments that might justify somewhat higher interchange fees in credit card systems. In particular, merchants, in aggregate, may gain some short-term benefit from consumers using credit cards over debit

12 *The Bank stated in* Reform of Credit Card Schemes in Australia: IV Final Reforms and Regulation Impact Statement *that 'The Reserve Bank is prepared to include the cost of funding the interest-free period as an "eligible cost", but only as part of the transition to a lower level of credit card interchange fees in Australia.' (p 37).*

cards, in that sales occur earlier than otherwise. While the Board recognises this possibility, the current difference in interchange fees in the credit and debit card systems is significantly higher than could reasonably be justified by this argument.

Given this assessment, this option involves a substantial narrowing of the existing difference in interchange fees in the debit and credit card systems. In particular, it envisages the benchmark applying to the credit card systems being reduced to around 0.30 per cent.

In summary, this option involves benchmarks which result in:

- a common cap of around 5 cents on the weighted-average interchange fee (paid to issuers) in each of the debit card systems; and
- a cap of no more than 0.30 per cent on the weighted-average interchange fee in the credit card systems.

Option 3: Remove explicit interchange regulation

The third option is for the Board to step back from interchange regulation if the industry is able to address a number of issues that would promote competition and efficiency in a timely fashion. Given its underlying concerns about the competitive forces in the payments system, the Board has ruled out the option of stepping back unconditionally.

If the Board were to step back, one important issue that would need to be addressed is the current structure of the EFTPOS system, given the potentially important role that this system plays as a competitor to the international card schemes. As discussed above, the Board's view is that the existing governance and technical arrangements mean that the EFTPOS system is at a structural disadvantage which limits its ability to provide effective competition longer term. Looking ahead, if the EFTPOS system is unable to provide effective competition (and another widely used and competitive payment system does not emerge), the Board's view is that the case for removal of interchange regulations is relatively weak.

While the Board does not wish to be prescriptive about exactly what is required, a number of developments would strengthen the case that the EFTPOS system was likely to provide meaningful competition in the Australian card payments system over the years ahead. These include:

(i) the introduction of a scheme to replace the existing bilateral contracts, with the scheme able to make decisions about multilateral interchange fees;

(ii) the creation of effective arrangements to promote the development of the system;

(iii) reform of current access arrangements; and

(iv) the development of alternative payment instruments for use in on-line payments (either by the EFTPOS scheme or through another channel).

For the Board to step back, it would need to have reasonable confidence that strong competition exists between the various card-based systems and that the environment is conducive to ongoing strong competition. The Board would want to see tangible progress towards establishing such an environment and not just statements of industry intention to work towards this outcome.

Another issue that would need to be addressed is the honour-all-cards rule. If the Board is to remove the existing interchange regulation, its view is that further steps would need to be taken to improve the ability of merchants to put downward pressure on interchange fees. Accordingly, in addition to the modifications to the honour-all-cards rule discussed in Section 5, the Board sees it as important that payment schemes allow merchants to make independent acceptance decisions for each type of card for which a separate interchange fee applies. This would allow a merchant to refuse acceptance of, say, premium cards if it thought the cost of acceptance was too high relative to the benefit gained. Ideally, such a change would be made voluntarily by the schemes, although the Board would consider imposing this requirement through regulation if the schemes did not change their rules and it was deemed appropriate to step back.

The Board recognises that a number of arguments have been made against this change. One is that it would have little benefit, as most merchants in Australia are charged a single merchant service fee regardless of the card type, and thus have little incentive to refuse acceptance of particular card categories. This may change over time, however, as more merchants move to 'interchange plus' contracts. Second, the change would involve additional costs for acquirers, as they would need to alter their systems to allow merchants to accept some cards, but not others. And third, it has been argued that further changes to the honour-all-cards rule would be confusing to customers and reduce the value of the international card brands.

While the Board recognises that additional costs would be incurred by this change, its judgement is that if interchange regulation is to be wound back, all feasible steps need to be taken to enhance the competitive environment. While this change might not have an immediate effect, over time it is likely to enhance competition, particularly if merchants become willing to threaten to decline acceptance of particular card types.

The Board is not proposing that this change to the honour-all-cards rule be made if either Option 1 or 2 were adopted. Under these options, the costs to financial institutions of making the necessary systems changes are likely to outweigh the benefits, given that interchange fees would be constrained at low levels through regulation.

A third avenue for improving the competitive environment is to further enhance the transparency of the system. In particular, the Board sees a strong case for greater transparency of scheme fees and average interchange fees, as well as the fees and procedures that apply if an acquirer wishes to bypass scheme switches. As discussed in Section 5, the schemes could voluntarily take steps to improve transparency in these areas, or the Bank could require greater transparency through regulation.

One other issue that the Board has considered is whether the case for this option would be strengthened if a framework was in place to ensure that the industry *itself* addressed issues of competition and efficiency. Some have argued in the consultation process that if such a framework were in place, direct regulation by the Board would be unnecessary.

The Board supports this approach in principle. As has been emphasised elsewhere in this document, the Board's clear preference is for the industry to address issues of competition and efficiency rather than for the Bank to impose regulations. Exactly how this might be done remains unclear. One possibility might be for industry to take meaningful steps to improve the competitive environment and promote innovation in the Australian payments system, perhaps through changes to access arrangements and upgrading of the existing technical infrastructure. Another might be for industry participants, including the international card schemes, to directly address the Board's concerns about interchange fees, transparency and merchant restrictions, reducing the need for regulation. Over the period ahead, the Board is prepared to work with industry on developing appropriate arrangements. However, it is not requiring that such a new framework be agreed and put in place before Option 3 could be considered, although clearly industry steps in this direction would strengthen the case for this option.

In summary, this option involves the Bank stepping back from the regulation of interchange fees subject to other changes to further improve the competitive environment, in particular by:

(i) putting in place arrangements that have a high probability of ensuring that there exists a strong effective competitor operating alongside the international card schemes;

(ii) further modifications to the honour-all-cards rule; and

(iii) greater transparency of scheme fees.

In the event that transparency of scheme fees is not improved, the Board would consider regulation to require the schemes to provide the relevant information. The Board would also consider imposing the changes to the honour-all-cards rule discussed above as part of Option 3 if the relevant changes were made to the EFTPOS system but the schemes were unwilling to voluntarily change their scheme rules. In the event that the necessary improvements to the competitive environment are not forthcoming, the Board would consider either Option 1 or 2.

6.2 Advantages and disadvantages of the options

6.2.1 Options 1 and 2

Both Options 1 and 2 involve continued regulation of interchange fees.

The main advantage of Option 1 over Option 2 is that it involves minimal change to the existing arrangements. As such it should involve fewer adjustment costs. It also provides a stable and known environment for industry participants in which to make and implement business plans.

There are two main advantages of Option 2 over Option 1. The first is that under Option 2, a common benchmark in the EFTPOS and scheme debit systems would place these systems on a more equal competitive footing with each other than is the case under Option 1. The second is that Option 2 establishes more appropriate relativities between debit and credit card interchange fees than does Option 1.

The Board has had a long-standing concern that the relativities between interchange fees in the EFTPOS and scheme debit systems could contribute to the atrophy of the EFTPOS system, resulting in a diminution of competition and choice. This concern was one factor that led to the introduction of the EFTPOS and Visa Debit interchange Standards in 2006, with these standards narrowing the difference in interchange fees on a $100 transaction from an average of around $0.75 to $0.17. While this change represents a significant levelling of the playing field, the Board remains concerned about the competitive effects of the current difference in interchange fees. In particular, the difference has the potential to lead issuers to promote scheme debit cards, not just on the basis of product characteristics, but also because of the more favourable interchange arrangements. By establishing similar interchange arrangements in the two systems, as is proposed under Option 2, competition between the schemes is likely to be more soundly based.

As discussed in Section 5, the Board's concerns in this area are not driven by a desire to promote the EFTPOS system: like other payment systems, the EFTPOS system should compete on the basis of the services and pricing it offers to cardholders and merchants. Notwithstanding this, an outcome in which the EFTPOS system declined partly because of the structure of interchange fees – and not because of the services it offers – could not be said to be in the public interest. In the Board's view, competition would be diminished if there were not a strong viable alternative to the international card schemes. The demise of the EFTPOS system would lead to higher costs in the payments system and would also lessen the competitive pressure on interchange fees. Indeed, recent experience suggests that the ability of merchants to offer the EFTPOS option to their customers has put downward pressure on at least some interchange fees in the scheme debit systems (see Section 5).

Option 2 would be expected to lead to a further realignment of relative prices of credit and debit cards. With interchange revenue for credit card transactions reduced, issuers would be expected to increase annual fees and further reduce the value of rewards programs. Since the decline in interchange fees would be around half that of the original reforms, the expected price changes would be correspondingly less. The changed interchange fees in the debit systems may also lead to some changes in pricing for debit card transactions. At the margin, these changes would be expected to lead to some further substitution away from credit cards and scheme debit to EFTPOS.

On balance, the Board favours Option 2 over Option 1. This reflects the fact that the benefits from Option 2, in the form of more appropriate interchange fees and price signals, would continue indefinitely while the benefits of Option 1 over Option 2 are relatively temporary.

6.2.2 Option 3

In contrast to Options 1 and 2, Option 3 envisages the Board stepping back from the regulation of interchange fees. The Board sees both advantages and disadvantages of this approach.

The main advantage is that it offers the prospect of a further improvement in the competitive environment, while allowing schemes more flexibility in the pricing of their payment services. It also provides a way for industry to address the Board's public-policy concerns regarding interchange fees, rather than these concerns being addressed through regulation. This is consistent with the Board's general approach.

Allowing card schemes to set their own interchange fees in an environment in which stronger competitive forces exist than has been the case historically would provide the various card payment systems with the flexibility to compete directly with one another for both acceptance and use. In the past the Board has expressed a concern that this type of competition could push up interchange fees, and this concern remains. There is, however, some prospect that the combination of the reforms to date and some further changes would result in an environment sufficiently competitive that interchange fees would no longer be under continual upward pressure.

One concern that the Board has previously expressed is that the same financial institutions effectively operate and control the various payment systems. This has led the Board to question whether competition between the various payment systems has been stifled. Recent changes to the ownership structure of the international card schemes has opened up the possibility of greater competition between these schemes and those operated and controlled by domestic institutions. The development of an EFTPOS system with appropriate governance arrangements may also be helpful in this regard.

In assessing this option, an important consideration has been the possibility that allowing schemes to set their own fees may increase the probability that the EFTPOS system will, over the longer term, remain a central part of the Australian payments landscape. While Option 2 would reduce the current disadvantage of the EFTPOS system in terms of interchange fees, there is a risk that, if the system remains subject to interchange regulation, financial institutions will not invest sufficiently in the maintenance and development of the system, and that ultimately competition may be weakened.

As noted above, the Board sees no evidence that the current arrangements have limited innovation to date. However, looking forward, it is possible that financial institutions may be more prepared to invest in systems which are able to set their own interchange fees. This might be because the regulatory risks are seen to be lower, or because interchange fees can be used to help finance the development of new and enhanced payment options (as has been the case for BPAY View for example). Allowing the EFTPOS system to set its own interchange fees might, for instance, allow it to develop an additional payment method for payments over the internet, with on-line merchants prepared to pay some of the costs through a higher interchange fee on these transactions.

A second potential advantage of Option 3 is that it removes the costs associated with industry attempting to circumvent the regulations and the Board responding to any circumvention. If interchange fees continue to be regulated, it is likely that the schemes will devote increased resources to seeking out ways of transferring funds from merchants to issuers, possibly through increases in scheme fees combined with a system of rebates to issuers. If such arrangements did emerge, regulation might need to become more far reaching and prescriptive – something the Board would prefer to avoid if possible.

There are also a couple of disadvantages of Option 3 compared to Option 2. The main disadvantage is that interchange fees are likely to be higher than under Option 2. Recent evidence suggests that, despite the improved competitive position of merchants, upward pressure on interchange fees remains. While some interchange fees have been reduced, the cap on weighted-average fees is binding, and indeed average interchange fees have risen above the benchmarks in both the credit and scheme debit card systems. In the Board's view, it is unlikely that the competitive environment will be sufficiently strong under Option 3 to deliver interchange fees lower than those being proposed under Option 2.

Higher interchange fees raise two distinct concerns. The first is that high fees can be associated with significant rent seeking and marketing which serves little useful purpose. The available evidence suggests that issuers' profits tend to rise with the level of interchange fees (indicating that this market is not perfectly competitive), prompting more marketing to attract cardholders. In the United States, for example, which has substantially higher average interchange fees than

Australia, 5.2 billion solicitations for new credit cards were mailed to households in 2007 – an average of around 45 solicitations per household.[13]

The second is that a potential distortion is created between the card-based systems with interchange fees and those systems without interchange fees. In particular, the direct cost to consumers of using the systems with interchange fees might be lower than that of the other systems, even though these systems might have higher underlying resource costs. This could lead to a migration of payments from these other systems even though such a migration would possibly reduce the overall efficiency of the payments system. It is important to note, however, that under Option 3, the Board's long-standing concerns about the relativity of interchange fees between the EFTPOS and scheme debit and credit card systems would be somewhat lessened. With all schemes free to set their own fees, there would be fewer grounds to be concerned that the resulting interchange fees were causing distortions, at least between these systems.

Another potential disadvantage of Option 3 is that it may provide less legal certainty. If the Board were to step back from regulation of interchange fees, the concerns over the setting of interchange fees that led to investigation by the ACCC over the course of 2000 and 2001 might remain. The exemption that currently exists in the *Trade Practices Act 1974* for interchange fees set in compliance with the Bank's Standards would no longer apply. It is therefore possible that the industry would need to seek authorisation from the ACCC for interchange fees. As has been demonstrated, for example in the case of EFTPOS interchange fees and cases currently underway in the United States, this can be a difficult and costly process. Furthermore, it may take many years to resolve, increasing uncertainty and potentially affecting investment and innovation in card payment systems.

6.3 Assessment

In the Board's view, the main consideration in deciding between Options 2 and 3 is whether the competitive environment can be made sufficiently strong to give the Board confidence that, in the absence of interchange fee regulation, the outcome would be one that promotes the efficiency of the payments system as a whole.

This is a difficult judgement. The Board recognises that the competitive forces on interchange fees are unusual and sees a strong case for Option 2. However, the potential advantages of Option 3 are such that the Board is prepared to remove interchange regulation if industry takes further steps to improve the competitive environment. If the necessary steps are not taken, the Board's current thinking is that interchange regulation will remain, and that the Standards will be altered to further reduce credit card interchange fees and eliminate the difference in fees between the various debit card systems as outlined under Option 2.

It is important to note that the Board is only contemplating the possibility of Option 3 as a result of the significant changes in the payments system that have occurred in response to the previous reforms. In particular, the increased transparency in the payments system and the growing prevalence of surcharging have changed the competitive environment and prompted better price signals to consumers. The Board's focus on interchange fees has also served to

13 *Mail Monitor (http://mailmonitor.synovate.com/news.asp); US Census Bureau.*

increase merchant understanding of these fees and this has helped improve the competitive environment.

Notwithstanding these changes, and the further changes required under Option 3, the Board remains concerned about the likely strength of the competitive forces acting on interchange fees. The possibility remains that these changes, while significant, may still not go far enough to create the competitive environment that is required. Therefore, if Option 3 were implemented and average interchange fees in the credit card systems were to increase materially, the Board would consider reimposition of interchange regulation, probably along the lines of Option 2. This reflects the Board's view that a rise in average interchange fees would likely be evidence that, despite its best efforts, insufficient competitive forces had been able to be brought to bear on these fees.

A significant issue with this option is timing. The Board understands that some of the changes being contemplated are substantial and will take time to implement. On the other hand, experience suggests that industry-based reforms can take longer than is strictly required.

The Board is proposing that the current interchange arrangements remain in place for the time being and that at its August 2009 meeting it re-assess the progress made in improving the competitive environment. If at that meeting it was decided that inadequate progress had been made, the Board would consider implementing arrangements similar to those outlined under Option 2. At that point it would release revised Standards for consultation, with a likely implementation date in the first quarter of 2010.

If instead, the various issues had been adequately addressed by August 2009, the Board would take steps to remove interchange regulation, with the likely implementation date in the first quarter of 2010.

In the interim, the Board intends to make a technical modification to the Standards to avoid industry undertaking the currently scheduled cost studies in 2009. The card schemes will, however, still be required to comply with the current benchmark on 1 November 2009.

The Board is prepared to implement any new arrangements earlier than indicated by the above timetable if industry is able to make the requisite changes relatively quickly. It is also prepared to require changes through regulation to the honour-all-cards rule and transparency before August 2009 if it is clear that the schemes are unwilling to make the necessary changes, and that doing so would allow a more timely implementation of a new regime. Achieving such changes voluntarily is, however, preferable.

7. Summary of the Main Conclusions

This section summarises the main preliminary conclusions of the Review and the Board's proposed direction for the regulation of card payment systems in Australia.

1. In the Board's view, the reforms have met their main objectives of: improving price signals in the Australian payments system; increasing transparency; improving access; and creating a more soundly based competitive environment. The reforms have improved competition and efficiency in the payments system, contributing to an improvement in overall resource allocation and substantial welfare gains to the community.

2. The Board acknowledges that the reforms have not affected all parties equally. In particular, those who use EFTPOS and cash are more likely to have been made better off as a result of the reforms than those who use credit cards extensively and pay their balances off by the due date. Previously, this latter group was receiving significant benefits, partly at the expense of the former.
3. Close oversight of retail payment systems will continue to be necessary. To a large extent, this stems from the way in which competition between merchants affects their ability to decline to accept payment cards. The competitive environment means that, in aggregate, merchants are prepared to pay more for credit card acceptance than the benefit they receive. In the past, this distortion has been amplified by various rules that have been imposed on merchants by the schemes.
4. The Board sees no case for allowing the schemes to re-impose their no-surcharge rules. It has considered altering the existing Standard to allow schemes to limit the size of any surcharge, but is of the view that such a restriction is unnecessary and would limit the competitive pressure on interchange fees that can be imposed by merchants.
5. The Board sees no case for allowing the schemes to re-impose their earlier honour-all-cards rules. Indeed, it is proposing further changes to scheme rules to ensure that merchants can make independent acceptance decisions about pre-paid cards. It is also proposing changes that would prohibit merchants being penalised with higher interchange fees if they do not accept all cards of a scheme. These changes could be made voluntarily by the schemes, but if this does not occur, the Board would consider imposing the changes through regulation.
6. The Board is proposing to retain the various Access Regimes. While access has been improved as a result of the reforms, further improvements are necessary, particularly to those systems based on bilateral contracts. With the current technology in a number of these systems nearing the end of its life, the Board encourages the industry, as a matter of priority, to examine alternative approaches that would address this issue and possibly allow entry on the basis of one connection only.
7. The Board sees a strong case for further improving the transparency of the payments system. In particular, average interchange fees and average scheme fees should be published regularly. The Board also sees advantages in clarifying the conditions surrounding bypass of scheme switches. Ideally, the schemes would provide this information voluntarily, although the Board is prepared to consider regulation if that is necessary.
8. While the Board sees a strong case for ongoing interchange regulation, it is prepared to step back from the regulation of these fees on the condition that industry takes further steps to improve the competitive environment. This option is now able to be considered as a result of the significant changes in the environment that have taken place over recent years as a result of the previous reforms. The Board remains of the view that these reforms – including the forced reduction of interchange fees – were appropriate given the state of competition that applied at the time.
9. The specifics of developments over the next year will be crucial in convincing the Board that its concerns about efficiency and competition would continue to be addressed if it removed interchange regulation. The Board has identified changes in three areas that would, in its opinion, further strengthen the competitive environment. These include: changes to the

EFTPOS system that would enhance competition; modifications to the honour-all-cards rule in addition to those discussed in point 5; and greater transparency around scheme fees and average interchange fees.

10. In the Board's view, if changes are not made to the EFTPOS system there is a significant risk that, in the longer term, the current system will not be able to compete effectively with the international card schemes. Without an effective competitor, the Board's view is that the case for allowing the industry to set interchange fees free of regulation is significantly weakened. In terms of specifics, the Board has identified a number of changes to the EFTPOS system that would be expected to improve the competitive environment. These include:
    - (i) the introduction of a scheme to replace the existing bilateral contracts, with the scheme able to make decisions about multilateral interchange fees;
    - (ii) the creation of effective arrangements to promote the development of the system;
    - (iii) reform of current access arrangements; and
    - (iv) the development of alternative payment instruments for use in on-line payments (either by the EFTPOS scheme or through another channel).
11. If the Board is to step back from interchange regulation, it is proposing that the honour-all-cards rule be modified to allow merchants to make independent acceptance decisions for each type of card for which a separate interchange fee applies. This change could be made by the schemes. If this does not occur, the Board will consider the case for making this change through regulation.
12. If the above steps to improve the competitive environment are not made within a reasonable time, the Board's current thinking is that interchange regulation would continue, although changes would be made to the current Standards. In particular, the Board would consider establishing a common benchmark for interchange fees in the EFTPOS and scheme debit systems of around 5 cents (paid to the issuer) and a further reduction in the credit card interchange fee benchmark to around 0.30 per cent. A number of technical changes to the operation of the interchange Standards would also be made.
13. If interchange regulation is to continue, the Board would not require the modification of the honour-all-cards rule discussed in point 11 above, as interchange fees would be constrained primarily by regulation, rather than through competitive forces.
14. The Board is conscious that the changes being suggested will take time for the industry to implement. It is proposing to take stock of progress in August 2009. At that time, it would decide whether to proceed to modify the Standards along the lines outlined in point 12 or remove the existing interchange fee Standards. Changes to the arrangements would then likely be effective in the first quarter of 2010.
15. If the Board did remove its regulations on interchange fees, and average fees in the credit card systems subsequently rose materially, the Board would consider the reimposition of interchange regulation, along the lines discussed in point 12. Although the Board recognises that interchange fees may well be higher in a deregulated environment than in the regulated environment, a substantial rise in these fees would likely signal that insufficient competitive forces had been able to be brought to bear on these fees.

16. The Board welcomes initiatives by industry participants to develop arrangements that would allow the industry *itself* to address the Board's concerns around competition and efficiency. The Board notes, however, that specific proposals are yet to be agreed upon.

8. Next Steps

The Board's conclusions set out in this document are preliminary, and the Bank is now seeking submissions from interested parties on these conclusions and the analysis set out in this document. Submissions should be sent by 30 June 2008 to:

Head of Payments Policy Department or pysubmissions@rba.gov.au
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

All submissions will be posted on the Bank's website (www.rba.gov.au) and parties making submissions will have the opportunity to discuss them with the Bank. Following consultation, the Board aims to release a document setting out its final conclusions in late August/early September 2008.

Appendix 1: Submissions

The Reserve Bank received a total of 27 submissions from the following organisations or individuals in response to the Issues Paper. Submissions are available on the Bank's website.[14]

Abacus Australian Mutuals Pty Ltd

ACIL Tasman Pty Ltd (on behalf of American Express Australia Limited)

American Express Australia Limited

Australia and New Zealand Banking Group Limited

Australian Bankers' Association

Australian Merchant Payments Forum

Australian Payments Clearing Association

Australian Settlements Limited

Bank of Queensland Limited

BPAY Pty Ltd

Commonwealth Bank of Australia

Cuscal Limited

Diners Club

Dr Alan Frankel (on behalf of the Australian Merchant Payments Forum)

Professor Joshua Gans

GE Money

Indue Limited

Mr Peter Mair

MasterCard Worldwide

National Australia Bank Limited

PayPal Australia Pty Ltd

St George Bank Limited

Tyro Payments

Village Mall Pty Ltd

Visa International

Westpac Banking Corporation

Woolworths Limited

14 *http://www.rba.gov.au/PaymentsSystem/Reforms/RevCardPaySys/responses_issues_paper.html*

Appendix 2: Possible Modifications to Existing Standards

If Options 1 or 2 were adopted, the Board sees a strong case for making a number of changes to the existing Standards to enhance their functioning. These are discussed below.

1. The Frequency of Cost Studies and Benchmark Recalculations

Through the consultation process a number of institutions have argued that there are high compliance costs associated with having to undertake cost studies every three years for the interchange Standards. Estimates of these costs provided to the Bank suggest that complying with the initial benchmark in 2003 cost financial institutions in the order of $1 million.

In the Board's view, the benefit from frequent cost studies is relatively small. As has been discussed elsewhere, the Board does not see interchange as being explicit compensation for particular costs that institutions incur in providing payment services. Rather, the cost studies have been used to establish transparent benchmarks for the setting of interchange fees. Having established these benchmarks, the case for updating the cost studies on a regular basis is not particularly strong, especially given that changes in costs do not necessarily justify changes in interchange fees. By eliminating the need to undertake these cost studies, compliance costs would be reduced and, at the margin, less frequent recalculation of the benchmark might also assist in longer-term planning.

The Board's preferred approach is to simply remove the need for any further cost studies and recalculation of the benchmark. Under this approach, all interchange Standards would be based on the credit card cost studies conducted in 2006. If at some future point, the Board decided to review the level of average interchange fees a new cost study could be undertaken, or the costs included in the Standards could be amended.

2. Compliance Arrangements

One issue that was raised in the consultation process was whether the compliance aspects of the Standards (particularly the credit card interchange fee Standard) were affecting competition between schemes.

The compliance arrangements have been under review for some time, with the Board seeking submissions in December 2006. Of particular interest has been whether the use of backward-looking, scheme-specific weights to calculate each scheme's weighted-average interchange fee meant that a scheme with a relatively high weight in a category with a high interchange fee was disadvantaged. Some industry participants have also expressed a concern that the weighted-average interchange fee was moving above the benchmark between the three-yearly compliance dates.

The compliance arrangements will also need to be reviewed if, as is discussed above, the three-yearly cost studies are no longer undertaken, as the existing Standards only require the schemes to meet the benchmark when the benchmark is recalculated (or when interchange fees are changed).

Three main suggestions for changing the current arrangements have been proposed by industry participants:

(i) using industry, rather than scheme-specific, weights in the compliance calculations;

(ii) requiring all interchange fees (rather than the weighted-average) to be below the benchmark; and

(iii) more frequent compliance.

Modifying the Standards so that the weights in the compliance calculation are determined using proportions of transactions across the whole industry presents some considerable practical difficulties. In particular, the schemes would somehow need to agree on common categories for the compliance calculations, and the categories would probably need to be included in the Standards. The Board is of the view that this approach introduces considerable complexity to the regulations and increases compliance costs with no increase in efficiency and competition. It therefore is not in favour of such an approach.

Modifying the Standards to require that all interchange fees be below the benchmarks has the advantage of simplicity. However, this change may reduce competition by inhibiting the ability of the four-party card schemes to compete with three-party schemes in the premium and commercial cards markets. It could also lead to all interchange fees being set at the cap to maximise the interchange revenue available to issuers. This would reduce the likelihood of particular incentives, such as for the installation of chip-capable terminals, being created through the interchange fee structure. The Board is therefore not in favour of this approach.

Increasing the frequency of the compliance calculations could help address concerns about competitive neutrality by reducing the incentive for issuers to switch schemes to take advantage of a high interchange fee in a particular category. As the weight of the high-fee category grows, the scheme will have to lower its fee in order to meet the benchmark. But since this would happen on a shorter time frame than currently, it may reduce the benefit that issuers can obtain from exploiting the difference in fees. This approach would also limit the degree to which the average could drift above the benchmark between calculations.

The Board has considered two main possibilities: annual compliance and 'continuous' compliance. Annual compliance is administratively more straightforward and would avoid the possibility of schemes 'accidentally' being in breach of the Standard because of unanticipated changes in the composition of spending. A number of acquirers have, however, expressed concerns that a move to annual compliance might lead to more frequent changes in interchange fees and thus additional costs to them due to the more frequent need to reprice acquiring services.

The Board's preliminary conclusion is that if interchange regulation remains, compliance should be annual. It would welcome feedback on the costs and benefits of such a change and whether there are other schedules or options that would address concerns over the effect of the compliance arrangements on scheme competition and average interchange fees.

3. Cash-out for EFTPOS

Under the current arrangements, interchange fees on transactions involving a cash-out are excluded from the EFTPOS interchange fee Standard. This reflected a view by the Board that if ATM interchange fees were not regulated, the case for regulating interchange fees on cash-out transactions was not particularly strong. Since that time, however, the ATM industry has agreed to reform involving the removal of interchange fees in ATM networks. Given this development, the exemption for cash-out transactions could beneficially be removed. Doing so would simplify the setting of interchange fees in the EFTPOS system with correspondingly lower costs for industry participants and easier access, and would be unlikely to have any detrimental effect related to relativities with the ATM system.

The Board's preliminary conclusion is, therefore, that if interchange regulation is maintained the exemption for cash-out transactions in the EFTPOS interchange fee Standard be removed.

Glossary of Terms and Abbreviations

ACCC	Australian Competition and Consumer Commission
Acquirer	An institution that provides a merchant with facilities to accept card payments and clears and settles the resulting obligations with card issuers.
ADI	Authorised Deposit-taking Institution. A body corporate authorised to undertake banking business in Australia. ADIs are authorised and regulated by APRA under the *Banking Act 1959*.
APCA	Australian Payments Clearing Association
APRA	Australian Prudential Regulation Authority
BPAY	A payments organisation owned by a group of retail banks. Individuals who hold accounts with a BPAY participating financial institution can pay BPAY billers using electronic transfers initiated by phone or internet.
Card issuer	An institution that provides its customers with debit, credit or other payment cards.
Charge card	A card whose holder has been granted a non-revolving credit line, enabling the holder to make purchases and possibly cash advances. A charge card does not offer extended credit; the full amount of any debt incurred must be settled at the end of a specified period.
Credit card	A card whose holder has been granted a revolving credit line. The card enables the holder to make purchases and/or cash advances up to a pre-arranged limit. The credit granted can be settled in full by the end of a specified period, or in part, with the balance taken as extended credit.
Debit card	A card that enables the holder to access funds in a deposit account at an ADI.
Designation	The first formal step by the Reserve Bank toward exercising powers conferred by the *Payment Systems (Regulation) Act 1998*. The Bank may subsequently impose standards or access regimes on a designated system, or arbitrate a dispute in relation to the system.
Direct entry system	A system used for bulk or batch-processed payment transfers between deposit accounts, typically on a next-day settling basis.
EFTPOS	Electronic Funds Transfer at Point of Sale. In Australia, EFTPOS transactions are authorised by personal identification number (PIN) and make use of processing infrastructure owned and operated by the domestic financial institutions.
Four-party card scheme	MasterCard and Visa are known as 'four-party' card schemes because four parties are typically involved in the payment process. The four parties are: the cardholder; the issuer; the acquirer; and the merchant.

Honour-all-cards rule	A rule that requires participating merchants to accept all cards issued under a particular scheme.
Interchange fee	A fee paid by the card acquirer to the card issuer, or *vice versa*, when a cardholder undertakes a transaction.
Merchant service fee	A per-transaction or *ad valorem* fee paid by a merchant to the acquirer when a cardholder undertakes a transaction.
No-steering rule	A rule that prevents merchants from steering cardholders to other forms of payment.
No-surcharge rule	A rule that prevents merchants from charging a fee for card transactions.
Pre-paid card	A card 'loaded' with a given value, paid for in advance. The card may be reloadable, or limited to initial purchase value.
Revolvers	Credit card holders who do not pay off their account in full by the end of the interest-free period.
Scheme debit card	A debit card issued under one of the international card schemes. Funds are drawn from the cardholder's deposit account at an ADI, utilising the processing infrastructure of the card scheme, rather than the EFTPOS system.
Scheme fees	Fees paid by both acquirers and card issuers to the card scheme.
Specialist Credit Card Institution	An ADI that engages in, or proposes to engage in, card issuing and/or acquiring, but does not otherwise conduct banking business.
Switch	A system that facilitates the exchange of payment messages between participants in a payment system.
Three-party card scheme	American Express and Diners Club are known as 'three-party' schemes. These schemes generally (although not always) act as sole issuers and acquirers, therefore the three parties involved in the payment process are the cardholder, the merchant and the scheme.
Transactors	Credit card holders who pay the full outstanding balance on their account by the end of the interest-free period.

EXHIBIT J

Regulatory intervention in the payment card industry by the Reserve Bank of Australia

Analysis of the evidence

Prepared By:

Robert Stillman, William Bishop, Kyla Malcolm, Nicole Hildebrandt

CRA International

99 Bishopsgate

London

Date: 28 April 2008

CRA Project No. D11723.00

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EXECUTIVE SUMMARY

Since 2003, the Reserve Bank of Australia (RBA) has implemented a series of regulations affecting the payment card industry in Australia. Most notably, the RBA reduced the interchange fee on four-party credit cards by approximately 50% and prohibited no-surcharge rules. Prior to these regulations, interchange fees on credit card transactions averaged approximately 0.95% and, while merchants that accepted MasterCard and Visa payment cards were allowed to offer cash discounts and to suggest that customers use other methods of payment, they were not allowed to apply surcharges on transactions conducted using a payment card.

The RBA is currently in the process of reviewing its regulation of Australia's payment card industry. On 21 April 2008, the RBA issued its preliminary conclusions concerning the effects of its regulations and invited public comment. This paper responds to the RBA's invitation by presenting a thorough analysis of the effects of the RBA's regulations and their impact on final consumers.[1]

Regulation should be employed only if there is clear evidence of a market failure and only if there is reason to believe that regulation is likely to benefit consumers. For the reasons explained in this paper, the market failures alleged (though not substantiated) by the RBA do not justify continuation of regulatory intervention in the payment card industry in Australia.

Further, the RBA's regulations have clearly harmed consumers by causing higher cardholder fees and less valuable reward programmes and by reducing the incentives of issuers of four-party cards to invest and innovate. At the same time, there is no evidence that these losses to consumers have been offset by reductions in retail prices or improvements in the quality of retailer service. The empirical evidence thus provides no support for the view that consumers have derived any net benefits from the intervention.

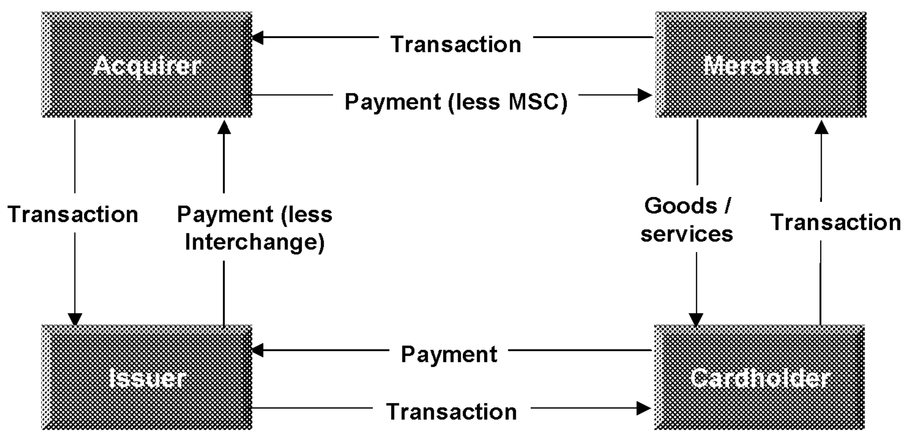
Payment card systems such as MasterCard and Visa involve four main parties, in addition to the systems themselves:

- the cardholder;
- the institution that provides the card to the cardholder – the issuer;
- the merchant that provides the goods or services to the cardholder; and
- the institution that provides services to the merchant – the acquirer.

1 Our research has been funded by MasterCard Worldwide, but the views expressed in this paper are our personal views, reflecting our independent analysis of the evidence. The views expressed here are those of the authors only. They should not be regarded as the views of CRA International, or necessarily to reflect the views of other economists employed by or affiliated with CRA International.

The following diagram illustrates a typical transaction in a four-party card system. The cardholder uses his or her card to make a purchase from a merchant. The acquiring institution makes a payment to the merchant equal to the retail price less a "merchant service charge" (MSC). The average merchant service charge in Australia on Visa and MasterCard credit card transactions currently is approximately 0.80%. The acquiring institution receives a payment from the card-issuing institution equal to the retail price less an "interchange fee". The average interchange fee on Visa and MasterCard credit card transactions in Australia is now approximately 0.50%.

The interchange fee is a cost from the perspective of the acquiring institution and affects the level of merchant service charges. The interchange fee, however, is a source of revenues from the perspective of issuing institutions. Issuers incur a variety of costs, including marketing to new cardholders, providing service to existing cardholders, extending credit, preventing fraud, etc. Revenues from interchange fees help issuers recover costs and help issuers hold down cardholder fees and maintain card benefits such as interest-free periods and reward programmes.



The RBA intervened in the payment card industry because it believed that interchange fees and other aspects of conduct in the payment card industry were reducing the efficiency of the payment system in Australia. The RBA felt that, in the absence of surcharges for credit card purchases, a consumer has an incentive to use a credit card for a transaction that could have been made with a debit card because the consumer pays the same price regardless of the method of payment and yet, when the consumer uses a credit card, he or she can delay payment for a period of time on an interest-free basis and can realise other benefits such as reward points. The RBA claimed that this incentive to use credit cards instead of debit cards results in economic inefficiency because, according to the results of a Joint Study conducted by the RBA and the Australian Competition and Consumer Commission (ACCC) in 2000 (and updated by the RBA in 2007), transactions conducted using credit cards consume significantly more real resources (i.e. were significantly more costly in social terms) than transactions conducted using EFTPOS debit cards (a domestic debit card scheme owned and operated by the Australian banks).

The RBA claimed that interchange fees exacerbate this alleged distortion in the price signals perceived by consumers with respect to their choice of a means of payment because revenue from interchange fees helps finance card benefits (e.g. the interest-free period and reward points) offered by credit card issuers. The RBA claimed that competition among card schemes only makes the alleged problem worse. The RBA felt that, in an environment in which merchant acceptance is not very sensitive to merchant service charges (which the RBA believes is the case in Australia), competition between four-party schemes was likely to lead to higher interchange fees as the schemes use higher interchange fees as a tool to persuade issuers to issue and promote the usage of their particular scheme's cards.

This paper analyses the RBA's intervention in the payment card industry. The analysis in this paper is based on an exhaustive review of the existing evidence on the impacts of the RBA's regulations, including the evidence contained in the submissions to the RBA as part of its 2007/08 review of its payment system reforms and the RBA's preliminary conclusions of this review released in April 2008. Our analysis also makes use of new research, including interviews with, and data from, MasterCard and the major Australian banks.

The main conclusions from our analysis are as follows:

The reductions in interchange fees ordered by the RBA have clearly harmed consumers by causing higher cardholder fees and less valuable reward programmes.

One of the RBA's key expectations was that reductions in interchange fees would lead to reductions in merchant service charges, and that those reductions in merchant service charges would be passed on to final consumers in the form of lower retail prices and/or higher quality of retailer service.

As expected, the reductions in interchange fees have led to reductions in merchant service charges. Merchants however have not presented any empirical evidence documenting the extent to which reductions in merchant service charges have been passed through to consumers, and neither has the RBA or anyone else.

Instead we see merchants lobbying aggressively for further reductions in interchange fees (indeed, for the elimination of interchange fees entirely). This conduct strongly suggests that merchants have retained a significant share of the reductions in merchant service charges rather than passing them on to consumers in the form of lower retail prices and/or improved quality of service.

In addition, there is evidence that merchants have imposed surcharges to a greater extent than is justified by their costs. On average, surcharges on users of four-party cards have exceeded average merchant service charges. Such surcharges imply that merchants are using surcharges to price discriminate against cardholders and to capture some of the value that would otherwise be derived by consumers from the use of payment cards.

While the RBA's regulations have clearly benefited merchants, they have harmed consumers by causing cardholder fees to increase and the value of card benefits such as reward programmes to decline. Consumers have also been harmed to the extent the reduction in the profitability of issuers caused by the RBA's regulations has reduced incentives to invest in new types of cards and payment system innovations. The Australian Bankers' Association and a number of other parties expressed the view that regulation in the payment system introduces a level of uncertainty that has had an inhibiting effect on investment decisions. Our interviews with the major Australian banks confirmed these views. Each of the banks in Australia we interviewed told us that the interventions have made it more difficult to develop a "business case" for investments related to four-party cards.

Thus, while the RBA's regulations have clearly harmed consumers by causing higher cardholder fees and less valuable reward programmes, there is no evidence that these undeniable losses to consumers have been offset by reductions in retail prices or improvement in the quality of retailer service. The RBA's intervention has redistributed wealth in favour of merchants.

The empirical evidence also undermines the RBA's argument that its regulations have increased the efficiency of the payment system in Australia. The RBA believed that interchange fees were causing a distortion in the payment system (a) because they believed that, on an incremental cost basis, credit card transactions were more costly in resource terms than EFTPOS debit card transactions and (b) because they believed that interchange fees were having significant effects on consumers' choices of payment methods. The empirical evidence does not support either leg of the RBA's case for intervention.

1. INTRODUCTION

Since 2003, the Reserve Bank of Australia (RBA) has implemented a series of regulations affecting the payment card industry in Australia.[2] Most notably, the RBA reduced the interchange fee on four-party credit cards by approximately 50% and prohibited no-surcharge rules.[3]

The RBA is currently in the process of reviewing its regulation of Australia's payment card industry. On 21 April 2008, the RBA issued its preliminary conclusions concerning the effects of its regulations and invited public comment.[4] This paper responds to the RBA's invitation by presenting a thorough analysis of the effects of the RBA's regulations and their impact on final consumers.[5] The analysis in this paper is based on an exhaustive review of the existing evidence on the impacts of the RBA's regulations, including the evidence contained in the submissions to the RBA as part of its 2007/08 review of its payment system interventions and the evidence cited in the RBA's preliminary conclusions of this review. Our analysis also makes use of new research, including interviews with, and data from, MasterCard and the major Australian banks.

Regulation should be employed only if there is clear evidence of a market failure and only if there is reason to believe that regulation is likely to benefit consumers. In addition, and especially because market economies are complex, regulators must always be concerned about the possibility that regulation will have negative unintended consequences. For the reasons explained in this paper, the market failures alleged (though not substantiated) by the RBA do not justify continuation of regulatory intervention in the payment card industry in Australia. The empirical evidence on the actual effects of the RBA's interventions provides no support for the view that the payment system in Australia is now operating more efficiently or that consumers have derived any net benefits from the intervention. Moreover, there is reason to be concerned that the regulatory uncertainty created by the RBA's interventions has negatively affected incentives to invest in payment system innovations.

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2 More formally, the RBA has implemented "standards" and "access regimes". The RBA has also obtained voluntary undertakings from certain participants in the payment card industry not directly affected by the standards and access regimes. The RBA refers to these standards, access regimes and undertakings collectively as "reforms". We refer to the RBA's interventions as regulations.

3 For readers unfamiliar with the payment card industry, Appendix A describes interchange fees, no-surcharge rules and other terms used in the payment card industry.

4 RBA, Reform of Australia's Payments System: Preliminary Conclusions of the 2007/08 Review (Apr 2008) ("Preliminary Conclusions of the 2007/08 Review").

5 It may be noted that the European Commission, in its recent decision disapproving MasterCard's methods for setting cross-border interchange fees in Europe, relied in part on a report on the effects of interchange regulation in Australia that was submitted by the RBA to the OECD. See Commission Decision of 19 December 2007 relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA Agreement in Cases COMP/34.579 Mastercard, COMP/ 36.518 EuroCommerce and COMP/38.580 Commercial Cards, paragraphs 634 to 644 (Provisional Non-Confidential version). The current study, however, casts substantial doubt on the RBA's views concerning the effects of its intervention in Australia and clearly warrants a re-examination of these effects.

Our paper has six parts and is organised as follows:

- Following this introduction (Part 1), Part 2 provides background information on the RBA's regulations;
- Part 3 summarises the effects that the RBA expected to result from its regulations and contrasts these predictions with those of the schemes;
- Part 4 analyses the evidence to date on the effects of the RBA's interventions;
- Part 5 critiques the reasons offered by the RBA to explain why it decided to intervene in the payment industry; and
- Part 6 summarises our main conclusions.

2. BACKGROUND ON THE RBA'S REGULATIONS

2.1. THE MARKET FAILURES ALLEGED BY THE RBA

The RBA intervened in the payment card industry because it believed that interchange fees and other aspects of conduct in the payment card industry were reducing the efficiency of the payment system in Australia. The RBA felt that, in the absence of surcharges for credit card purchases, a consumer has an incentive to use a credit card for a transaction that could have been made with a debit card because the consumer pays the same price regardless of the method of payment and yet, when the consumer uses a credit card, he or she can delay payment for a period of time on an interest-free basis and can realise other benefits such as reward points.[6] The RBA claimed that this incentive to use credit cards instead of debit cards results in economic inefficiency because, according to the results of a Joint Study conducted by the RBA and the Australian Competition and Consumer Commission (ACCC) in 2000 (and updated by the RBA in 2007), transactions conducted using credit cards consume significantly more real resources (i.e. are significantly more costly in social terms) than transactions conducted using EFTPOS debit cards (a domestic debit card scheme owned and operated by the Australian banks).[7] We review and critique these cost studies in Part 5 below.

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6 See e.g. RBA, Reform of Australia's Payments System: Issues for the 2007/08 Review (May 2007), paragraph 28 ("Issues for the 2007/08 Review"); Address by Mr. IJ Macfarlane, Governor, to Australasian Institute of Banking and Finance Industry Forum, 23 March 2005, Gresham's Law of Payments, transcript as published in *RBA Bulletin* (Apr 2005), p. 9; RBA, Reform of Credit Card Schemes in Australia IV: Final Reforms and Regulation Impact Statement (Aug 2002), pp. 3-4 ("Final Reforms and Regulation Impact Statement").

7 See RBA & ACCC, Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access (Oct 2000), pp. 45, 65, 76-79 ("Joint Study"). See also RBA, Issues for the 2007/08 Review (May 2007), paragraph 28; Address by Mr. IJ Macfarlane, Governor, to Australasian Institute of Banking and Finance Industry Forum, 23 March 2005, Gresham's Law of Payments, transcript as published in *RBA Bulletin* (Apr 2005), pp. 8-9; RBA, Final Reforms and Regulation Impact Statement (Aug 2002), p. 4. EFTPOS debit cards are described in more detail in Appendix B, which provides background information on the banking industry in Australia.

The RBA claimed that interchange fees exacerbate this alleged distortion in the price signals perceived by consumers with respect to their choice of a means of payment because revenue from interchange fees helps finance card benefits (e.g. the interest-free period and reward points) offered by credit card issuers.[8] The RBA claimed that competition among card schemes only makes the alleged problem worse. The RBA felt that, in an environment in which merchant acceptance is not very sensitive to merchant service charges (which the RBA believes is the case in Australia), competition between four-party schemes was likely to lead to higher interchange fees as the schemes use higher interchange fees as a tool to persuade issuers to issue and promote the usage of their particular scheme's cards.[9]

2.2. SUMMARY OF THE RBA'S REGULATIONS

In response to these alleged market failures, the RBA has implemented a series of regulations since 2003.

Visa, MasterCard, American Express and Diners Club have been prohibited since January 2003 from enforcing no-surcharge rules.

In October 2003, the RBA implemented a regulation that had the effect of reducing the average interchange fee on credit card transactions from approximately 0.95% to 0.55%. Under the current application of this regulation on credit card interchange fees (in effect since November 2006), the weighted average interchange fee on both Visa and MasterCard credit card transactions cannot exceed 0.50%.

In November 2006, the RBA implemented a regulation that reduced the average interchange fee on Visa debit card transactions from 0.53% of the transaction value to 12 cents per transaction.[10] This regulation applied *de facto* to MasterCard because MasterCard had provided an undertaking to the RBA that it would comply with the Visa debit card interchange regulation.[11]

The RBA also implemented regulations in November 2006 that affected the interchange fees on EFTPOS debit card transactions, the domestic debit card scheme owned and operated by the Australian banks. As explained further in Appendix B, the vast majority of debit card transactions

8 See e.g. RBA, Issues for the 2007/08 Review (May 2007), paragraph 29; Address by Mr. IJ Macfarlane, Governor, to Australasian Institute of Banking and Finance Industry Forum, 23 March 2005, Gresham's Law of Payments, transcript as published in *RBA Bulletin* (Apr 2005), p. 9; RBA, Final Reforms and Regulation Impact Statement (Aug 2002), pp. 3-4.

9 See e.g. RBA, Issues for the 2007/08 Review (May 2007), paragraph 30; Address by Mr. IJ Macfarlane, Governor, to Australasian Institute of Banking and Finance Industry Forum, 23 March 2005, Gresham's Law of Payments, transcript as published in *RBA Bulletin* (Apr 2005), p. 10.

10 RBA, Issues for the 2007/08 Review (May 2007), pp. 20-21.

11 MasterCard did not introduce its scheme debit card in Australia until late 2005, after the regulatory process for Visa debit had begun. In December 2005, MasterCard indicated to the RBA that it would voluntarily conform to the standards imposed on Visa Debit. See RBA, Reform of the EFTPOS and Visa Debit Systems in Australia: Final Reforms and Regulation Impact Statement (Apr 2006), pp. 32-33.

in Australia (approximately 85% in 2006)[12] are made using an EFTPOS debit card. Interchange fees on EFTPOS transactions are paid by the issuing institution to the acquiring institution; this is the reverse direction from the flow of interchange fees on credit card purchases and thus is sometimes described as a negative interchange fee. The RBA implemented a regulation in November 2006 that requires banks to set the (negative) interchange fee on EFTPOS debit card transactions at between 4 and 5 cents. (This regulation does not apply to transactions involving "cash back".) Prior to this regulation, the negative interchange fee on EFTPOS debit card transactions had averaged around 20 cents.

Visa and MasterCard "honour all cards" rules were modified in January 2007 so that a scheme could no longer require merchants to accept a scheme's debit card as a condition of accepting the scheme's credit card (or vice versa).[13]

In addition to the regulations described above, there have been other regulations related to access and transparency. The RBA imposed access regimes related to four-party credit cards in February 2004. The regimes allow non-financial institutions to issue and acquire Visa and MasterCard credit cards as "Specialist Credit Card Institutions" (SCCIs) and prevent the schemes from imposing penalties on institutions that seek to specialise in acquiring (net acquirer rules). A similar regime related to the Visa debit system was imposed in August 2005. The RBA's EFTPOS access regime, introduced in September 2006, sets out procedures and timetables under which existing participants must negotiate connections with new participants, and sets a cap on the price current participants can charge for new connections. Regarding transparency, the RBA required that the Visa and MasterCard schemes provide information on their interchange fees and rules for access to the public. The RBA has also commenced publishing payment system statistics (e.g. average merchant service fees for four-party and three-party schemes, market shares of four-party and three-party schemes) on its website.

3. REVIEW OF THE PREDICTED EFFECTS OF THE RBA'S REGULATIONS

This section summarises the effects that the RBA and the four-party schemes anticipated when the RBA's proposed regulations were being debated in 2001-02. We then contrast these predicted effects with evidence on the actual effects in Part 4 below.

3.1. THE RBA'S EXPECTATIONS

The RBA assumed that the reduction in credit card interchange fees mandated by its regulations would cause issuers to increase fees to cardholders (including, possibly, the introduction of per-

12 RBA, Reform of the EFTPOS and Visa Debit Systems in Australia: Final Reforms and Regulation Impact Statement (Apr 2006), p. 1.

13 Visa declined to voluntarily modify its honour all cards rule and, as a result, the RBA imposed a standard requiring that the rule be modified in the manner described above. In contrast, MasterCard voluntarily complied with this standard. Although American Express does not issue a debit product in Australia, it also agreed to voluntarily comply with this standard should it decide to introduce debit or pre-paid products in the future.

transaction fees) and reduce card benefits.[14] As a result, consumers would face a higher cost for using credit cards and would thus have an incentive to switch to other payment methods, in particular debit cards, which the RBA alleged were less costly in resource terms than credit cards.

The RBA assumed that issuers would not be able to fully recover the reduction in interchange fees. In the August 2002 Final Reforms and Regulation Impact Statement, the RBA estimated that the regulations would reduce issuers' annual revenues by approximately AU$2.7 billion.[15]

On the acquiring side, the RBA predicted that the reduction in interchange would be passed on to merchants in the form of lower merchant service fees.[16] In addition, the RBA expected that the increased transparency brought about by the interchange regulations would help ensure that merchants were better informed in negotiations with acquirers. It was speculated, however, that the search and adjustment costs faced by merchants could limit the pressure on acquirers to pass through interchange reductions, in particular for smaller merchants.

The RBA anticipated that lower merchant service fees for four-party schemes would give merchants a stronger position in their dealings with three-party card schemes.[17] Thus, the RBA expected that reductions in merchant service fees for three-party schemes would also be achieved.

With respect to the impact on consumers, the RBA expected that competition among retailers would ensure that the reduction in merchant service fees would be passed through to the final prices of goods and services.[18] The RBA reviewed available evidence on concentration and profit margins in the retailing sector and concluded that the sector was "vigorously competitive". It expressed confidence that, where merchants chose not to take advantage of surcharging, competitive pressures would ensure pass-through of reduced merchant service charges to consumer prices. The RBA noted that this pass-through could be difficult to detect, but implicitly assumed that these reductions in retail prices would more than offset the negative effects on consumers of higher cardholder fees and lower card benefits.

Regarding the prohibition of no-surcharge rules, the RBA did not believe that surcharging would become widespread.[19] However, it argued that merchants should have the right to surcharge

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14 RBA, Reform of Credit Card Schemes in Australia I: A Consultation Document (Dec 2001), pp. 114 and 116-117 ("Consultation Document"); RBA, Final Reforms and Regulation Impact Statement (Aug 2002), p. 23.

15 This estimate includes the impact of all three credit card regulations. The RBA expected that the access regime and interchange standard would reduce interchange revenues, and that the reduction in interchange would exert upward pressure on annual fee revenues. At the same time, the access regime was anticipated to exert downward pressure on annual fee and interest margin revenues. RBA, Final Reforms and Regulation Impact Statement (Aug 2002), p. 23.

16 Information in this paragraph is from RBA, Consultation Document (Dec 2001), pp. 125-126.

17 RBA, Consultation Document (Dec 2001), pp. 122-123.

18 Information in this paragraph is from RBA, Consultation Document (Dec 2001), pp. 126-127.

19 RBA, Consultation Document (Dec 2001), p. 75; RBA, Final Reforms and Regulation Impact Statement (Aug 2002), p. 20. RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 6.

and that, to the extent that surcharging did occur, the cost of accepting credit and charge cards would no longer be reflected in the prices of goods and services paid by non-card users.[20] Surcharging was also expected to reduce credit card usage and shift usage towards debit cards and other payment methods.[21]

Finally, the RBA anticipated that its access regime would facilitate entry by non-traditional institutions with the "scale, skills and infrastructure" to compete with existing issuers and acquirers.[22] The RBA believed that the entry or threat of entry by such institutions would stimulate competition in the credit card industry. It was anticipated that the access regime would lead to downward pressure on interest margins and annual fee revenues for issuers and merchant service charges for acquirers.

3.2. THE FOUR-PARTY SCHEMES' EXPECTATIONS

Both MasterCard and Visa strongly disagreed with the RBA's contention that the interchange regulation would lead consumers to shift significantly toward using debit cards. Instead, Visa and MasterCard argued that the main effect on consumer behaviour would be a substitution to three-party cards, in particular American Express. Visa and MasterCard did not expect that the three-party schemes would feel forced to adjust their merchant service charges in lock-step with the reduction in four-party credit card interchange fees.[23] The schemes anticipated instead that the three-party schemes could increase profits by not matching the reductions in merchant service charges of the regulated four-party schemes. By maintaining higher merchant service charges and even allowing the spread between three-party and four-party merchant service charges to widen, the three-party schemes would have a better ability to finance and maintain their pre-regulation fee and benefit structures. Even though fewer merchants might choose to accept three-party cards, consumers would want to use these cards wherever they were accepted. Some merchants would therefore be willing to pay a greater premium for accepting these cards. Economic consultants retained by Visa concluded that this would be a profitable strategy for three-party schemes even if there was strong inter-system competition between the three- and four-party schemes.

Visa expected cardholder fees to increase and card benefits to become less generous as a result of the reduction in interchange fees.[24] MasterCard agreed that this was a possibility and

20 RBA, Consultation Document (Dec 2001), p. 116.

21 RBA, Consultation Document (Dec 2001), pp. 67, 78-79.

22 Information in this paragraph is from RBA, Consultation Document (Dec 2001), p. 124; RBA, Final Reforms and Regulation Impact Statement (Aug 2002), p. 23.

23 Information in the rest of this paragraph is from MasterCard, Response to the December 2001 consultation document of the Reserve Bank of Australia (Mar 2002), p. 4; NECG, Delivering a level playing field for credit card payment schemes: A study of the effects of designating open but not closed payment schemes in Australia (Aug 2001), pp. 8, 42-43. The NECG report was prepared for Visa International.

24 NECG, Delivering a level playing field for credit card payment schemes: A study of the effects of designating open but not closed payment schemes in Australia (Aug 2001), p. 2.

expressed concern that the RBA's regulations might have significant negative effects on the number of four-party cards in use and eventually merchant acceptance.[25] MasterCard also emphasised its view that a reduction in interchange fees would force small issuers to exit the industry and would encourage large four-party issuers and acquirers to migrate their businesses to more expensive and less efficient three-party systems.[26] Visa agreed that smaller issuers would be disproportionately harmed by the regulations.[27]

The schemes agreed with the RBA's prediction that surcharging would not become widespread.[28] However, the schemes disagreed with the RBA's prediction that the amount of any surcharges would be cost-based. The schemes anticipated that surcharging would be used by at least some merchants as a means of discriminatorily extracting the value associated with credit cards.[29] The schemes also disagreed with the RBA's view that surcharging would correct price distortions, simply because they did not believe these distortions to exist in the first place.[30]

The schemes also anticipated that the RBA's access regime would have little impact on the level of competition in the credit card industry. The schemes disagreed with the RBA's contention that their membership rules were restrictive – in fact, MasterCard explicitly stated that the RBA's access regime was essentially consistent with its existing scheme rules and policies.[31]

25 MasterCard, Response to the December 2001 consultation document of the Reserve Bank of Australia (Mar 2002), p. 40.

26 MasterCard, Response to the December 2001 consultation document of the Reserve Bank of Australia (Mar 2002), pp. 4-5.

27 NECG, Delivering a level playing field for credit card payment schemes: A study of the effects of designating open but not closed payment schemes in Australia (Aug 2001), pp. 43-44.

28 MasterCard, Response to the December 2001 consultation document of the Reserve Bank of Australia (Mar 2002), p. 42; NECG, Response to the Reserve Bank of Australia's consultation document and report of Professor Michael Katz (Mar 2002), p. 17. The NECG report was prepared for Visa International.

29 MasterCard, Response to the December 2001 consultation document of the Reserve Bank of Australia (Mar 2002), pp. 6 and 9; NECG, Credit card schemes in Australia – a response to the Reserve Bank of Australia and Australian Competition and Consumer Commission Joint Study (Jan 2001), pp. 26 and 36-37. The NECG report was prepared for Visa International.

30 MasterCard, Response to the December 2001 consultation document of the Reserve Bank of Australia (Mar 2002), p. 43; NECG, Credit card schemes in Australia – a response to the Reserve Bank of Australia and Australian Competition and Consumer Commission Joint Study (Jan 2001), pp. 30-31.

31 See MasterCard, Response to the December 2001 consultation document of the Reserve Bank of Australia (Mar 2002), p. 6.

4. EVIDENCE ON THE ACTUAL EFFECTS OF THE RBA'S REGULATIONS

Our analysis of the actual effects of the RBA's regulations is based on an exhaustive review of the existing evidence on the impacts of these regulations and new research, including interviews with MasterCard and the major Australian banks and analysis of data from MasterCard and the banks.

We begin with a summary of the main findings:

- As predicted by the RBA, the reduction in interchange fees has led to an increase in cardholder fees and a decrease in card benefits. In the preliminary conclusions of its 2007/08 review, the RBA acknowledges that its interchange fee regulations "have resulted in a reduction in the value of reward points and higher annual fees, increasing the effective price of credit card transactions facing many consumers".[32] Though intended by the RBA, these effects nonetheless represent harm to consumers.

- Even though issuers have been able to offset the reduction in interchange revenue to some extent with higher cardholder fees and fewer card benefits, the profitability of issuing four-party credit cards appears to have declined. The reduction in the profitability of issuing has reduced incentives for new entrants to enter the industry, and has made it more difficult for smaller issuers to compete. The reduction in interchange fees has encouraged issuers to place a greater focus on customers that carry a balance (revolvers) and has caused major issuers to start offering three-party cards. The reduced profitability of issuing four-party cards has also reduced the incentive of issuers to invest in new types of four-party cards and in other payment system innovations.

- On the acquiring side, merchant service charges for four-party schemes have declined in line with the reduction in interchange fees. The decline in Visa and MasterCard merchant service charges has been on the order of AU$870 million per year (at current levels of spending).[33]

- Some merchants have decided to surcharge but, as expected by both the RBA and the schemes, surcharging remains limited. However, as anticipated by the schemes, surcharging on average on Visa and MasterCard transactions has not been cost-based; average surcharges on users of four-party cards have exceeded average merchant service charges. Surcharging that is not cost-based implies that merchants are using surcharging as a means to price discriminate against cardholders and to capture some of the value that would otherwise be derived by consumers from the use of payment cards.

- American Express and Diners Club have increased their annual fees on rewards-based charge cards at about the same rate as issuers have increased annual fees on rewards-based Visa and MasterCard credit cards. This is another source of harm to consumers related to the RBA's regulations.

32 RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 17.

33 RBA, Issues for the 2007/08 Review (May 2007), p. 22.

- American Express and Diners Club reduced their merchant service charges slightly in response to the reduction in merchant service charges on the four-party cards, but not nearly to the same extent as Visa and MasterCard. The fact that American Express and Diners Club have increased their annual fees in line with the increases in fees charged by Visa and MasterCard issuers but have reduced their merchant service charges by much less suggests that the RBA regulations have had less effect on the profits of the three-party card systems than on the profits of the four-party card systems (and may have led to an increase in the profits of three-party card systems).

- One of the RBA's key expectations was that reductions in merchant service charges would be passed on to final consumers through lower retail prices. Merchants however have not presented any empirical evidence documenting the extent to which reductions in merchant service charges have been passed through to consumers, and neither has the RBA or anyone else. Thus, while the RBA's regulations have clearly harmed consumers by causing higher cardholder fees and less valuable reward programmes, there is no evidence that these undeniable losses to consumers have been offset by reductions in retail prices or improvements in the quality of retailer services. The RBA's intervention has redistributed wealth in favour of merchants.[34]

- The RBA's intervention has reduced the incentive of issuers to invest and innovate in four-party cards. It has been suggested that the RBA's intervention has also adversely affected the incentive to invest in other payment cards (specifically EFTPOS debit cards) because of the regulatory uncertainty created by the RBA's actions.

- The RBA's access regime has had no significant effect in encouraging new entry into issuing or acquiring. In fact, as anticipated by MasterCard[35], the regulations may have led to an increase in concentration of the issuing segment by making it harder for smaller issuers to compete and helping to force some smaller issuers out of the business.

4.1. IMPACT ON CARDHOLDERS

Data provided by the RBA imply that cardholders in Australia are paying approximately AU$480 million each year in additional fees to issuing banks for Visa and MasterCard credit cards as a result of the RBA's regulations.[36] At the same time, card benefits have been reduced

34 The proposition that consumers as a group can be net losers from a regulatory reduction in interchange fees, over a wide range of plausible parameter values and even when there is no effect on card membership or merchant acceptance, is demonstrated formally in a mathematical model attached as Appendix E.

35 MasterCard, Response to the December 2001 consultation document of the Reserve Bank of Australia (Mar 2002), pp. 4-5.

36 The RBA recently estimated that average fee revenue on bank-issued personal credit cards has increased by AU$40 since 2002. According to the RBA's statistics, there were 12 million personal credit card accounts in December 2006. AU$40 per account times 12 million accounts implies an annual increase of approximately AU$480 million. RBA, Issues for the 2007/08 Review (May 2007), p. 23; RBA, RPS statistics, available at http://www.rba.gov.au/PaymentsSystem/PaymentsStatistics/ExcelFiles/RPS.xls, accessed 23 April 2008.

significantly. Thus, holders of credit cards are now paying higher fees and receiving lower card benefits.

In addition to higher cardholder fees and reduced benefits, the RBA's regulations have also reduced the incentive of issuing banks to invest in new products and technologies for four-party cards. These effects on innovation, which are another element of consumer harm, are discussed further in Part 4.10 below.

4.1.1. Four-party cardholder fees

Issuers have responded to the reduction in interchange fee revenue by increasing cardholder fees for four-party credit cards. Credit card annual fees are perhaps the most visible category of fees that have been increased. However, issuers have also implemented increases to other types of credit card fees, including late-payment and over-limit fees, foreign currency conversion fees and cash advance charges.

Fees on credit cards between 2001 and 2006 are shown in Table 1 below, based on data published by the RBA. Although the credit card interchange standard was introduced in October 2003, issuers knew of the likelihood of regulation many months earlier. It has been suggested that issuers adjusted cardholder fees in advance of the implementation of the interchange regulation in order to smooth its impact.[37] We have therefore focused in Table 1 on the changes in cardholder fees between 2001 and 2004 and, alternatively, between 2002 and 2004. The table shows that, on average, annual fees for standard cards rose by 22% between 2001 and 2004, while annual fees for rewards cards rose by 47%-77% over this period. Additional data on the cardholder fees charged by specific banks is provided in Appendix C.

37 NECG, Early evidence of the impact of the Reserve Bank of Australia regulation of open credit card schemes (May 2005), p. 34. The NECG report was prepared for Visa International.

Table 1: Fees on credit cards, 2001-2006

	2001	2002	2003	2004	2005	2006	% change, 2001-2004	% change, 2002-2004
Annual fees (AU$)								
No-frills cards	n/a	n/a	n/a	n/a	38	38	n/a	n/a
Standard cards	23	25	27	28	28	28	22%	12%
Standard rewards-based cards	48	61	76	85	85	85	77%	39%
Gold rewards-based cards	87	98	128	128	134	140	47%	31%
Cash advance fees								
Own bank's ATM (AU$)	0.6	1	1.4	1.4	1.4	1.4	133%	40%
Percent of value	0.4	0.8	0.8	1.1	1.1	1.1	175%	38%
Other bank's ATM (AU$)	1.3	1.6	1.6	1.6	1.6	1.6	23%	0%
Percent of value	0.4	0.8	1.1	1.4	1.4	1.4	250%	75%
Overseas ATM (AU$)	3.9	3.9	3.6	3.6	3.6	3.6	-8%	-8%
Percent of value	0.4	0.8	1.1	1.4	1.4	1.4	250%	75%
Foreign currency conversion fee (%)	1.0	1.0	1.3	1.5	2.4	2.4	50%	50%
Late-payment fee (AU$)	20	21	23	29	29	31	45%	38%
Over-limit fee (AU$)	6	13	25	28	29	30	367%	115%

Source: CRA International, based on RBA, "Banking Fees in Australia", *RBA Bulletin* (May 2007), pp. 59-62 at 62 (based on Cannex data). Figures are for the end of June in each year.

4.1.2. Four-party card benefits (reward programmes)

In addition to increases in cardholder fees, issuers have responded to the reduction in interchange fee revenue by reducing card benefits, in particular the value of reward programmes. Relying on information for four rewards cards issued by the major banks, the RBA estimates that the value of reward points has been reduced by approximately 23% since 2003, with the majority of this decline occurring between 2003 and 2004. This is shown in Table 2 below.

Table 2: Value of Visa and MasterCard credit card reward programmes - four major banks

	Average spending required for AU$100 voucher	Benefit to cardholder as a proportion of spending (bp)
2003	12,400	81
2004	14,400	69
2005	15,100	66
2006	16,000	63
2007	16,200	62

Source: RBA, Issues for the 2007/08 Review (May 2007), p. 23. Four banks/products are: ANZ Telstra Rewards Visa, Commonwealth Bank MasterCard Awards, National Australia Bank Visa Gold, Westpac Altitude MasterCard.

For the most part, issuers have reduced the value of reward programmes by reducing the number of points earned per dollar spent ("earn rate") above a certain level or by increasing the number of points required to redeem a prize ("redemption rate"). Issuers have also introduced caps on the number of points that can be earned in a given period. In order to retain customers that value reward programmes highly, three of the four major issuers, at the same time as imposing a cap on rewards for existing cards, also introduced a new premium product that offered the pre-regulation earn rate (or better) without capping, at a higher annual fee. For two of these issuers, the product introduced was a three-party card. This is notable because, prior to 2003, none of the four major issuers had ever offered an American Express or Diners Club card to the consumer segment. However, in line with the schemes' expectations, the RBA's regulations provided these banks with incentives to offer three-party cards. This is discussed further in Part 4.2.3.

Changes to the major reward programmes offered by the four large issuers are summarised briefly here:

- ANZ was the first major issuer to make changes to its reward programme, when it announced changes to its Qantas Visa – the most widely-held credit card in Australia – and Telstra Visa reward programmes in September 2003.[38] Designed to "minimise the impact of the RBA reforms", the changes halved the earn rate on spending in excess of AU$1,500 per month (AU$2,500 for Gold cards) and capped the number of points that could be earned in a month. Customers affected by these changes were offered the ANZ Frequent Flyer Diners Club charge card (Qantas Visa cardholders) or the ANZ Rewards Diners Club charge card (Telstra Visa cardholders), which continued to offer one point per dollar spent with no cap.

- Westpac announced similar changes to its Altitude programme in February 2004.[39] As of March 2004, Westpac reduced the redemption rate of Altitude points to airline frequent flyer

38 Information in this paragraph is from: ANZ Press Release, "ANZ and Diners Club to launch new cards: Announce changes to reward programs", 12 September 2003.

39 Westpac Media Release, "Changes to Altitude", 20 February 2004, available at http://www.westpac.com.au/internet/publish.nsf/Content/WIMCMR04+Archive+media+release+20+February+2004, accessed 23 April 2008.

points from one to 0.5 frequent flyer points per Altitude point. No other redemption rates changed. At the same time as the rewards change announcement, Westpac also announced the launch of the Altitude American Express, which offered two Altitude points per dollar spent (by contrast, the Visa and MasterCard Altitude cards earned only one point per dollar spent).

- Also in February 2004, CBA announced that it would introduce points capping and reduce the Qantas frequent flyer point redemption rate for its reward programme.[40] Beginning in July 2004, points for Standard cards were capped at 50,000 per annum and the redemption rate for Qantas frequent flyer miles was halved. Similarly, Gold card points were capped at 100,000 per year, with points redeemable for Qantas miles at 1.5 to 1 (previously the redemption rate was 1 to 1). Simultaneously, CBA introduced a new Platinum MasterCard, which offered cardholders no cap on points and Qantas redemption at the pre-existing rate (1 to 1). According to CBA, the changes to the reward programme were "in direct response to the Reserve Bank of Australia's recently introduced credit card reforms".

- NAB changed the structure of its NAB Gold Rewards programme in July 2005, halving the earn rate on spending in excess of AU$3,000 per month and offering no points on spending in excess of AU$10,000 per month.[41] NAB also increased the redemption rate for retail vouchers, credit and other rewards, but maintained the same redemption rate for Qantas rewards. At the same time as the rewards cut-backs, NAB increased the annual reward programme fee by 73% (from AU$33 to AU$57.20). The changes to NAB's reward programme were attributed to "costs attached to the programme".

Numerous sources attribute the changes to annual fees and reward programmes to the reduction in interchange revenue brought about by the RBA's regulations.[42] However, while the RBA's regulations undoubtedly pressured issuers to reduce cardholder benefits, it should be noted that issuers simultaneously faced rising costs associated with providing reward programmes, especially frequent flyer points.[43] Following the collapse of Australia's Ansett Airlines in 2001, Qantas (as the only remaining domestic provider of free flights to bank card programmes) increased the cost of frequent flyer points to bank issuers and simultaneously scaled back on the value of its frequent flyer miles.[44] Although the level of this cost increase is confidential, one

40 CBA Media Release, "The Commonwealth Bank restructures credit card offering ahead of Platinum launch", 20 February 2004, available at http://about.commbank.com.au/group_display/0,1922,CH2071%255FTS10479,00.html, accessed 23 April 2008.

41 NAB Media Release, "NAB changes Gold Rewards loyalty program", 21 April 2005, available at http://www.nab.com.au/About_Us/0,,65195,00.html, accessed 23 April 2008.

42 See, for example, Grant Halverson, "Australian interchange review: three years on", *Australian Banking & Finance*, 15 February 2007.

43 Unless otherwise indicated, information in this paragraph is from Ian Rogers, "Australia's credit card market is losing its shine", *Cards International*, 7 March 2003.

44 Robin Arnfield, "A shakeup in Australia's card market", *Credit Card Management*, March 2003.

industry expert estimated the increase at a factor of between two and three compared with the cost of points in the late-1990s.

4.1.3. Cardholder fees and card benefits for three-party cards

The four-party schemes had predicted that the three-party schemes would not increase cardholder fees or reduce the value of reward programmes in any significant way after the RBA's regulations commenced in 2003. Some sources have concluded that this in fact is what has transpired. For example, in a 2005 report prepared for Visa International, NECG concludes that there is "no direct evidence of any reward benefit reductions, or increased card costs in closed card [American Express and Diners Club] schemes".[45]

Our review of available data on the cardholder fees charged by American Express suggests otherwise. Our analysis indicates that American Express appears to have increased cardholder annual and reward programme fees. Fees on selected American Express offerings are shown in Table 3 below.[46] Table 4 follows with a comparison of the increases in total annual fees on American Express charge cards (i.e. annual fees plus reward programme annual fees) between June 2002 and June 2005 with changes in the annual fees on standard and gold reward-based four-party credit cards over the same period as reported by the RBA. It is noteworthy that the increase in American Express annual fees over the period analysed is very similar to the increase in the annual fees on the analogous four-party cards.

45 NECG, Early evidence of the impact of the Reserve Bank of Australia regulation of open credit card schemes (May 2005), p. 35.

46 Information on Diners Club offerings was not available.

Table 3: Annual and reward programme fees for selected American Express products, June 2002, June 2005 and April 2008 (AU$)

	Annual fee			Reward programme annual fee			Total (annual fee + reward programme fee)		
	6/02	6/05	4/08	6/02	6/05	4/08	6/02	6/05	4/08
Amex Gold Credit	70	70	70	33	59	80	103	129	150
Amex Blue Credit	35	35	0	33	59	0	68	94	0
Amex Green Charge	65	65	80	27.50	59	80	92.50	124	160
Amex Gold Charge	95	95	130	27.50	59	80	122.50	154	210
Suncorp Gold Amex	70	70	70	33	59	80	130	129	150
Suncorp Blue Amex	25	25	No longer offered	33	59	No longer offered	58	84	No longer offered

Source: Cannex, Product and Pricing Features as at 30 September 2005; American Express and Suncorp websites, accessed 23 April 2008. * Amex Blue Credit – Amex Blue Sky credit was used for current information. As of April 2008, American Express was offering this credit card with no annual fee. Previously, the annual fee was AU$95 inclusive of the reward programme fee (American Express website, accessed 15 November 2007).

Table 4: Changes to annual fees (including reward programmes fees) for American Express charge cards and Visa/MasterCard rewards-based cards, June 2002 – June 2005

	Absolute change (AU$)	% change
Amex Green Charge	$31.50	34%
Amex Gold Charge	$31.50	26%
Visa/MC standard rewards-based cards	$24.00	39%
Visa/MC Gold rewards-based cards	$36.00	37%

Source: CRA International. Changes are between June 2002 and June 2005. Visa/MasterCard figures are from RBA, "Banking Fees in Australia", *RBA Bulletin* (May 2007).

Unfortunately, we were unable to obtain much information on changes in the value of the card benefit programmes of American Express and Diners Club since the RBA's intervention. There have been suggestions that American Express has also diluted the value of its reward programmes,[47] but our impression is that, in general, issuers of Visa and MasterCard cards have reduced the value of these card benefit programmes by more than any reductions in the value of American Express and Diners Club card benefit programmes.

47 "Australian interchange: three years on", *Card International*, 20 February 2007.

The increase in annual fees for three-party cards (and the possible reduction in the value of reward programmes) is an additional harm to consumers related to the RBA regulations.

4.2. IMPACT ON ISSUERS

4.2.1. Impact on issuer profitability

Despite the increase in cardholder fees and reduction in card benefits, the reduction in interchange fees required by the RBA regulations appears to have reduced the profitability of issuing four-party credit cards. This conclusion is based on our interviews with major issuers in Australia, as well as on bank financials and other public information. In August 2002, following the RBA's release of the interchange standard, ANZ reported that the impact of the regulations and recent increases in the cost of frequent flyer points would likely reduce credit card annual after-tax profit by approximately AU$40 million by the 2004 financial year.[48] NAB reported in its half-year 2004 financial results that "the implementation of RBA designated credit card interchange margins from 31 October 2003 unfavourably impacted income by AU$20 million", and attributed flat operating income as compared to September 2003 in part to the RBA interchange standard.[49] In its full-year financials for 2004, NAB attributed a 3.6% decline in "other banking and financial services income" in part to "the negative impact of the Reserve Bank of Australia credit card interchange fee reform".[50] In its August 2007 submission to the RBA, St. George (Australia's fifth-largest bank) also stated that:

> *"St. George believes that in aggregate the reforms redistributed the net financial flows associated with interchange away from banks in favour of merchants, to the net cost of banks and consumers".*[51]

As mentioned above, issuers increased annual cardholder fees by approximately AU$40 (on a per account basis) between 2002 and 2006. Multiplied by the number of accounts, this implies an increase in issuer revenues of AU$480 million per annum in 2006. In contrast, the RBA's interchange regulation reduced interchange revenues in 2006 by approximately AU$647 million.[52] These figures imply that issuers have been able to recover about 74% of the loss in interchange revenues.[53] As discussed further in Part 4.10, to the extent RBA's regulations have

48 ANZ Media Release, "Impact of RBA credit card scheme reform on ANZ", 27 August 2002, available at http://www.anz.com/australia/support/library/MediaRelease/MR20020827.pdf, accessed 23 April 2008.

49 NAB, Half-year 2004 Financial Results, p. 28.

50 NAB, 2004 Annual Report, p. 21.

51 St. George, Submission to the RBA in the Review of the Reforms to Australia's Payments System (31 Aug 2007), p. 6.

52 Total purchase value for personal Visa and MasterCard credit cards was AU$143.9 billion in 2006, and the regulations reduced interchange by approximately 0.45% (AU$143.9 billion x 0.45% = AU$647 million). RPS statistics, available at http://www.rba.gov.au/PaymentsSystem/PaymentsStatistics/ExcelFiles/RPS.xls, accessed 23 April 2008.

53 Note that this calculation focuses only on cardholder fees and does not take into account reductions in the value of benefit programmes.

reduced the profitability of issuing four-party cards, there is a reduction in the incentives of issuers to invest in new types of four-party cards and in other payment system innovations.

4.2.2. Transactors versus revolvers

The decision by issuers to reconsider their customer acquisition strategies and place a greater focus on customers that carry a balance ("revolvers") provides further evidence that the increases in cardholder fees and reduction in card benefits have not offset the negative effect on issuer profitability of the RBA-mandated reduction in interchange fees.[54] The reduction in interchange fees has reduced the profitability of issuing credit cards to all types of customers. But the negative effect in percentage terms has been greater on cards issued to individuals who rarely pay interest charges because they rarely carry a balance ("transactors"). Interchange fees account for a much higher percentage of total revenue on cards issued to transactors. It is for this reason that issuers have shifted their marketing efforts to customers likely to be revolvers.

4.2.3. Issuing of American Express and Diners Club cards

The reduction in interchange fees on Visa and MasterCard credit cards has also made issuers more interested in becoming issuers for American Express and Diners Club. We will show below how merchant service charges on American Express and Diners Club cards declined only slightly following the implementation of the RBA's interchange standard. At the same time, as shown above, annual fees at least on American Express charge cards have increased since the RBA's intervention at about the same rate as the annual fees on Visa and MasterCard credit cards which offer rewards programmes. The combination of these effects has meant less pressure on American Express than on issuers of Visa and MasterCard reward-based credit cards to reduce the value of cardholder benefit programmes since the RBA's intervention. While there are indications that American Express has reduced the value of its reward programmes to some extent, it seems clear that issuers have made larger reductions in the value of Visa and MasterCard reward programmes.

These developments have led some banks to realise that they could create an attractive offering for consumers especially interested in benefits (such as reward points) by offering American Express or Diners Club cards as a companion card to Visa or MasterCard credit cards. Issuers were also attracted of course by the fees that could be earned by issuing American Express and Diners Club cards – fees that the three-party systems found easier to offer because their merchant service charges declined only slightly following the implementation of the RBA's interchange standard.

Since September 2003, three of the four major issuing banks have introduced three-party credit or charge cards. This was a notable event in the history of the Australian payment card industry. Although the major issuers were first approached by American Express in the 1990s, they were not interested in working with the scheme at that time.[55] Except for Westpac's BusinessChoice American Express charge card, which was first issued in April 2001, the four major banks did not

54 Interviews with banks.

55 "Competition in Australia reaches new heights", *Cards International*, 16 November 1999.

issue American Express or Diners Club products to the personal or corporate segments prior to the implementation of the interchange regulation in 2003.[56]

Since 2003, both Westpac and NAB have started to issue American Express credit cards, while ANZ has started to issue Diners Club charge cards. All of these products are aimed at the consumer credit card segment, although some have also been made available as corporate card offerings. It is interesting to note that all but one of these offerings of American Express and Diners Club have been targeted at a bank's *existing* Visa and MasterCard credit card customers or have been issued in the first instance as a "companion card" in conjunction with a Visa or MasterCard (i.e. an account includes one American Express card and one Visa/MasterCard card). Issuing banks combined the offering of American Express or Diners Club with Visa or MasterCard because, while American Express and Diners Club have richer card benefit programmes (and therefore should be the preferred card for a consumer interested in these benefits), American Express and Diners Club are accepted at many fewer merchants (and therefore it would be useful for consumers to have a Visa or MasterCard credit card in their wallets because of the wider acceptance of these cards).

The American Express and Diners Club offerings issued by the major banks in Australia since 2003 are summarised in Table 5 below.

56 NECG, Delivering a level playing field for credit card payment schemes: A study of the effects of designating open but not closed payment schemes in Australia (Aug 2001), p. 53.

Table 5: Recent Bank-issued American Express and Diners Club offerings in Australia, 2003 to present

Issuer	Card	Date Introduced	Companion card?	Details
ANZ	ANZ Rewards Diners Club	Sep-03	YES	Issued to ANZ Telstra Visa cardholders
ANZ	ANZ Frequent Flyer Diners Club	Sep-03	YES	Issued to ANZ Qantas Visa cardholders
Westpac	Altitude American Express	Feb-04	YES	Issued to Westpac Altitude MasterCard customers, now available as part of a package with Altitude MasterCard; also available in corporate version
NAB	NAB Ant American Express	Jul-04	NO	
NAB	Velocity NAB American Express	Nov-05	YES	Offered as part of a package with Velocity NAB Visa card, also available in corporate version (aimed at small businesses)
Westpac	Earth American Express	Jun-06	YES	Offered as part of a package with Earth MasterCard

Source: ANZ Press Release, "ANZ and Diners Club to launch new cards: Announce changes to reward programs", 12 September 2003, available at http://www.anz.com/australia/support/library/MediaRelease/MR20030912.pdf, accessed 23 April 2008; "American Express and Westpac announce card issuing deal", *The Asian Banker Journal*, 29 February 2004; "National launches new American Express card", *The Asian Banker Journal*, 15 July 2004; NAB Media Release, "Flying high with NAB and Virgin Blue", 15 November 2005, available at http://www.nab.com.au/About_Us/0,,76275,00.html, accessed 23 April 2008; "Westpac launches earth: the first 'value rewards' credit card", 5 June 2006, available at http://www.westpac.com.au/internet/publish.nsf/Content/WIMCMR06+Archive+media+release+05+June+2006b, accessed 23 April 2008; Bank websites.

Additional detail on the American Express and Diners Club cards issued by the Australian banks is provided in Appendix D.

4.3. IMPACT ON MERCHANT SERVICE CHARGES

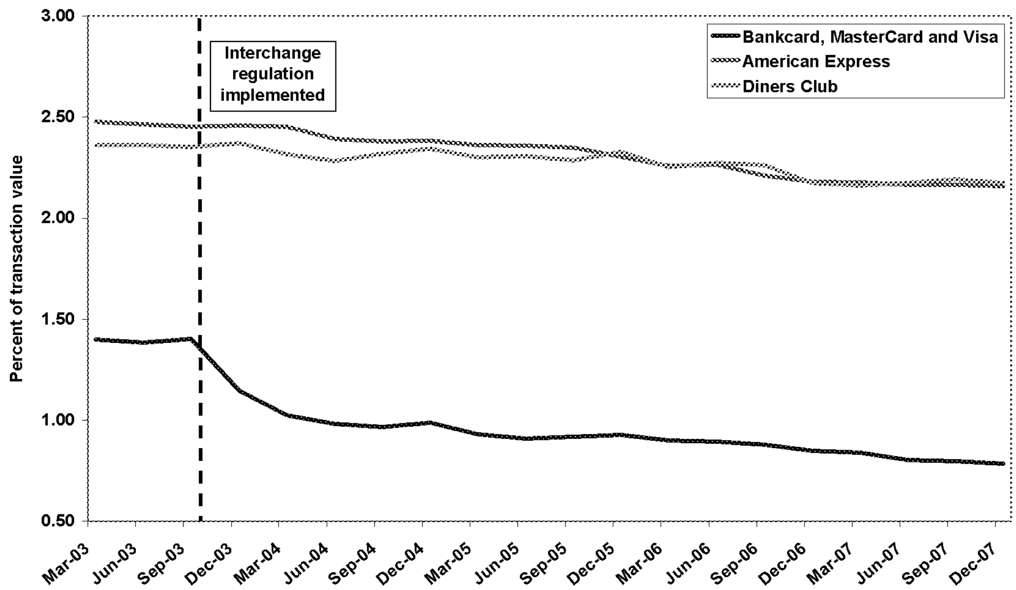
As expected, merchant service charges for Visa and MasterCard have declined considerably since the introduction of the interchange standard. Interchange fees fell by an average of approximately 40 basis points in October 2003, from approximately 0.95% to 0.55%. Between September 2003 and September 2004, merchant service charges for four-party credit cards fell by approximately the same amount. The average merchant service charge for four-party credit cards declined over this period by 44 basis points, from 1.40% to 0.97%.[57]

57 Data on merchant service charges are from RBA, C03 Merchant Fees for Credit and Charge Cards, available at http://www.rba.gov.au/Statistics/Bulletin/index.html, accessed 23 April 2008.

Merchant service fees for American Express and Diners Club also declined following the implementation of the RBA's regulations on interchange fees, but by much less than the decline in the merchant service charges on four-party credit cards. The average American Express merchant service charge declined by just 7 basis points between September 2003 and September 2004, from 2.45% to 2.38%. The average Diners Club merchant service charge declined over this period by just 3 basis points, from 2.35% to 2.32%.

Merchant service charges have continued to decline since September 2004 by amounts that are similar across cards. The average merchant service charge on four-party credit cards has declined by 18 basis points between September 2004 and December 2007, from 0.97% to 0.79%. The average merchant service charges on American Express and Diners Club cards have declined over the same period by 22 and 15 basis points respectively. Thus, as shown in Figure 1 below, the widening of the gap between four-party and three-party merchant service charges that occurred in the 12 months following the implementation of the RBA's interchange standard has largely remained in place over the ensuing period. This widening of the gap between merchant service charges for four- and three-party cards is what the schemes predicted when the RBA's regulations were under consideration in 2001-2002.

Figure 1: Merchant service charges in Australia, March 2003-December 2007



Source: CRA International, based on RBA, C03 Merchant Fees for Credit and Charge Cards, available at http://www.rba.gov.au/Statistics/Bulletin/index.html, accessed 23 April 2008.

The RBA estimates that the decline in Visa and MasterCard merchant service charges since the RBA's interchange regulation has reduced the costs of Australian retailers by approximately

AU$870 million per annum (at current levels of spending).[58] This RBA estimate is based on the decline in merchant services charges over more than three years (between September 2003 and March 2007) and therefore may include the effects of other factors.[59] But even if one focuses on the decline in merchant service charges during just the first 12 months following the implementation of the RBA's interchange standard, the regulations reduced the costs of Australian retailers by approximately AU$676 million per annum (at current levels of spending).[60]

4.4. IMPACT ON MERCHANT ACCEPTANCE

The RBA's intervention does not appear to have had any significant effect on merchant acceptance of four-party payment cards. Figure 2 below shows the growth in merchant acceptance of MasterCard payment cards in Australia, measured in terms of merchant acceptance locations.[61] Merchant acceptance of MasterCard payment cards grew at an average annual rate of 6.7% between the first quarter of 2001 and the third quarter of 2003 (just prior to the implementation of the RBA's interchange regulations). Since then (and through the second quarter of 2007), merchant acceptance of MasterCard payment cards has grown at an average annual rate of 8.4%. While there appears to have been some slight increase in the growth of acceptance between the 2001Q1-2003Q3 and 2003Q3-2007Q2 periods, the difference is not substantial and is largely due to increased growth in acceptance beginning in the latter half of 2005, approximately two years after the RBA's interchange standard was introduced.

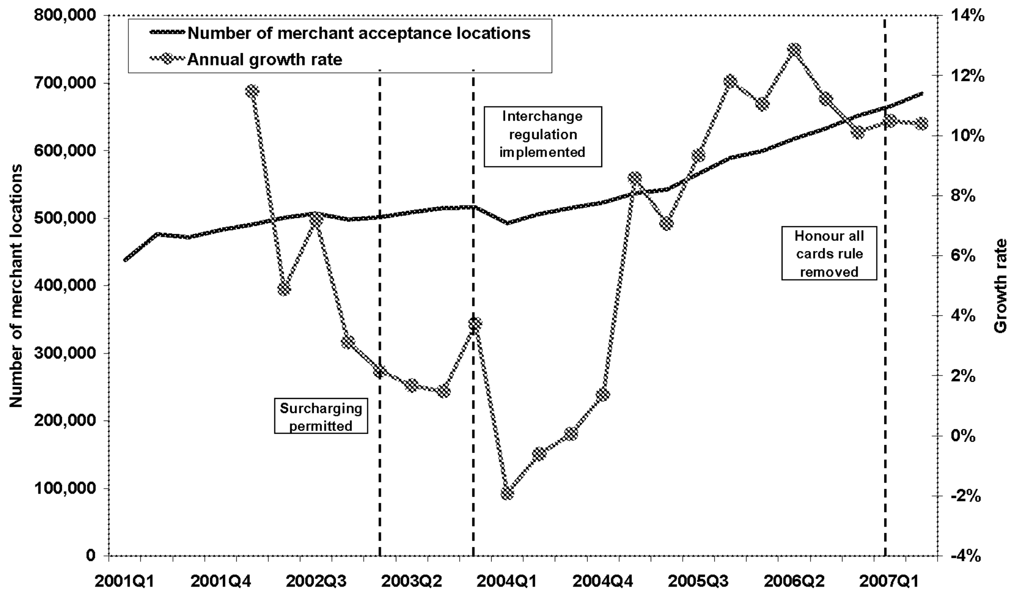
58 RBA, Issues for the 2007/08 Review (May 2007), p. 22.

59 In its preliminary conclusions of the 2007/08 review, the RBA claims that its regulations have resulted in "a significant decline in the margin between average merchant service fees and average interchange fees" and that this alleged decline in acquiring margins is an indication that the regulations "appear to have contributed to increased competition in acquiring". RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 22. The RBA's analysis, however, is based on the entire period since the introduction of the interchange fee regulations, September 2003 – December 2007. As discussed in the text above, in the first 12 months after the introduction of the RBA's interchange fee regulations (when one would expect the effects of the regulations to be most pronounced), merchant service charges on four-party cards declined in line with the reduction in interchange fees (implying no narrowing of acquiring margins).

60 Working backward from the RBA calculation that a 0.56 percentage point reduction is worth AU$870 million per year at current levels of spending, we can obtain the RBA's estimate of current levels of spending (AU$155.1 billion). Multiplying this figure by 0.44 percentage points yields a figure of $676 million per annum in savings (AU$155.1 billion x 0.44% = AU$675.5 million).

61 Growth rates are calculated as the difference between logs; the annual growth rate is difference between the log at quarter t and the log at quarter t-4, one year earlier.

Figure 2: Growth in MasterCard merchant acceptance locations, 2001-2007



Source: CRA International, based on MasterCard internal data.

The banks in Australia that we interviewed attribute the continued growth in merchant acceptance to normal industry expansion.[62] Merchant surveys find that most merchants which have started to accept credit cards since 2003 have done so because customers regularly asked to use these cards.[63]

The RBA claims that the removal of no-surcharge rules has led to increased merchant acceptance of payment cards. The RBA claims that some merchants have begun to accept credit cards with a surcharge where previously they were unwilling to accept cards.[64] The RBA provided no support for this claim. While the major banks with which we spoke agreed that there could be some merchants who only began to accept cards after surcharging was permitted, they did not believe that there were many merchants in this category. NECG also concluded that this phenomenon was rare.[65]

62 Interviews with banks.

63 NECG, Early evidence of the impact of the Reserve Bank of Australia regulation of open credit card schemes (May 2005), p. 50.

64 RBA, Issues for the 2007/08 Review (May 2007), p. 19.

65 NECG, Early evidence of the impact of the Reserve Bank of Australia regulation of open credit card schemes (May 2005), p. 49.

4.5. IMPACT ON SURCHARGING

As a result of the RBA's regulations, merchants have been permitted to add a surcharge to credit and charge card transactions since 1 January 2003. Discounts for other forms of payment and suggestions by merchants that customers use other means of payment had been permitted by MasterCard and Visa before 2003. But surcharging was not allowed until 2003.

While it is difficult to measure the take-up of surcharging in the Australian marketplace with precision, survey evidence suggests that surcharging is increasing. A merchant survey published in 2007 by the research firm East & Partners found that there has been a gradual increase in the number of merchants levying a surcharge and that, as of December 2006, approximately 14 percent of "very large" merchants and 5 percent of "very small" merchants engaged in surcharging.[66] A December 2007 update of the East & Partners study cited by the RBA in its preliminary conclusions of the 2007/08 review indicates that by the end of 2007 these percentages had increased to around 23% for very large merchants and 10% for small or very small merchants.[67] Another survey – carried out by UMR Research on behalf of Visa International – indicates that in May 2006 nearly half of credit and charge card holders had experienced surcharging since the implementation of the RBA's regulations.[68]

Whereas the RBA expected surcharging to be cost-based, the schemes expected merchants to use surcharging as a means of price discriminating against consumers who used payment cards. The schemes expected merchants to attempt to use surcharging as a means of capturing some of the value that would otherwise be derived by consumers from the use of payment cards.[69]

The available evidence on surcharging in Australia reveals that, in line with the schemes' expectations, surcharging on average has not been cost-based: merchants on average appear to have set surcharges on Visa and MasterCard transactions that are greater than merchant service charges.[70] The January 2007 East & Partners survey indicates the average surcharge for Visa and MasterCard transactions to be approximately 1%[71], 15 basis points higher than the average

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66 Very large merchants are those with turnover in excess of $340 million, while very small merchants are those with turnover between AU$1 and AU$5 million. (East & Partners, Australian Merchant Acquiring and Cards Markets, Special purpose market report prepared for the RBA (Jan 2007), as cited in RBA, Issues for the 2007/08 Review (May 2007), pp. 18-19.)

67 RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 17.

68 UMR Research, Community Perceptions of the RBA Changes to the Credit Card System – DRAFT (May 2006), slide 18.

69 See, e.g. Marius Schwartz and Daniel Vincent, "The No Surcharge Rule and Card User Rebates: Vertical Control by a Payment Network", *Review of Network Economics*, Volume 5, No. 1 (Mar 2006), pp. 72-102.

70 The RBA suggests in its preliminary conclusions of the 2007/08 review that surcharges tend to be set in line with merchant service charges. RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 26. The data cited here on the relationship between average surcharges and average merchant service charges suggest otherwise.

71 East & Partners, Australian Merchant Acquiring and Cards Markets, Special purpose market report prepared for the RBA (Jan 2007), as cited in RBA, Issues for the 2007/08 Review (May 2007), p. 19.

merchant service charge in December 2006.[72] An earlier survey conducted by Cannex found that the average surcharge for Visa and MasterCard transactions was 1.8%, approximately 81 basis points higher than the average merchant service charge in December 2004.[73] The results of the East & Partners and Cannex surveys are shown in Table 6 below.

Table 6: Survey evidence on average surcharges for three- and four-party cards

	Cannex survey – Nov 2004			East & Partners survey – Dec 2006	
	Visa/MC	Amex	Diners Club	Visa/MC	Amex + Diners Club
Average surcharge (%)	1.80%	2.60%	2.50%	1.00%	2.00%
Average MSC (%)	0.99%	2.38%	2.34%	0.85%	2.18%
Difference	0.81%	0.22%	0.16%	0.15%	-0.18%

Notes and Sources: Average MSCs shown are for December 2004 (Cannex) and December 2006 (East & Partners), and are from RBA, C03 Merchant Fees for Credit and Charge Cards, available at http://www.rba.gov.au/Statistics/Bulletin/index.html, accessed 23 April 2008. Surveys are Cannex, Card Reforms in Australia: Monitoring of Market Effects (Nov 2004), as cited in NECG, Early evidence of the impact of the Reserve Bank of Australia regulation of open credit card schemes (May 2005), pp. 47-48 and 50-51; East & Partners, Australian Merchant Acquiring and Cards Markets, Special purpose market report prepared for the RBA (Jan 2007), as cited in RBA, Issues for the 2007/08 Review (May 2007), pp. 18-19.

The Cannex (2004) and East & Partners (2007) surveys also compared surcharges on Visa and MasterCard transactions with surcharges on American Express and Diners Club transactions. Both surveys found that merchants who surcharged tended to apply higher surcharges for American Express and Diners Club transactions than for Visa and MasterCard transactions, but that the difference in surcharges was less than the difference in merchant service charges. These findings thus suggest that merchants who surcharge on average apply a higher mark-up on Visa and MasterCard transactions than on American Express and Diners Club transactions.

The available evidence on surcharging also indicates that large merchants have adopted surcharging to a greater degree than smaller merchants. The East & Partners survey indicates that surcharging is three times more prevalent among very large merchants than among very small merchants.[74] This is despite the fact that smaller merchants are likely to face higher costs associated with accepting credit cards due to the greater level of bargaining power typically possessed by large merchants with respect to merchant service charges.

72 Information on merchant service charges is from RBA, C03 Merchant Fees for Credit and Charge Cards, available at http://www.rba.gov.au/Statistics/Bulletin/index.html, accessed 23 April 2008.

73 Cannex, Card Reforms in Australia: Monitoring of Market Effects (Nov 2004), as cited in NECG, Early evidence of the impact of the Reserve Bank of Australia regulation of open credit card schemes (May 2005), pp. 47-48 and 50-51.

74 The Cannex survey from 2004 also found that surcharging was more common among larger merchants (Cannex, Card Reforms in Australia: Monitoring of Market Effects (Nov 2004), as cited in NECG, Early evidence of the impact of the Reserve Bank of Australia regulation of open credit card schemes (May 2005), pp. 47-48 and 50-51.)

Among the merchants that have adopted surcharging are Australia's major airlines (Qantas and Virgin Blue) and its major telecommunications providers (Telstra and Optus), all of which are large firms with a greater degree of bargaining power. It is interesting to note that these firms apply surcharges to scheme debit transactions in addition to credit and charge card transactions. Further, these firms have tended to set a single surcharge for all three forms of payment, regardless of the significant differences in merchant service charges for the different forms of payment. The current surcharges assessed by these companies are shown in Table 7.

Table 7: Surcharges assessed by Qantas, Virgin Blue, Telstra and Optus

	Surcharge	Payment methods surcharged
Qantas	AU$6.60 per passenger per booking for domestic and trans-Tasman flights; AU$18 per passenger per booking for international flights	Credit, charge and scheme debit cards
Virgin Blue	AU$3 per passenger per flight segment for domestic flights; AU$5 per passenger per flight segment for international flights booked in Australian dollars	Credit, charge and scheme debit cards
Telstra	0.69% for Visa, MasterCard and American Express; 1.68% for Diners Club	Credit and charge cards (and possibly scheme debit cards)
Optus	1%	Credit, charge and scheme debit cards

Sources: Telstra website, Payment Processing Fee, available at http://www.telstra.com.au/paymentprocessingfee/index.htm; Optus website, Payment Options, available at http://personal.optus.com.au/web/ocaportal.portal?_nfpb=true&_pageLabel=Template_wRHS&FP=/personal/customerhelp/accountsandbillinghelp/billpaymentinformation/paymentoptions&site=personal; Virgin Blue website, http://www.virginblue.com.au/Personal/Bookings/Feessurcharges/index.htm; Qantas, "Credit Card Service Fee Increase", 17 October 2007, available at http://www.qantas.com.au/agents/dyn/qf/news/200710/1042; Qantas website, FAQs, http://qantas.custhelp.com/cgi-bin/qantas.cfg/php/enduser/std_adp.php?p_faqid=526. All websites accessed 23 April 2008.

The experience with surcharging by Qantas is interesting with respect to the question of the relationship between the RBA's regulations and retail prices. The RBA anticipated that surcharging would provide merchants with an incentive to reduce prices to non-card users. Yet when Qantas announced its intention to surcharge in February 2003, it publicly stated that it would not reduce prices to consumers paying by cash or cheque. Qantas defended its position by arguing that the level of its surcharge was still less than the level of its "merchant fees" (i.e. merchant service charges). It is not clear whether the RBA would find this defence convincing. Even under these circumstances, the RBA presumably still would have expected surcharging to have resulted in some reduction in prices to non-card users. The fact that Qantas expressly declared that surcharging would have no effect on the prices paid by customers using other means of payment is thus noteworthy in assessing whether the RBA's regulations have had the impact that the RBA expected.[75]

75 Transcript from The World Today, ABC radio broadcast, "Qantas to introduce credit card surcharge", 10 February 2003, available at http://www.abc.net.au/worldtoday/stories/s780783.htm, accessed 23 April 2008.

In May 2006, the RBA's regulations were reviewed in a special hearing by the House of Representative Standing Committee on Economics, Finance and Public Administration. The Committee, which heard from the RBA, industry participants and academics, also observed that surcharging was often not cost-based and was taken up more widely by large merchants. In its report, the Committee concluded that:

> *"…surcharging has not yet become commonplace, particularly in highly competitive industries. Unsurprisingly, the committee heard that surcharging has only become common in industries where organisations have market dominance. While the committee is supportive of the rights of merchants to surcharge, the committee doubts whether surcharging will ever become widespread. Many merchants actually prefer being paid by card and therefore would not want to discourage its use by surcharging.*
>
> *The committee was concerned by evidence which suggested that some merchants are profiteering from the ability to surcharge…Surcharging - and in particular excessive surcharging - occurs in markets not subject to high levels of competition".*[76]

Numerous submissions made to the RBA as part of its 2007/2008 review also report that large Australian merchants have engaged in excessive surcharging[77], and call upon the RBA and the ACCC to take action. Abacus – Australian Mutuals, the industry association for credit unions and mutual building societies, calls for the RBA to work with the ACCC to prevent what it refers to as "predatory surcharging" by merchants.[78] Australian Settlements Limited, a service cooperative that aggregates member building societies' and credit unions' transactions to deliver volume-based pricing in the payment system, also recommends that the RBA to establish guidelines on the degree to which merchants can surcharge different payment options.[79]

4.6. IMPACT ON RETAIL PRICES

One of the key expectations of the RBA's regulations was that reductions in merchant service charges would be passed on to final consumers through lower retail prices. Without this pass-through, merchants – rather than final consumers – would be the main beneficiaries of the intervention. As previously discussed, there has been a clear increase in cardholder fees and reduction in the value of cardholder benefits as a consequence of the regulations. There has also been a significant reduction in merchants' costs associated with accepting credit cards. However, there is no evidence that the undeniable losses to cardholders have been offset by reductions in retail prices or improvement in the quality of service.

76 House of Representatives Standing Committee on Economics, Finance and Public Administration, Review of the Reserve Bank of Australia and Payments System Board Annual Reports 2005 (Jun 2006), p. 63.

77 See, for example, Abacus- Australian Mutuals, Submission to the RBA's Payment Reform Review (31 Aug 2007), p. 5; PayPal, Submission to RBA in the 2007/08 Review of Australia's Payments System (11 Sep 2007), p. 3.

78 Abacus- Australian Mutuals, Submission to the RBA's Payment Reform Review (31 Aug 2007), p. 5.

79 Australian Settlements Limited, Submission to the Reserve Bank of Australia on Review of the Reforms to Australia's Payments System (31 Aug 2007), pp. 2-3.

Evaluating the extent to which merchants have passed through to consumers any part of the decline in merchants' costs resulting from the reduction in merchant service charges is complicated by several factors:

- First, the cost savings associated with reduced interchange are relatively small for retailers on a per-transaction basis. The reduction in merchant service charges has been about 62 basis points for purchases made with Visa and MasterCard credit cards,[80] which comprise only about one quarter of retail transactions.[81] For an average merchant, the overall cost reduction associated with the interchange reforms would therefore be 0.16 percent. The RBA has made a similar point regarding the difficulty of measuring price effects. The RBA has commented that "when fully passed through, the reduction in fees would be expected to reduce the Consumer Price Index (CPI) by between 0.1 and 0.2 percentage points. While important, this change is difficult to observe in the overall CPI, which is increasing, on average, by around 2.5 per cent per year".[82]

- Second, the empirical literature on price rigidities makes it doubtful that a small cost reduction would affect final goods prices very quickly, even if there was extensive retail competition.[83] In other words, merchants may hesitate to adjust prices to account for such a small reduction in overall cost.

- Third, even if one could obtain detailed data on retailer prices (or margins) and changes in the merchant service charges faced by these retailers, analysing the impact of the RBA's interventions on final goods prices would be complicated by the need to take into account other factors that could affect price levels or retailer margins.

When the RBA has considered this issue, it has relied on an assumption that competition in the retailing sector will ensure that most if not all of the reduction in merchant service charges will be passed through to final consumers. For example, the RBA explained in its December 2001 analysis of the likely impact of its proposed regulations:

> *"On the available evidence, the Reserve Bank is confident that, where merchants do not pass reductions in merchant service fees onto credit cardholders on a 'fee for service' basis [i.e.*

80 Change in merchant service charges between September 2003 and December 2007, from RBA, C03 Merchant Fees for Credit and Charge Cards, available at http://www.rba.gov.au/Statistics/Bulletin/index.html, accessed 23 April 2008

81 Howard Chang, David S. Evans and Daniel D. Garcia-Swartz, "The effect of regulatory intervention in two-sided markets: an assessment of interchange-fee capping in Australia", *Review of Network Economics*, 4(4): December 2005, pp. 328-358 at p. 340.

82 NECG, Early evidence of the impact of the Reserve Bank of Australia regulation of open credit card schemes (May 2005), p. 36, quoting RBA, Payment Systems Board Annual Report, 2004, p. 12.

83 Howard Chang, David S. Evans and Daniel D. Garcia-Swartz, "The effect of regulatory intervention in two-sided markets: an assessment of interchange-fee capping in Australia", *Review of Network Economics*, 4(4): December 2005, pp. 328-358 at p. 341.

surcharges], competitive pressures will ensure that merchants pass these reductions through to the prices of final goods and services."[84]

The economics of pass-through are more complicated than the RBA's explanation. Even if firms are in a textbook perfectly competitive market, an increase or decrease in input costs will not be passed through fully to consumer prices unless the industry has constant marginal costs. In any market setting in which firms have even a measure of market power (i.e. in which firms are not pure "price takers"), the analysis becomes even more complex. Economists who have considered pass-through rates in markets where suppliers are oligopolists offering differentiated products find that the rate of pass-through depends on the nature of consumer demand for the different firms' offerings.[85] They find that, even when marginal costs are constant, pass-through rates can be significantly less than one.

The RBA recognises that the extent to which merchants have passed through the reduction in merchant service charges resulting from the interchange fee regulations is a critical issue in determining the net effect of these regulations on final consumers. In the absence of empirical evidence on the degree of merchant pass-through, the RBA attempts to rely on economic theory to support its implicit view that pass-through has been sufficient to more than offset the effects of higher cardholder fees and reduced card benefits. This appeal to economic theory, however, does not answer the question. There is no basis in economic theory for claiming that whatever degree of merchant pass-through occurs will be sufficient to more than offset the effects of higher cardholder fees and reduced card benefits.

Chang, Evans and Garcia-Swartz reach a different conclusion from the RBA regarding the extent to which merchants have passed through reductions in merchant service charges resulting from the regulation of interchange fees:

"The very limited empirical evidence there is suggests that, in fact, merchants have tended not to pass through the reduction in the merchant discount to consumers in the form of lower prices." [86]

These authors base their conclusion on a merchant survey carried out by Cannex in 2004. The survey, which asked merchants about the impact of the interchange regulations on their regular business practices, found that less than five percent of merchants experiencing a change in their merchant service charge declared that they had reduced prices to consumers. By contrast, over 20 percent reported increased profits and nearly 60 percent reported no change in their regular operations.

Worthington reaches a similar conclusion:

84 RBA, Consultation Document (Dec 2001), p. 127.

85 See, e.g. Johan Stennek and Frank Verboven, Merger control and enterprise competitiveness: empirical analysis and policy recommendations, chapter 4 in *European Merger Control: Do we need an efficiency defence?*, Fabienne Ilzkovitz and Roderick Meiklejohn, eds. (2006) , Edward Elgar Publishing.

86 Howard Chang, David S. Evans and Daniel D. Garcia-Swartz, "The effect of regulatory intervention in two-sided markets: an assessment of interchange-fee capping in Australia", *Review of Network Economics*, 4(4): December 2005, pp. 328-358 at p. 341.

> *"Retailers have adapted to the new interchange levels by broadly speaking 'pocketing' the reduction in MSC's (ie there is no evidence of reduced prices as the RBA had hoped) and using the new transparent MSC's (and the RBA's publication of them) to force down the MSC's they pay to all of the card schemes."*[87]

It is important to note that the RBA has publicly acknowledged that there is "no quantitative proof" on the extent to which merchants have passed-through savings in merchant service charges to final consumers.[88] It should also be noted that merchants in Australia have not provided evidence of the extent of pass-through to consumer prices. Rather, in their August 2007 submission to the RBA, the Australian Merchant Payments Forum simply states that pass-through has occurred without any supporting data or documentation.[89]

Recognising that it is difficult to isolate price effects, the fact remains that no evidence has been presented that would allow one to conclude that the undeniable losses to cardholders have been offset by reductions in retail prices or improvement in the quality of retail service. In contrast, we know with confidence that merchants have been beneficiaries of the RBA's intervention. We know this from the fact that merchants were in favour of the past reductions in interchange fees and now would like even further reductions. It is extremely unlikely that merchants would be taking this position if reductions in merchant service charges resulting from the RBA's regulations were simply passed through to consumers in the form of lower prices and/or higher quality service.

4.7. IMPACT ON CREDIT AND CHARGE CARD USAGE RELATIVE TO DEBIT CARD USAGE

As noted above, the RBA believed that a reduction in interchange fees would provide consumers with an incentive to switch to other payment methods. Based on the available evidence, it is still difficult to determine exactly what impact the RBA's intervention has had on the use of credit and charge cards relative to debit cards. Credit and charge card usage has continued to grow in Australia in recent years, notwithstanding the effects of the RBA's regulations on cardholder fees, card benefits and surcharges. However, as explained in more detail below, the introduction of low-rate credit cards and the growth of e-commerce in Australia are unrelated factors that

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87 Steve Worthington, "The Payments System Regulator and the Retailers: The Australian Experience", *Monash Business Review*, 2006, 2(3), at p. 4. Visa and American Express have also concluded that there is no evidence of pass-through to retail prices. (See, e.g. Visa, Submission to the RBA Payments System Review (4 Sep 2007), p. 5; American Express, Review of Payments System Reforms – A Submission to the Reserve Bank of Australia (Aug 2007), p. 5.)

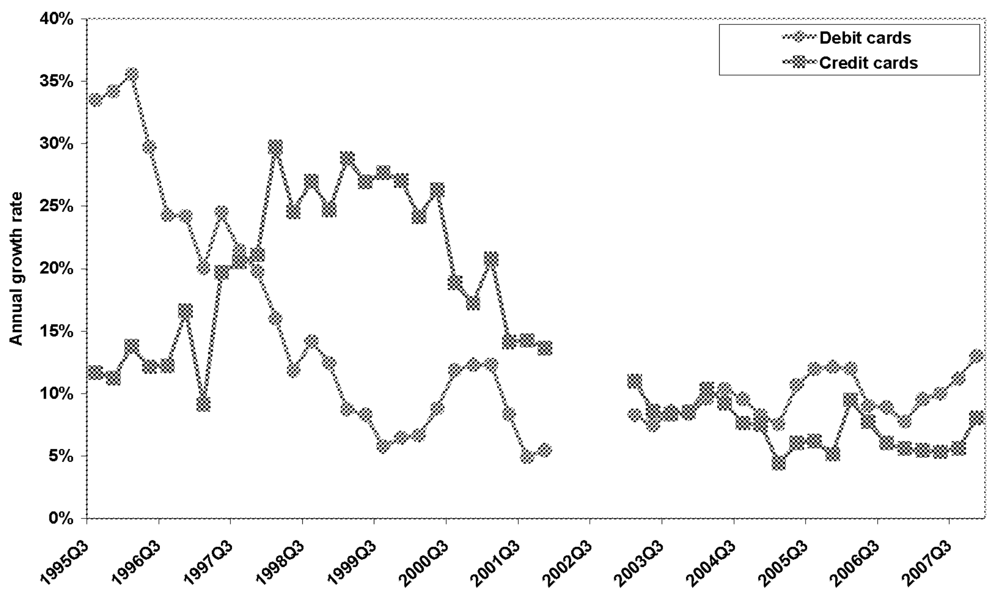
88 House of Representatives Standing Committee on Economics, Finance and Public Administration, Review of the Reserve Bank of Australia and Payments System Board Annual Reports 2005 (Jun 2006), p. 41. Several of the August/September 2007 submissions to the RBA make the point that there is no evidence of pass-through, and more specifically, that the RBA has failed to produce such evidence. See, e.g. St. George, Submission to the RBA in the Review of the Reforms to Australia's Payments System (31 Aug 2007), p. 1 of Appendix. The Visa, MasterCard, and American Express submissions to the RBA make similar statements.

89 The Australian Merchant Payments Forum is a coalition of Australian retailers. Members include the Australian Retailers Association, Australia Post, BP, Bunnings, Caltex, Coles Group, Mitre 10, Spark's Shoes Pty Ltd and Woolworths Limited. (Australian Merchant Payments Forum, The Reserve Bank of Australia's 2007/08 Review of Payment System Reforms (31 Aug 2007), pp. 4-5.)

occurred contemporaneously and could explain at least some of the observed increase in credit card usage. Thus, while there is no evidence that the RBA's intervention has had any significant effect on credit and charge card usage relative to debit card usage, it is possible that there has been an effect but the effect has been masked by confounding factors.

Figure 3 compares the annual growth rates over the period of 1995 to 2007 in the number of credit and debit card transactions. There is a break in the data series in 2002. In January 2002 the RBA increased the coverage of the data to include more reporting institutions and made several significant definitional changes. This change in the RBA's coverage means that meaningful growth rates for 2002 cannot be calculated.

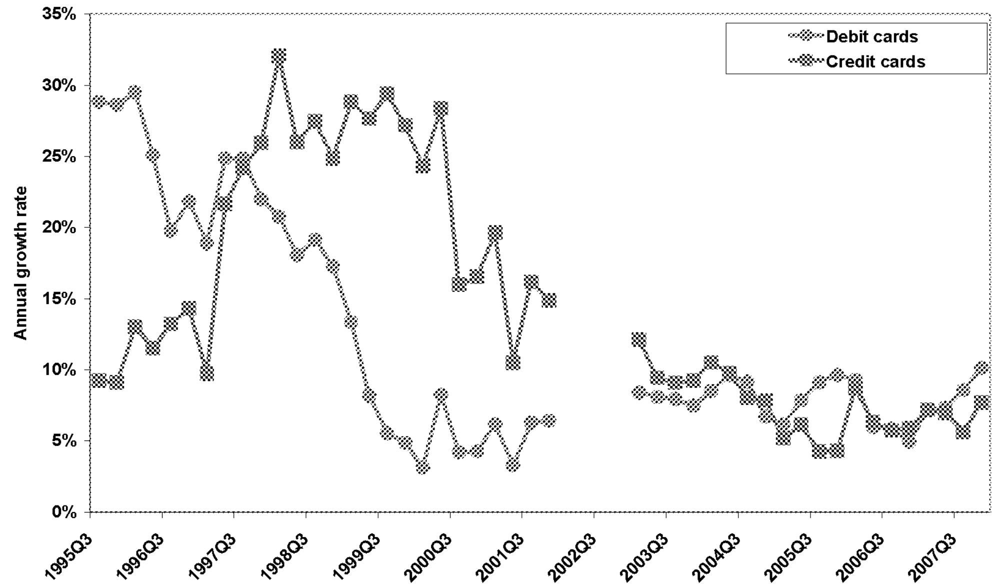
Figure 3: Growth in the number of credit and debit card transactions, 1995Q3-2007Q4



Source: CRA International, based on RBA payments data, accessed 3 March 2008. Credit cards include general-purpose credit cards issued to individuals (i.e. excluding charge cards and cards issued to businesses). Debit cards include EFTPOS and scheme debit. Credit card and debit card transactions include all point-of-sale transactions (i.e. excludes debit card ATM cash withdrawals and credit card cash advances).

Figure 4 presents the same growth rate comparison, but this time based on the credit and debit card transaction value.

Figure 4: Growth in credit and debit card transaction value (AUD), 1995Q3-2007Q4



Source: CRA International, based on RBA payments data, accessed 3 March 2008. Credit cards include general-purpose credit cards issued to individuals (i.e. excluding charge cards and cards issued to businesses). Debit cards include EFTPOS and scheme debit. Credit card and debit card transactions include all point-of-sale transactions (i.e. excludes debit card ATM cash withdrawals and credit card cash advances).

Whether one looks at growth in the number or value of transactions, the picture is the same. The growth in credit card transactions was lower in the period after the RBA's regulations, but the decline in the growth in credit card transactions began prior to the RBA's intervention. The growth in debit card transactions is somewhat higher in the period after the RBA's intervention than in the period immediately before. However this difference in growth rates is not dramatic.[90]

The RBA discusses the same data on the growth rates of credit and debit card transactions in its preliminary conclusions of the 2007/08 review but reaches a different conclusion. The RBA concludes "the available evidence strongly supports the idea that relative prices matter to consumers' choice of payment instrument".[91] This interpretation of the data on growth rates in

90 The figures presented above are for transactions occurring at the point-of-sale, i.e. excluding cash advances for credit cards and excluding ATM cash withdrawals for debit cards. We have also analysed total usage of credit and debit cards, including transactions occurring at ATMs such as cash advances and ATM cash withdrawals. The general trends are the same when looking at this measure of usage.

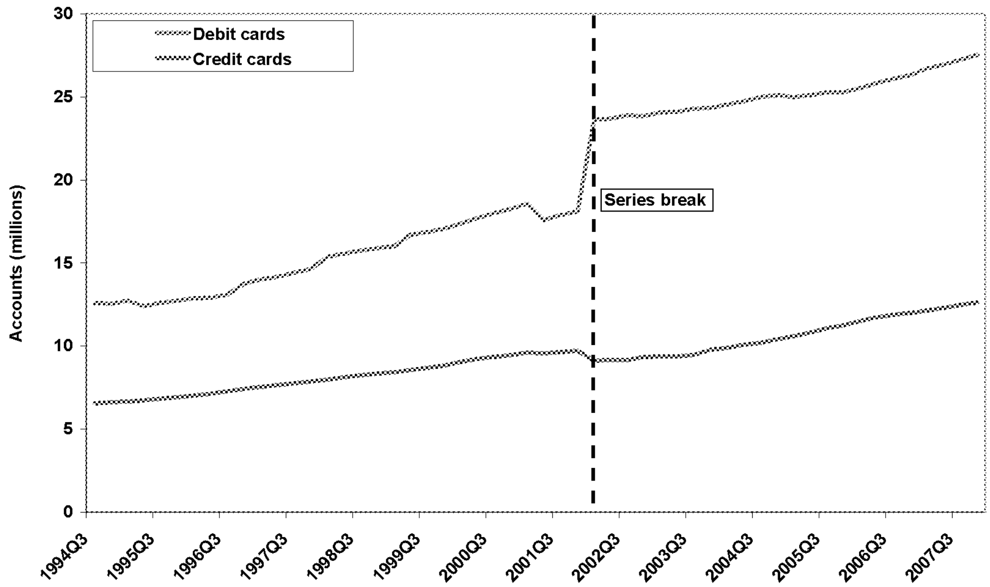
91 RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), pp. 18-19.

credit and debit card transactions is difficult to reconcile with the growth-rate evidence shown in the figures above.[92]

Figure 5 compares the number of four-party credit card accounts with the number of debit card accounts (EFTPOS and scheme debit). Figure 6 compares the annual growth rates in the number of credit and debit card accounts. These data are also affected by the change in the coverage of the RBA's data in January 2002, so we have again excluded growth rate calculations for the four quarters of 2002 (because this would require comparing data from 2002 with non-comparable data from 2001). The data in these figures show that the growth rates for credit card accounts after the RBA's interventions were generally similar to the growth rates prior to the RBA intervention. The growth in debit card accounts was actually lower in the period after the RBA's intervention.

92 The RBA notes two other pieces of evidence in support of its conclusion that its interchange fee regulations have affected consumers' choice of payment instrument. The RBA notes first that confidential information provided by a scheme shows that, when a merchant imposes surcharges, use of cards at the merchant declines. This finding is not surprising: the relevant question however is whether, in the aggregate, these effects are material. The available evidence provides no support for this proposition. The RBA also observes that credit card "transactors" use credit cards more (22% of their transactions) than credit card "revolvers" (12% of their transactions). Conversely, credit card revolvers tend to use debit cards more frequently. This finding also is not surprising. It does not however address the relevant question, which is the extent to which the behaviour of each of these groups has been affected by the changes in fees and card benefits resulting from the RBA's interchange regulations. (See RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 18.)

Figure 5: Number of debit and credit card accounts, 1994Q3-2007Q4



Source: CRA International, based on RBA payments data, accessed 3 March 2008. Credit cards include general-purpose credit cards issued to individuals (i.e. excluding charge cards and cards issued to businesses). Debit cards include EFTPOS and scheme debit.

Figure 6: Growth in the number of debit and credit card accounts, 1995Q3-2007Q4

Source: CRA International, based on RBA payments data, accessed 3 March 2008. Credit cards include general-purpose credit cards issued to individuals (i.e. excluding charge cards and cards issued to businesses). Debit cards include EFTPOS and scheme debit.

The data analysed above provide no evidence that the RBA's intervention has had any significant effect on the use of credit and charge cards relative to the use of debit cards. This result is consistent with the results of prior studies.[93] However, there are at least two potentially confounding effects that make it difficult to reach firm conclusions with respect to the impact of the RBA's regulations on card usage: the introduction of low-rate credit cards and the growth of e-commerce. It is therefore possible that the RBA's intervention has in fact reduced the use of credit cards relative to the use of debit cards but that this result cannot be seen in the data because of confounding factors.

The first potentially confounding factor is the introduction in Australia of low-rate credit cards, a product that was introduced at roughly the same time as the reduction in interchange fees. Low-rate credit cards, as their name implies, offer lower interest rates than standard credit cards, and often provide low or zero interest rates on balances transferred from existing credit card accounts. The first low-rate credit cards were introduced in Australia by smaller issuers between 2000 and 2002. However, the Virgin Money MasterCard (a joint offering between Westpac and Virgin), launched in May 2003, was arguably the first "major" low-rate offering. Following on the

93 See Howard Chang, David S. Evans and Daniel D. Garcia-Swartz, "The effect of regulatory intervention in two-sided markets: an assessment of interchange-fee capping in Australia", *Review of Network Economics*, 4(4): December 2005, pp. 328-358; Richard Hayes, "An Econometric Analysis of the Impact of the RBA's Credit Card Reforms", mimeo, 26 August 2007.

successful launch of the Virgin Money card, large and small issuers alike began to develop and launch their own low-rate products, mostly in the period following the introduction of the credit card interchange regulation. Low-rate products have been very popular in Australia, and account for a growing share of total credit cards in circulation. For example, as of September 2007, low-rate credit card accounts made up between 5% and 22% of total credit card accounts at the four major Australian issuers.[94] It is therefore possible that the growth of low-rate credit cards in the post-regulation period has offset some of the reduction in the growth of standard, non low-rate credit cards brought about by the regulations.

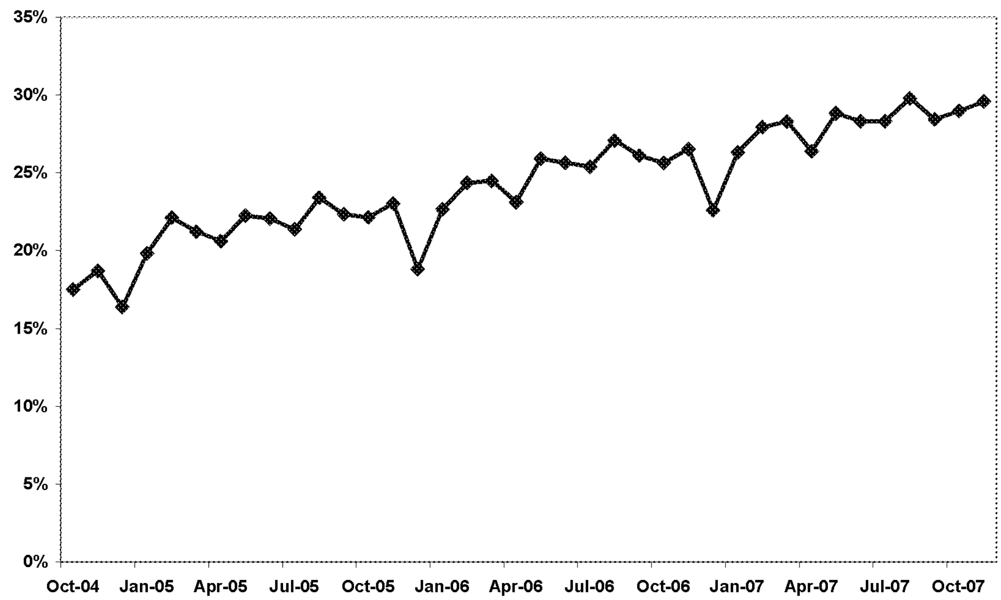
It should be noted that, in our view, low-rate cards are not a reaction to the RBA regulations; rather, they are an international development. This view is supported by our interviews with the major banks, in which we were informed that the growth of low-rate cards was triggered by Virgin's entry into the Australian market.

Another potentially confounding factor is the growth of e-commerce in Australia in the post-regulation period. As shown in a recent report on electronic payments in Australia, the percent of Australian households making internet purchases and paying bills online has steadily increased since the late-1990s, and credit cards have been the payment method of choice for these types of card-not-present transactions.[95] This trend towards e-commerce has promoted the use of scheme payment cards because the EFTPOS debit card lacks the functionality that would allow it to be used in a card-not-present environment, such as with internet purchases. Figure 7 presents data on card-not-present transactions as a share of total MasterCard credit and scheme debit card transactions from October 2004 to November 2007. The figure shows a steady increase in the share of card-not-present transactions – from about 17% of total MasterCard transactions in 2004 to about 30% in 2007 – due mostly to growth in internet and standing order/recurring transactions. Although data are not readily available prior to October 2004, it is likely that a similar trend is evident in the first year of the RBA's intervention as well.

94 Information is based on confidential data provided by the four major Australian card issuers (ANZ, NAB, CBA and Westpac).

95 Centre for International Economics and Edgar, Dunn & Company, Exploration of Future Electronic Payments Markets, prepared for the Australian government department of communications, information technology and the arts (DCITA) and industry sponsors (Jun 2006), pp. 48-49.

Figure 7: Card-not-present transactions as a share of total MasterCard credit and debit transactions (number of approved authorisations)



Source: MasterCard data.

4.8. IMPACT ON USAGE OF FOUR-PARTY CARDS RELATIVE TO USAGE OF AMERICAN EXPRESS AND DINERS CLUB

As mentioned above, Visa and MasterCard expected that the RBA's regulations would provide American Express and Diners Club with a competitive advantage that would lead to increased use of the three-party cards. It appears that the RBA did not report data on usage of American Express and Diners Club until January 2002, therefore the "before" period for testing this hypothesis is necessarily limited.

The RBA has published data since August 2002 that allow one to exclude cash advances for credit and charge cards and cash-only transactions for debit cards[96] and to focus instead on the use of credit and debit cards for purchases only. The relative shares of the different payment methods on this basis, based on value of transactions, are shown in Figure 8. This figure shows a small increase in the debit card share over this period (from 30.1% to 31.7% between 2002 and 2007) as well as a small increase in the share accounted for by American Express and Diners club (from 10.3% to 10.8% between 2002 and 2007), but with no sharp jump in the share of either method of payment following the RBA's intervention in 2003.[97]

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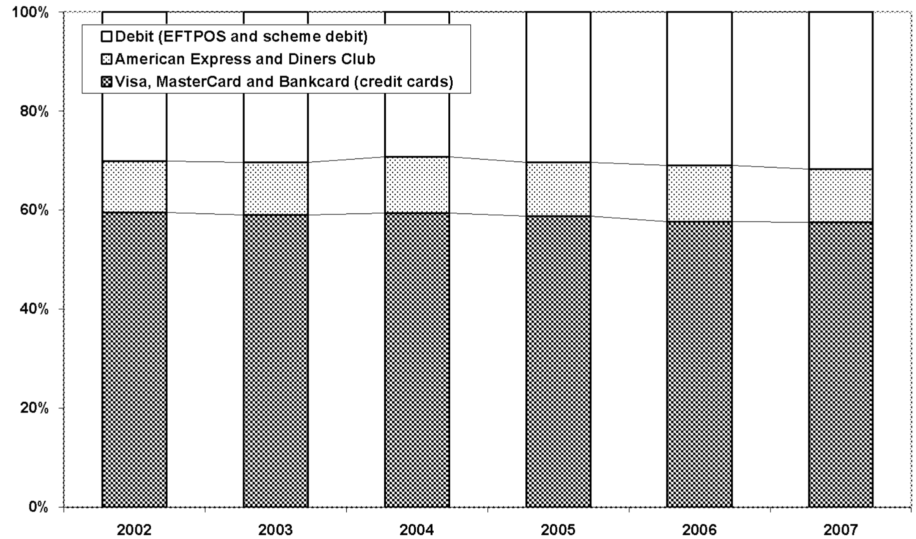
96 The RBA has published data that allow one to exclude cash advances for credit cards since 1994. However, the RBA did not begin to publish data that allow one to exclude cash-only transactions for debit cards until August 2002.

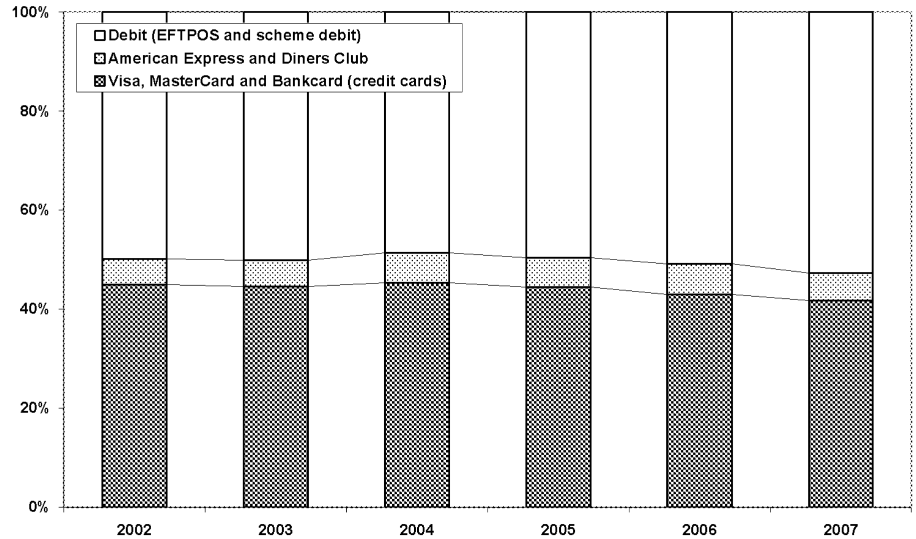
97 Percentages are for August of each year.

Figure 8: Four-party credit card, three-party credit and charge card and debit card share of purchase transaction value (dollar value of transactions), 2002 –2007



Source: CRA International, based on RBA payments data. Figures are for August of each year. Debit card transactions exclude ATM transactions and cash-only transactions. Credit and charge card transactions exclude cash advances. Data for purchase-only transactions for debit cards are not available prior to August 2002.

Figure 9: Four-party credit card, three-party credit and charge card and debit card share of purchase transaction volume (number of transactions), 2002 –2007

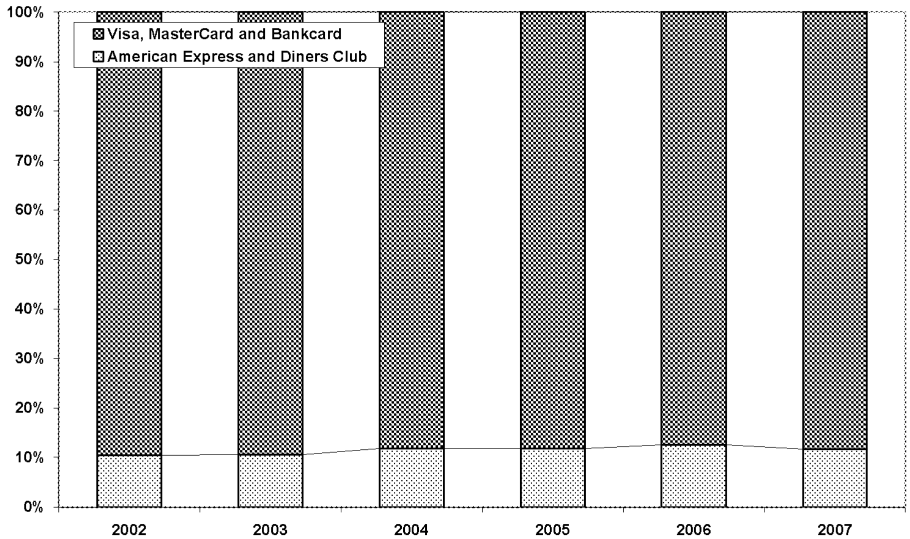


Source: CRA International, based on RBA payments data. Figures are for August of each year. Debit card transactions exclude ATM transactions and cash-only transactions. Credit and charge card transactions exclude cash advances. Data for purchase-only transactions for debit cards are not available prior to August 2002.

Figure 9 presents the same information, but in terms of the number of transactions. Because average debit card transactions tend to have lower average ticket sizes than average credit or charge card transactions, the credit and charge card shares are lower when shares are measured based on number of transactions. Even so, the conclusions are the same. The data show no sharp jump in debit card usage following the RBA's intervention in 2003. By this measure, the debit card share increased by 2.9%, from 49.8% to 52.7%, over the 2002-2007 period. The four-party credit card share fell by approximately 3.2% (from 44.9% to 41.8%) while the three-party credit and charge card share increased by 0.3% (from 5.2% to 5.5%).

Figure 10 looks more closely at the share of the four-party credit cards offered by Visa, MasterCard and Bankcard relative to the share of the three-party cards offered by American Express and Diners Club. As the schemes predicted when the RBA regulations were being considered, the increase in the share of the three-party cards has increased. But the increase was relatively modest and occurred mainly in the first half of 2004, when the share increased from 10.1% in January to 11.8% in July. This was right around the time Westpac began issuing American Express cards and ANZ began issuing Diners Club cards (see Section 4.2.3 above). Since then, the share of three-party cards has reached a peak of 12.8% in April 2006, but for the most part has hovered around 12%.

Figure 10: Four-party and three-party credit and charge card share of purchase transaction volume (number of transactions), 2002-2007



Source: CRA International based on RBA payments data. Figures are for August of each year.

4.9. IMPACT ON INDUSTRY STRUCTURE OF ACQUIRING AND ISSUING

As part of its intervention in the payment card industry, the RBA also introduced an "access regime" designed to facilitate entry into issuing and acquiring, particularly for non-financial institutions. However, as predicted by the schemes when this proposal was being considered in 2001-2002, the RBA's access regime has been largely ineffective at encouraging entry into either of these industries. To the contrary, when considered in their entirety, the RBA's regulations have, if anything, led to an increase in concentration among issuers by forcing smaller issuers out of the business.

To date, only two companies have taken advantage of the RBA's access regime: GE Money and MoneySwitch.[98] GE Money received authorisation in 2004 and is currently offering a suite of MasterCard credit card products to consumers.[99] In 2005, MoneySwitch (a start-up firm) received authorisation to acquire credit and debit card transactions. Moneyswitch, which changed

98 Unless otherwise noted, information in this paragraph is from RBA, Issues for the 2007/08 Review (May 2007), p. 24. The RBA states in its preliminary conclusions that two new acquirers and one new issuer have taken advantage of the RBA's access regime. RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 24. The website of the Australian Prudential Regulation Authority (APRA) however lists only two firms under the heading "specialised credit card institutions" – the category created by the RBA's access regime. APRA website, available at http://www.apra.gov.au/adi/ADIList.cfm#SCC, accessed 22 April 2008.

99 GE Money website, Credit Cards, available at http://www.gemoney.com.au/cardhome.html, accessed 23 April 2008.

its name to Tyro in 2007, currently offers merchant acquiring services to clients such as Toyota Financial Services.[100]

The RBA's regulations were not responsible for GE Money's entry. GE Money had issued credit cards in Australia through an overseas affiliate prior to the implementation of the access regime. The only effect of the access regime was a change of status. In its September 2007 submission on the RBA's 2007/08 review, GE attested to the fact that the access regime has had "very little effect" on access in the Australian payment system.[101]

Aussie Home Loans and Virgin have entered the issuing industry since 2003, but have chosen to do so through co-branding arrangements with existing issuers rather than as Specialised Credit Card Institutions (or SCCIs, the status created by the RBA's access regime for non-financial institutions desiring to enter the industry). Thus, it is not clear that the access regime has impacted entry into the issuing business at all.[102]

The main reason that the RBA's access regime has proven ineffective appears to be because it has not significantly reduced the financial and regulatory requirements needed to enter the payment card business. This was emphasised by the schemes in 2001-2002 when the RBA's regulations were under consideration, and has since been re-iterated by other parties such as American Express.[103] American Express also points out that SCCIs are actually subject to a 15% higher minimum capital ratio than existing competitors, which issue and acquire as Authorised Deposit-Taking Institutions (ADIs).[104]

Viewed in their entirety, the RBA's regulations appear to have reduced the incentives to enter the issuing business in Australia. The substantial reduction in interchange revenues appears to have reduced incentives to issue credit cards. In recent years, smaller issuers have begun to sell off their portfolios (e.g. CUSCAL's sale of its MyCard credit card portfolio to Citibank in December

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100 "Moneyswitch becomes Tyro", *Australian Banking and Finance*, 15 May 2007.

101 GE Money, Submission to the RBA for the 2007/08 review of payment system reforms (11 Sep 2007).

102 The RBA essentially agrees that the impact of its access reforms has been limited, noting that "further progress is required" in this area. After making this observation, this section of the RBA's preliminary conclusions then notes that "there have been a number of cards issued under co-branding arrangements with established issuers". (RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 24.) This is a curious juxtaposition in that it could be read to suggest (incorrectly) that the increase in co-branding arrangements was related to the RBA's access reforms. Co-branded credit cards have been present in Australia since the mid-1990s, and many of the most successful co-brand offerings were introduced prior to the RBA's intervention into the market (e.g. the Qantas ANZ Visa and the ANZ Rewards Visa). Thus, rather than supporting the efficacy of the RBA's access reforms, the fact that many companies choose to enter credit card issuing via co-branding arrangements rather than as SCCIs (the status created by the RBA's access reforms) is further evidence that these reforms have had little effect on the market structure of issuing.

103 American Express, Review of Payments System Reforms – A Submission to the Reserve Bank of Australia (Aug 2007), p. 17.

104 American Express, Review of Payments System Reforms – A Submission to the Reserve Bank of Australia (Aug 2007), p. 17.

2003 and the Bank of Queensland's sale of its issuing portfolio to Citibank in December 2006).[105] The Australian Bankers' Association concurs that the interchange regulations have had a larger negative impact on smaller issuers.[106]

It is also clear that the uncertainty brought about by the RBA's intervention has created concerns about the viability of smaller issuers and the likelihood of new entry. For example, under the RBA's current modification of the schemes' "honour all cards" rules, merchants are not required to accept a scheme's debit card as a condition of accepting the scheme's credit card (or vice versa). However, the RBA has discussed modifying the regulation to allow a merchant to accept some, but not all types of a scheme's credit cards (e.g. a merchant could accept standard cards but refuse premium cards).[107] In its August 2007 submission to the RBA, Abacus – Australian Mutuals argues that the removal of the honour all cards rule creates barriers to entry into card issuing: allowing merchants to refuse certain categories of cards creates uncertainty about card acceptance, such that issuers may be forced to offer multiple cards to consumers in order to compete effectively. This is particularly burdensome for potential entrants and existing small issuers, because it reduces economies of scale and commercial sustainability.[108] This point was also advanced by Cuscal, a wholesale provider of transactional banking, liquidity and capital management products to credit unions and other financial services institutions:

> *"In our view, however, the impact of the reform process has been to strengthen the market position of large merchants and to advantage larger financial institutions to the detriment of smaller issuers in the market…*
>
> *…the removal of the Honour All Cards rule has the potential to reduce the capacity of smaller institutions to promote and invest in product innovation. With unpredictability of card acceptance, the commercial reality for new participants is that multiple cards need to be offered to maximise acceptance options for consumers, reducing economies of scale and sustainability. In our view, the unintended outcome has been to increase barriers to entry for new entrants and to constrain smaller participants."*[109]

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105 Neither Bank of Queensland nor CUSCAL cited the RBA's regulations as the impetus for their decisions to sell; regardless, it is difficult to believe that the 50% reduction in interchange did not have an impact on the business case to sell. Our interviews with large banks confirmed this view. (Interviews with banks; Bank of Queensland Media Release, "BOQ to drive credit card portfolio growth through alliance with Citibank", 21 December 2006, available at http://www.boq.com.au/aboutus_media_20061221.htm, accessed 23 April 2008; Citibank Media Release, "Citibank and CUSCAL announce transfer of credit card portfolio", 18 December 2003, available at http://www.citibank.com.au/AUGCB/APPS/portal/loadPage.do?tabId=home&path=/info/sub_det/aboutus_news_20031218.htm, accessed 23 April 2008.)

106 Australian Bankers' Association, ABA's Submission: 2007/08 Payment Systems Review (31 Aug 2007), p. 17.

107 RBA, Issues for the 2007/08 Review (May 2007), p. 30; RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 33.

108 Abacus- Australian Mutuals, Submission to the RBA's Payment Reform Review (31 Aug 2007), pp. 3-4.

109 Cuscal, Review of Reforms to Australia's Payments System (31 Aug 2007), p. 2.

There is also anecdotal evidence that the regulatory uncertainty brought about by the RBA's intervention has limited incentives for large offshore issuers to enter Australia. In a February 2007 article from *Card International*, it was noted that:

> *"There is…evidence that major offshore card issuers have bypassed the Australia market because of the protracted nature of the RBA reforms, preferring to enter markets where conditions appear more stable."*[110]

In reviewing changes in the structure of the payment card industry since the RBA's intervention in 2003, another major development was the exit of Bankcard. Bankcard was a domestic credit card scheme launched by the major Australian banks in 1974, prior to the introduction of Visa and MasterCard in Australia.[111] When Visa and MasterCard were introduced to Australia in 1984, the Bankcard scheme began to lose cardholders, who preferred to hold cards that could be used abroad. In February 2006, Bankcard announced that its members would progressively withdraw Bankcard credit cards from Australia. Banks phased out cards over 2006 and merchants stopped accepting Bankcard in 2007. According to the media release announcing Bankcard's closure, the decision to close the scheme was precipitated by changing market conditions and the continued growth of Visa and MasterCard, which made a domestic, "Australia-only" credit card unattractive to consumers:

> *"Bankcard is no longer seen as attractive by today's market that seeks internationally accepted credit cards and other features and benefits that Bankcard is unable to match…With an evolving market and declining customer demand for Bankcard credit cards, the long-term future of the scheme would be doubtful if it were to continue."*[112]

4.10. IMPACT ON INVESTMENT AND INNOVATION

In adding up the costs and benefits of the RBA's interventions, it is important to consider the effects of the regulations on incentives to invest and innovate. Over the long run, innovation can have a much greater impact on consumer welfare than static effects on price levels.

It is generally accepted that market regulation can reduce the incentives to invest in a market by creating uncertainty about the returns that can be realised from these investments. In public submissions to the RBA, American Express, CBA, the Australian Bankers' Association and BPAY all expressed the view that regulation in the payment system introduces a level of uncertainty that

110 "Regulation: Australian Interchange – three years on", *Card International*, 20 February 2007.

111 Information in this section is from Bankcard Milestones, available at http://www.bankcard.com.au/, accessed 24 July 2007; Bankcard website, History, available at http://www.bankcard.com.au/, accessed 24 July 2007. This website has since become inactive.

112 Bankcard Media Release, "Bankcard announces progressive withdrawal from Australian credit card market", 2 February 2006, http://www.bankcard.com.au/, accessed 21 July 2007.

has had an inhibiting effect on investment decisions.[113] As noted by the Australian Bankers' Association, "the risk of sub-optimal levels of investment and innovation are very real".[114] Similarly, BPAY, a bill-payment scheme in Australia that remains unregulated, stated to the RBA that any fee regulation in BPAY could jeopardise innovation in the system.[115]

The RBA intended that its interventions would reduce the profitability of issuing four-party cards, and this reduction in profitability naturally reduces issuers' incentives to invest in new types of four-party cards. Our interviews with the major Australian banks confirmed these views. Each of the banks in Australia we interviewed told us that the interventions have made it more difficult to develop a "business case" for investments related to four-party cards. Banks cited the introduction of EMV/Chip and PIN and the provision of prepaid cards to commercial clients as examples of projects that have been adversely affected by the RBA's interventions.

Less obviously, but equally if not more important, the banks suggested to us that the RBA's interventions have adversely affected incentives to invest in other payment systems. Investments in EFTPOS cards, in particular adding card-not-present functionality, were mentioned as an example. While the lack of a governance structure for EFTPOS is likely the largest contributing factor to the lack of investment in the EFTPOS scheme, the banks suggested that the regulatory uncertainty caused by the RBA's intervention in the payment card industry has also been a factor in reducing the incentives to invest in the system. The impact of the regulations on incentives to invest in EFTPOS was explained as follows in CBA's August 2007 submission to the RBA:

> *"Given the extended period of regulatory uncertainty prior to the standard being set and now with the current RBA review, Acquirers and Card Issuers continue to be understandably reluctant to develop the EFTPOS payment system. This has resulted in a lack of innovation and development of EFTPOS despite obvious opportunities (e.g. online EFTPOS)."*[116]

If this is indeed the case, then the impact on payment cards is potentially significant. Currently, a major "selling feature" of scheme debit cards over EFTPOS debit cards is that scheme debit cards can be used for internet purchases whereas EFTPOS debit cards cannot. If EFTPOS debit cards added card-not-present functionality, then an important competitive advantage of scheme debit cards would be eliminated. Given the RBA's stated desire to correct distortions that it believed were leading to the over-use of credit and charge cards and the under-use of EFTPOS debit cards, the RBA should regard this kind of negative effect on the incentives to improve EFTPOS

113 American Express, Review of Payments System Reforms – A Submission to the Reserve Bank of Australia (Aug 2007), p. 17; CBA, Submission to the Reserve Bank of Australia – Reform of Australia's Payments System – Issues for the 2007/08 Review (31 Aug 2007), p. 7; BPAY, Submission by BPAY Limited on Reform of Australia's Payments System – Issues for the 2007/08 Review (31 Aug 2007); Australian Bankers' Association, ABA's Submission: 2007/08 Payment Systems Review (31 Aug 2007), p. 3.

114 Australian Bankers' Association, ABA's Submission: 2007/08 Payment Systems Review (31 Aug 2007), p. 3.

115 BPAY, Submission by BPAY Limited on 'Reform of Australia's Payments System – Issues for the 2007/08 Review (31 Aug 2007).

116 CBA, Submission to the Reserve Bank of Australia – Reform of Australia's Payments System – Issues for the 2007/08 Review (31 Aug 2007), p. 5.

functionality as an unintended and perverse consequence of its regulation of the payment card industry.

5. ASSESSMENT OF THE RBA'S REASONS FOR INTERVENING IN THE PAYMENT CARD INDUSTRY

The RBA's intervention in the payment card industry was driven by its view, derived from the cost calculations in the RBA-ACCC Joint Study (and updated by the RBA in 2007), that credit card transactions are more costly in resource terms than EFTPOS debit card transactions. The RBA anticipated that, by ordering a reduction in interchange fees, there would be a significant increase in the use of EFTPOS debit cards relative to credit cards and that, because credit card transactions were believed to be more costly than debit card transactions, this shift in card usage would imply a significant savings in real resources.

In its preliminary conclusions of the 2007/08 review, the RBA continues to assert that its interchange regulations have contributed "to an improvement in overall resource allocation and substantial gains in welfare to the community".[117] This conclusion is not based on the effects of the regulations on final consumers.[118] Instead, the RBA's conclusion is based on its view that (a) its regulations have induced a significant number of consumers to use EFTPOS debit cards for transactions that otherwise would have been conducted using credit cards; and (b) this shift from credit cards to EFTPOS debit cards has improved allocative efficiency because the incremental resource costs of EFTPOS debit card transactions are believed to be less than the incremental resource costs of credit card transactions. To punctuate this point, the RBA presents a back-of-the-envelope calculation in which it assumes that the regulations have reduced the number of credit card transactions by 5% and increased the number of EFTPOS debit card transactions by a like amount. The RBA claims that such substitution from credit cards to EFTPOS debit cards would have reduced costs by about AU$100 - AU$150 million per year.[119]

There is no basis for either of the key assumptions on which the RBA's analysis is based. As discussed in Part 4.7 above, the available data simply do not support the RBA's claim that its regulations have had a significant effect on the use of credit cards relative to EFTPOS debit cards. There is certainly no basis for assuming that the regulations have affected card usage by anything like the 5% figure assumed in the RBA's welfare calculation. Further, as explained in the remainder of this section, there are fundamental flaws with the RBA's resource cost analysis and its conclusions regarding the impact on allocative efficiency of shifting transactions from credit cards to EFTPOS debit cards.

117 RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 38.

118 The RBA notes that it has received various submissions arguing that its regulations have made credit card holders worse off. The RBA states in response that it "does not accept this argument". It notes that "[w]hile the reforms have clearly affected different groups differently", its concern is with the impact of its regulations on "overall welfare" and claims that "the major benefits to the Australian economy" from the regulations accrue "through the improved allocative efficiency resulting from more appropriate price signals". RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 19.

119 RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 19.

5.1. SUMMARY OF THE COST STUDIES ON WHICH THE RBA HAS RELIED

We begin by reviewing the cost calculations in the 2000 Joint Study – the calculations on which the RBA relied when it made its decision to intervene in the payment system. We then summarise the updated study released by the RBA in November 2007.

5.1.1. The cost calculations in the 2000 Joint Study

The RBA's original analysis of the relative resource costs of conducting transactions using credit and debit cards is presented at pages 76-79, Table 5.1 (page 45) and Table 6.1 (page 65) of the Joint Study released in October 2000. The analysis is based on data for 1999 provided by the four major Australian banks and some smaller institutions.[120]

It is important to recognise that, when the RBA claims that credit card transactions are more costly in resource terms than debit card transactions, it is not referring to the difference in merchant service charges. The RBA recognises that merchant service charges are heavily influenced by interchange fees and that interchange fees are not a resource cost. Interchange fees are simply a transfer payment from one party to another which does not divert resources from an alternative use.[121]

The Joint Study attempted to analyse the resource costs per AU$100 transaction on the acquiring and issuing sides associated with credit card and EFTPOS debit card transactions. For credit card transactions, the Joint Study concluded that the sum of acquiring and issuing costs in 1999 averaged approximately AU$2.01 per AU$100 transaction. For EFTPOS debit card transactions, the Joint Study concluded that these costs in 1999 summed to an average of approximately AU$0.41 per AU$100 transaction. The RBA relied on these results for its conclusion that credit card transactions were significantly more costly in resource terms than EFTPOS debit card transactions.

5.1.2. The RBA's updated cost calculations

The RBA released updated cost calculations in November 2007 that are based on data from the respondents' 2005-06 fiscal year.[122] The updated calculations provide more detail on the costs of acquiring and issuing banks; they also attempt to estimate the resource costs to merchants and consumers associated with different payment methods.

120 RBA & ACCC, Joint Study (Oct 2000), pp. 43, 64.

121 The RBA thus excludes interchange fees from its calculations of resource costs. See RBA & ACCC, Joint Study (Oct 2000), pp. 45 and 65. As an example of an activity that *would* constitute a resource cost, consider the time spent by employees to process card transactions. That time would be a resource cost if the employee could have spent the time in a productive alternative use.

122 RBA, Payment Costs in Australia – A study of the costs of payment methods (29 Nov 2007). The paper was prepared for the Payments System Review Conference organised by the RBA and the Centre for Business and Public Policy, Melbourne Business School, Sydney, 29 November 2007.

Table 8 summarises the RBA's updated calculations of resources costs. As in the Joint Study, these updated calculations exclude interchange fees and other items that are transfer payments rather than resource costs. The RBA estimated resource costs for an average size transaction using different payment mechanisms (AU$132 for credit cards and AU$59 for EFTPOS). Given that the issue is the costs that would have been incurred if transactions conducted using a credit card had been made with a debit card, this design in principle is imperfect. If the average credit card transaction is AU$132, it would have been better to calculate the costs for an EFTPOS transaction of AU$132. However, in practice, this difficulty with the design of the RBA's analysis may not be important – the RBA found that "[f]or transactions through the EFTPOS system, the resource costs are largely invariant with respect to the value of the transaction".[123]

123 RBA, Payment Costs in Australia (29 Nov 2007), p. 9.

Table 8: Summary of the RBA's updated cost calculations, AU$ (unless stated otherwise)

	Reference to RBA, Payment Costs in Australia	Credit	EFTPOS	Difference
Average transaction size		132	59	
Financial institutions	*Table 2*	**Credit**	**EFTPOS**	**Difference**
Acquiring		0.19	0.11	0.08
Issuing				
Authorisation and processing		0.08	0.05	0.03
Scheme fees		0.11	-	0.11
Fraud and fraud prevention		0.11	0.01	0.10
Cost of capital (excl credit losses)		0.05	0.01	0.04
Other		0.04	0.04	-
		0.40	0.11	0.29
Sub-total		**0.59**	**0.22**	**0.37**
Merchants	*Table 8*	**Credit**	**EFTPOS**	**Difference**
Tender time		0.31	0.24	0.07
Other point-of-sale		0.07	0.06	0.01
Back-office processing		0.01	0.01	-
Other		0.01	-	0.01
Sub-total		**0.40**	**0.31**	**0.09**
Consumers	*Table 10*	**Credit**	**EFTPOS**	**Difference**
Time (seconds per transaction)				
Tender time		45	35	10
Statement reconciliation		5	5	-
Bill payment		13	-	13
		63	40	23
Assumed value of time (AU$ / hour)	*Page 20*	12.50		
Assume value of time (AU$ / second)		0.0035		
Implied value of time spent		0.22	0.14	0.08
Total Resource Costs	*Table 11*	**1.21**	**0.67**	**0.54**

Taken at face value, the RBA's updated cost calculations imply that the resource costs for an average credit card transaction exceed the resource costs for an EFTPOS transaction by AU$0.54. Of this total difference, AU$0.37 is at the financial institution level (AU$0.08 on the acquiring side and AU$0.28 on the issuing side); AU$0.09 is at the merchant level; and AU$0.08 is at the consumer level.

Table 9 compares the results on the costs at the financial institution level from the updated study issued in 2007 with the results for issuing and acquiring in the Joint Study published in 2000. It is noteworthy that, after allowing for the effects of inflation, the cost estimates in the updated study are significantly lower than the cost estimates from the Joint Study on which the RBA originally based its decision to intervene. The sum of issuing and acquiring costs in the updated study (covering respondents' 2005-06 fiscal year) for credit and EFTPOS debit card transactions are 77% and 57% respectively lower than the estimates in the Joint Study (based on data from 1999).

Table 9: Comparison of the RBA's Joint Study (2000) and Updated Study (2007) cost calculations, AU$ (unless stated otherwise)

			Nominal cost per transaction		Real cost per transaction (2006 dollars)		
Study	**Year of study**	**Costs included**	**Credit**	**EFTPOS**	**Credit**	**EFTPOS**	**Difference (Credit – EFTPOS)**
Joint Study (2000)	1999	Costs associated with financial institutions only	2.01	0.41	2.52	0.51	2.01
Updated Study (2007)	FY2005-06	Costs associated with financial institutions only	0.59	0.22	0.59	0.22	0.37
	FY2005-06	Costs associated with financial institutions, merchants and consumers	1.21	0.67	1.21	0.67	0.54

Source: CRA International. Real costs were determined using the annual inflation rate between 1999 and 2006 according to the RBA's website (http://www.rba.gov.au/calculator/calc.go#divFrmCalcA, accessed 23 April 2008).

The fact that the updated study in 2007 has arrived at inflation-adjusted cost estimates that are so much lower than the cost estimates in the original Joint Study inevitably raises questions regarding the quality of the estimates. The RBA has not tried to explain this difference in its cost estimates, and it is improbable that there truly were changes in cost conditions that can explain the difference between the original Joint Study and updated cost estimates. If we are to accept the updated estimates, the natural conclusion is that the cost estimates in the original Joint Study – the study on which the RBA based its decision to intervene – were very significantly overstated.

Putting this same point in a different way, even if one accepts the accuracy of the updated cost estimates (which, for reasons explained below, we do not), the updated cost estimates imply that the RBA should regard its case for intervening in the payment card industry as significantly weaker than the case it thought it had in 2003 based on the cost calculations in the Joint Study. Table 9 shows that, even if one includes the estimates of transaction costs at the merchant and consumer level presented in the updated study, the RBA's own estimate of the difference between the costs of credit and EFTPOS debit card transactions in the updated study is approximately 73% less than the estimate in the Joint Study on which the RBA originally relied (after allowing for the effects of inflation).

5.2. COMMENTS ON THE COST STUDIES

5.2.1. The cost calculations should be based on incremental costs

As explained above, the RBA believes that interchange fees have promoted the use of credit cards relative to EFTPOS debit cards and that this has reduced the efficiency of the payment system in Australia because it believes, based on its cost studies, that credit card transactions are more costly in resource terms than EFTPOS debit card transactions.

Because the RBA is focusing on a subset of credit card transactions, namely credit card transactions that would be made using EFTPOS debit cards if interchange fees were lower or eliminated, the RBA's conclusion regarding relative resource costs requires evidence that the *incremental* resource costs of conducting additional credit card transactions are significantly greater than the *incremental* resource costs of conducting additional debit card transactions. The fixed costs of a credit card system should not be included in this calculation because, even if interchange fees were reduced, there would still be credit card transactions and thus there would still be need for the infrastructure required to conduct credit card transactions.

In its updated cost study issued in November 2007, the RBA makes clear that there is no disagreement that incremental costs are the relevant consideration. The RBA's updated report states clearly:

> *"In principle, this study is attempting to measure the long-run incremental resource cost of each payment method. This is the additional resource cost incurred in the long run if a substantial number of extra payments were made using a particular payment method."*[124]

5.2.2. The cost elements that should be included in incremental cost depend on the extent to which card usage is affected by the RBA's regulations

Even though the RBA agrees that incremental costs (and not average total costs) are the relevant consideration, the question remains as to what cost elements should be included in the calculation of incremental costs. As the quotation above makes clear, the RBA takes the position that the analysis should consider the impact on costs "if a *substantial number* of extra payments were made using a particular payment method" (emphasis added). Having defined the exercise in this manner, the RBA states that the costs which are relevant for calculating incremental costs "include those incurred in putting in place the additional infrastructure that would be needed to make a *substantial number* of extra payments" (emphasis added).[125] Because of this perceived need to include incremental infrastructure costs in the measure of long-run incremental costs, the

124 RBA, Payment Costs in Australia (29 Nov 2007), p. 2.

125 Ibid.

RBA concludes that long-run incremental cost "would be significantly higher than the marginal cost of making an extra payment through the existing infrastructure"[126].

This argument is driven by the assumption that, in calculating incremental costs, one should necessarily be considering the impact on costs "if a *substantial number* of extra payments were made using a particular payment method". This formulation is not necessarily correct. The calculation of incremental costs is not being conducted in a vacuum. To determine which costs should be included, it is important to remember the context: the issue is the incremental costs that would be avoided or incurred if interchange fees were reduced and if, as a result, use of credit cards declined and use of EFTPOS debit cards increased.

With this framework in mind, it is clear that determining which costs should be included in the measure of incremental cost depends on the effects of the RBA's regulations on card usage. If the effects of the regulations on card usage are relatively modest (and recall from Part 4.7 that there is no evidence to date that the regulations have had a significant effect on card usage), then the changes in card usage resulting from the regulations will have had little effect on the levels of infrastructure required to operate the credit and EFTPOS debit card systems. Under these circumstances, it would be inappropriate to include any significant allowance for infrastructure costs when analysing the impact on resource costs of the change in card usage resulting from the RBA's regulations. The correct measure of costs will be much closer to short-run marginal costs.

5.2.3. The updated study incorrectly uses average total costs as a proxy for incremental costs

The RBA has ignored this link between the impact of its regulations on card usage and the determination of which costs should be included in incremental cost. The RBA has measured incremental cost in a way that implicitly assumes that its regulations have affected the choice of payment method on a "substantial number" of transactions, yet there is no evidence to support this assumption.

The RBA has compounded this problem by assuming in its cost calculations that average total cost can be used as a reasonable proxy for long-run incremental costs. The RBA states in its report issued in November 2007:

> *"Given the practical difficulties involved with this forward-looking concept [long-run incremental cost], the approach taken here is to measure the average cost of different payment methods. In many situations, average cost is likely to be a reasonable indication of long-run incremental resource cost, although some caveats are discussed later in the paper."*[127]

For the reasons explained above, there is no basis for this assumption. Especially if the RBA's regulations have had only a modest effect on card usage, the relevant measure of incremental costs should be based almost exclusively on short-run variable costs (and should include little if any overhead or other infrastructure costs).

126 Ibid.

127 Ibid.

5.2.4. Comments on specific elements of the RBA's updated cost study

Without access to the details of the calculations in the RBA's updated cost study, it is not possible to correct the RBA's analysis to eliminate the influence of infrastructure costs and to focus just on costs that are truly likely to vary in response to modest changes in the volume of credit and EFTPOS debit card transactions. We cannot, in other words, prepare alternative versions of the tables in the updated study that correct the RBA's mistaken use of average total costs.

This subsection highlights other problems in the RBA's updated cost study. The problems identified in this subsection are only a subset of the larger set of problems with the RBA's updated calculations.

Fraud losses, prevention and investigation

AU$0.10 of the difference in estimated costs on the issuing side relates to the costs of fraud losses, prevention and investigation associated with credit card transactions that are not associated with EFTPOS debit card transactions. In explaining why these costs are higher for credit cards, the RBA notes that these costs reflect "the practice of authorising credit card transactions by signature and the use of credit cards in situations in which the card is not present".[128] The implication is that fraud is a greater problem with transactions approved by signature (credit cards) rather than with a PIN (EFTPOS) and that fraud is also a greater problem with card-not-present transactions (where credit cards can be used, but EFTPOS cards cannot).

Here again there is a mismatch between the cost calculation in the RBA's updated study and the objective of the analysis. The RBA's focus is (or should be) on transactions conducted using a credit card that would have been made using an EFTPOS debit card if interchange fees had been lower. Precisely because EFTPOS debit cards cannot be used for card-not-present transactions, any fraud costs related to card-not-present credit card transactions should be excluded from the analysis. Even if the RBA's regulations caused EFTPOS debit cards to be used more (and credit cards less), there would be no material reduction in card-not-present transactions and hence no material reduction in fraud costs related to card-not-present transactions.

A similar point can be made with respect to point-of-sale transactions. If it is more difficult to perpetrate fraud when a PIN is required (as is the case with EFTPOS transactions), then the consumers who might be induced to use EFTPOS debit cards instead of credit cards in response to the RBA's regulations will not be the fraudsters. Fraudsters will continue using credit cards (which only require signature approval), because this is where the opportunities for fraud are greater. The cardholders who are induced to switch from credit cards to EFTPOS debit cards will tend to be the legitimate credit card users, who are not responsible for the point-of-sale fraud losses embedded in the RBA's cost of fraud calculations. Therefore, even if the RBA's regulations caused EFTPOS debit cards to be used more (and credit cards less), there should be no material change in the volume of fraudulent point-of-sale transactions and hence no material reduction in fraud cost related to point-of-sale transactions.

128 RBA, Payment Costs in Australia (29 Nov 2007), p. 8; RBA, Preliminary Conclusions of the 2007/08 Review (Apr 2008), p. 8.

Costs to merchants of longer tendering time

Based on time and motion studies supplied by merchants, the RBA concludes that point-of-sale credit card transactions take 10 seconds longer on average to complete than EFTPOS transactions, primarily because obtaining signature approval (credit cards) takes more time than entering a PIN (EFTPOS). The RBA notes that "using typical wage rates in the retail industry, a 30 second saving in tender time could save a merchant around $0.17 per transaction".[129] Evidently based on this estimate of the value of a 30 second time saving, the RBA concludes that the 10 extra seconds that it takes merchants on average to process credit card transactions has a value of AU$0.07.[130]

This estimate almost surely overestimates the typical additional cost to merchants (in terms of increased tender time) associated with point-of-sale transactions conducted using a credit card that could have been made with an EFTPOS debit card. This method of calculating the costs of added tender time assumes that merchants have a goal of limiting customer queuing time to a particular figure so that any increase in queuing time resulting from an increase in tendering time means that the merchant should hire additional tellers. This is obviously a very crude method of estimation which assumes, among other things, that merchants always have queues that are near the maximum length that the merchant is willing to accept. This estimation method ignores important points that the RBA itself highlighted in its commentary (but which it seems to have disregarded in its calculations):

> *"For other merchants, particularly small businesses, tender time may be less important as a driver of costs. This is particularly so in environments in which queues at the check-out are atypical, and where the time taken for the payment to be processed can be used by the merchant to develop a stronger relationship with the customer. In our sample, some merchants with lower turnover estimated payment costs on the basis of informal estimates which were much closer across payment methods than those based on time and motion studies."*[131]

Transaction costs at the consumer level

The RBA's comparison of the transaction costs at the consumer level for credit card and EFTPOS transactions has two main elements – differences in tender time (discussed above) and the time spent by consumers reviewing credit card statements prior to paying their bills that are unnecessary with EFTPOS transactions (because the monies are deducted from the consumer's account at the time of purchase). As mentioned above, it is assumed (based on time and motion studies) that credit card transactions take 10 seconds longer on average than EFTPOS transactions. The estimate for bill payment time is calculated as follows. The RBA assumes that it takes consumers, on average, two minutes to pay their credit card bills. The average number of credit card transactions on a credit card reportedly is approximately 9 per month. The RBA

129 RBA, Payment Costs in Australia (29 Nov 2007), p. 16.

130 The RBA does not explain why its estimate is not AU$0.06 = AU$0.17 x (10 seconds / 30 seconds).

131 RBA, Payment Costs in Australia (29 Nov 2007), p. 16.

therefore concludes that each additional credit card transaction increases a consumer's bill payment time by about 13 seconds (= 120 seconds / 9).

The RBA's estimate of bill payment time is exceptionally crude. First, no source is provided for the estimate that the average consumer takes two minutes to pay his or her credit card bill. Second, there is no explanation as to why the length of time it takes to pay should vary with the number of transactions on the bill. The figure of 13 seconds is meant to cover bill *payment* time and does not include time spent reconciling the statement – statement reconciliation is listed as a separate item in the RBA's 2007 study. This is an important point because the issue, once again, concerns the costs associated with transactions conducted using a credit card that could have been made with a debit card. Even if a consumer made increased use of his or her EFTPOS debit card, the consumer might still have credit card transactions – because of on-line or other card-not-present transactions or because of large purchases where the consumer made use of the credit functionality of a credit card. Therefore, even if credit card holders made increased use of EFTPOS cards for transaction purposes, many if not most would still have credit card bills to pay – and it seems far more likely that the time spent actually paying a bill (as opposed to reconciling) would have little relation to the number of transactions on the bill.

5.2.5. Summary with respect to the cost studies

The RBA is clearly concerned about the reliability of its cost calculations. It cautions that "while every effort has been made to promote accuracy, precise estimation of payment costs is a challenging task". While expressing confidence in the rankings implied by the calculations, the RBA warns "these results should, however, be interpreted as providing a guide to the general orders of magnitude, rather than precise estimates".[132]

We submit that even this cautious interpretation of the RBA's updated cost calculations is not cautious enough. Aside from the difficulty which the updated study still faces of collecting comparable data across respondents, even an initial review of the RBA's updated study released in late November 2007 indicates a number of areas where it appears that the RBA includes costs that should be excluded or where the reliability of the RBA's estimates is highly questionable.

5.3. THE RELATIVE BENEFITS OF CREDIT AND DEBIT CARDS

The original cost analysis relied upon by the RBA was criticised by a number of parties because it focused only on costs and did not consider the relative benefits of credit and debit cards.[133] Various parties made the point that credit cards provide consumers with range of special benefits, most obviously access to credit, but also entitlement to refunds if goods or services are not

132 RBA, Payment Costs in Australia (29 Nov 2007), p. 21.

133 See e.g. MasterCard, Response to the December 2001 Consultation Document of the RBA (Mar 2002); NECG, Credit card schemes in Australia – A response to the RBA and ACCC Joint Study (Jan 2001); Appendix A to NAB, Letter to the Governor, Joint Study into Debit and Credit Card Schemes in Australia (5 Dec 2000) (Gans and King, Observations on the Joint RBA/ACCC Study 'Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access' (9 Nov 2000)).

delivered and various other features. It was suggested that any comparison of the relative efficiency of credit and debit cards would need to take these benefits into account.

The RBA now agrees that relative benefits need to be considered as well as relative costs (while implying that it has never suggested otherwise):

> *"The Bank has repeatedly acknowledged that an outcome in which individuals use a payment method which involves higher resource costs can be efficient, particularly if the prices individuals base their choices upon are broadly reflective of the costs of providing the payment method."*[134]

6. SUMMARY OF CONCLUSIONS

Interchange fees and no-surcharge rules are issues that are being actively considered by regulators in various countries around the world. The effects of the RBA's decisions to order a 50% reduction in credit card interchange fees as of November 2003 and to prohibit no-surcharge rules as of January 2003 are therefore of great interest internationally, as well as in Australia.

The evidence on the actual effects of the RBA's interventions since 2003 should cause the RBA to reconsider and should give pause to regulators in other countries considering similar regulations. One of the main effects of the RBA's interventions has been a redistribution of wealth in favour of merchants. Merchant service charges have declined as a result of the RBA's regulations. The fact that merchants in Australia are lobbying aggressively for further reductions in interchange fees (indeed, the elimination of interchange fees) is clear evidence that they have benefited from the RBA's regulations and strongly suggests that they have not simply passed through reductions in merchant service charges in the form of lower prices and/or improved quality of service. In addition, there is evidence of merchants applying above-cost surcharges as part of an effort to capture some of the value that would otherwise be derived by consumers from the use of payment cards.

The RBA's regulations in contrast have harmed consumers by causing cardholder fees to increase and the value of card benefits such as reward programmes to decline. Consumers have also been harmed to the extent that the reduction in the profitability of issuers has reduced their incentive to invest in new types of cards and payment system innovations. Against these undeniable sources of consumer harm, merchants have not presented any empirical evidence documenting the extent to which reductions in merchant service charges have been passed through to consumers, and neither has the RBA or anyone else. Thus, while the RBA's regulations have clearly harmed consumers by causing higher cardholder fees and less valuable reward programmes and possibly reducing payment system innovation, there is no evidence that these undeniable losses to consumers have been offset by reductions in retail prices or improvement in the quality of service.

The RBA's case for intervening in the payment card industry was based on its belief that credit card transactions were more costly in resource terms than debit card transactions and its belief that interchange fees exacerbate this alleged inefficiency by promoting the use of credit cards

134 RBA, Issues for the 2007/08 Review (May 2007), paragraph 40.

relative to debit cards. In addition to analysing the impact of the RBA's regulations on final consumers, we have examined the cost studies on which the RBA has relied in reaching its conclusion that credit cards are more costly than debit cards. We have shown that the cost calculations on which the RBA relies (including the updated cost calculations) are deeply flawed and that, in fact, there is no basis for concluding that there is a significant waste of resources in Australia associated with transactions conducted using a credit card that could have been made using a debit card.

As we noted in the introduction, regulation should be employed only if there is clear evidence of a market failure and only if there is reason to believe that regulation is likely to benefit consumers. The evidence in this paper suggests that the RBA's intervention in the payment card industry in Australia failed both legs of this test. The market failures alleged (but not substantiated) by the RBA do not justify continuation of regulatory intervention. Moreover, the actual effects of the RBA's intervention provide no evidence that the payment system in Australia is now operating more efficiently or that consumers have derived any net benefits from the intervention.

APPENDIX A: INTRODUCTION TO PAYMENT CARDS

A.1 PAYMENT CARDS AND INTERCHANGE FEES

Payment cards such as debit cards and credit cards typically involve four parties, in addition to the systems themselves:

- The cardholder;
- The institution that provides the card to the cardholder – the issuer;
- The merchant that provides the goods or services to the cardholder; and
- The institution that provides services to the merchant – the acquirer.

In the case of MasterCard and Visa credit and debit cards, the schemes themselves do not issue or acquire transactions, but rather their member institutions provide these services to the end cardholder or merchant. In addition, the issuer and acquirer can be different institutions and hence these schemes are often referred to as "four-party schemes".

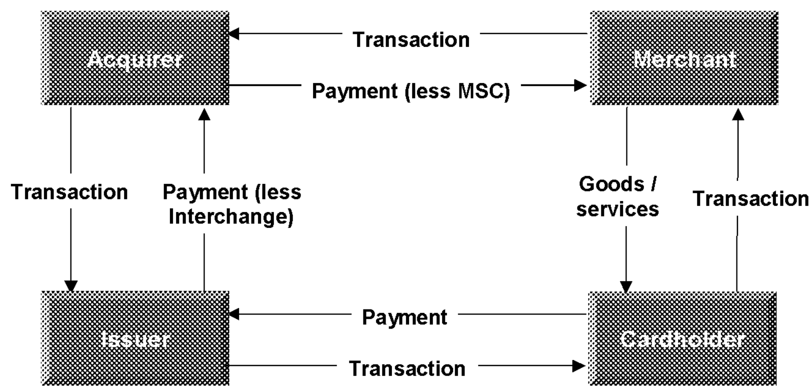
In the case of American Express and Diners Club, the schemes themselves both issue and acquire transactions. Hence these schemes are often referred to as "three party schemes" since the issuer and the acquirer is the same institution, namely the scheme.[135]

It is typical for payment cards to include an "interchange fee" which is a fee that is paid between issuers and acquirers. In the MasterCard and Visa schemes the interchange fee is paid by the acquirer to the issuer.

Figure 11 below provides a schematic of the parties involved and the flows of money within the MasterCard and Visa payment card schemes.

[135] In some cases American Express and Diners Club will offer a franchise to other institutions to issue or acquire on their behalf.

Figure 11: Four party scheme payment card



Source: CRA International

A.2 ROLE OF INTERCHANGE FEES

In both the three party schemes and the four party schemes, there are two distinct sets of users of payment card functionality – the cardholders and the merchants. Both of these users need to participate in the system if it is to function:

- Cardholders could not use their cards if there were no merchants who accepted cards; and
- Merchants could not accept cards if there were no cardholders.

For this reason, payment card schemes are often referred to as "two sided markets".

Furthermore, there are important interactions between these two "sides" of the market since the value of the system to one side depends on the participation of the other side:

- The greater the number of consumers who use cards, the greater the value to merchants from accepting them; and
- The greater the number of merchants accepting cards, the greater the value to consumers from having cards.[136]

Because interchange fees are a cost to acquirers, interchange fees tend to increase merchant service charges. Interchange fees however are a source of revenue to issuers. The receipt of

136 These are sometimes referred to as "indirect network effects". Network effects arise where the value of being part of the network varies depending on the size of the network – typically where the value from joining the network increases as the network increases. The interactions above are described as indirect network effects because the value from joining the network increases as the size of the "other side" increases.

these revenues enables issuers to offer lower cardholder fees and/or increase the value of card benefits (e.g. interest-free periods and reward points).

Assuming that merchants do not apply surcharges to users of scheme credit or debit cards, interchange fees can be a method of encouraging card usage. If merchants do not surcharge, the cardholder benefits from interchange fees (lower cardholder fees and/or increased cardholder benefits) will not be offset by higher prices at the retail level.

Economists recognise that interchange fees can be used to realise the full benefits of the indirect network effects described above – cardholders benefit when more merchants accept payment cards; merchants benefit when more consumers use payment cards. Interchange fees can be used in four-party card systems to balance demand on the two sides of the market in a way that realises the full benefits of indirect network effects and which optimises card usage and acceptance.[137]

A.3 NO-SURCHARGE RULES

Visa and MasterCard had a no-surcharge rule in Australia until January 2003, when no-surcharge rules were prohibited by the RBA. No-surcharge rules ensure that cardholders will not face above-cost surcharges in which merchants use surcharges as an opportunity to extract value from credit card users. The incentive of merchants to use surcharging in this manner is recognised in the economic literature.[138]

No-surcharge rules also ensured that schemes could use interchange fees to promote card usage and realise the full benefits of indirect network effects. Gans and King[139] have shown that, if surcharging is frictionless (so that all merchants surcharge), then changes in interchange fees might have no effect on card usage. For example, if surcharging was frictionless and there was an increase in interchange fees, the resulting decrease in cardholder fees and/or increase in card benefits would be exactly offset in the Gans-King analysis by the resulting increase in surcharges applied by merchants on card transactions. No-surcharge rules ensure that the use of interchange fees to promote card usage and to realise the full benefits of indirect network effects would not be "un-done" by surcharging.

137 For a non-technical discussion of these points, see e.g. David Evans and Richard Schmalensee, "The Economics of Interchange Fees and Their Regulation: An Overview", AEI-Brookings Joint Center for Regulatory Studies, Related Publication 05-12, May 2005, available at http://aei-brookings.org/admin/authorpdfs/redirect-safely.php?fname=../pdffiles/php6A.pdf, accessed 23 April 2008. For a more technical overview, see e.g. Julian Wright, "The determinants of optimal interchange fees in payment systems", *Journal of Industrial Economics* Vol. 52, Issue 1 (March 2004), pp. 1-26.

138 Marius Schwartz and Daniel Vincent, "The No Surcharge Rule and Card User Rebates: Vertical Control by a Payment Network", *Review of Network Economics*, Volume 5, No. 1 (March 2006), pp. 72-102.

139 Joshua Gans and Stephen King, "The Neutrality of Interchange Fees in Payment Systems", *Topics in Economic Analysis and Policy*, Vol. 3, Issue 1 (2003), pp. 1-16..

APPENDIX B: BACKGROUND INFORMATION ON THE PAYMENT CARD INDUSTRY IN AUSTRALIA

This appendix provides some high-level background information on the Australian payment card industry.

B.1 CREDIT AND CHARGE CARDS

There are currently two credit card schemes and two charge card schemes in the Australian payment system. Visa and MasterCard are four-party credit card schemes, while American Express and Diners Club are typically classified as three-party charge card schemes (although some banks now issue American Express and Diners Club products and American Express now offers credit card products in addition to charge cards). Until its demise in 2006, Bankcard was another four-party credit card scheme active in the Australian payment system.

Visa has historically been the largest credit/charge card scheme in Australia. In 2000, the RBA/ACCC Joint Study estimated that Visa had a 51.4% share of the general-purpose credit and charge card business based on cards issued. MasterCard and Bankcard were the next-largest schemes, followed distantly by American Express and Diners Club. The RBA's estimates are shown in Table 10 below.

Table 10: Shares of major credit and charge card schemes, 1999/2000

	Share (based on cards on issue)
Visa	51.4%
MasterCard	22.7%
Bankcard	19.2%
American Express (credit and charge cards)	5.0%
Diners Club	1.7%

Source: Roy Morgan consumer survey, as cited in RBA & ACCC, Joint Study (Oct 2000), p. 15.

Credit cards are widely held and used in Australia. A survey conducted by Roy Morgan Research in May 2007 found that approximately 54 percent of adults hold a credit or charge card.[140]

B.2 DEBIT CARDS (EFTPOS AND SCHEME DEBIT)

There are three debit card schemes in Australia: EFTPOS, Visa Debit and MasterCard Debit. While there has been some growth in the Visa Debit scheme over the past several years, EFTPOS continues to be the leading scheme, with an 86% share in terms of cards issued and an

140 RBA, Issues for the 2007/08 Review (May 2007), p. 17.

80% share in terms of transaction value in 2006.[141] Visa Debit holds most of the remaining share (due to the fact that MasterCard only entered the business in late-2005).

B.2.1 EFTPOS

EFTPOS is a domestic PIN debit system that was established by the major banks in 1984.[142] The EFTPOS system consists of a series of bilateral links between issuers and acquirers (as opposed to a centralised switch like in the Visa and MasterCard schemes). EFTPOS is run through the bilateral links between the different banks, with the Australian Payments Clearing Association (APCA) playing a role to set technical standards. The APCA and Australian Bankers' Association have recently entered into discussions to put a more comprehensive governance system into place.[143]

One unique aspect to the Australian EFTPOS system is the interchange fee, which is bilaterally negotiated and flows from the issuer to the acquirer ("negative interchange"). The direction of interchange for EFTPOS likely relates to the beginnings of the system. According to several sources, merchants and acquirers invested heavily in the system at its start, with large retailers such as Coles Myer investing in their own EFTPOS terminals.[144] As a result, negative interchange fees were negotiated to finance the investments that were undertaken by these entities. This practice has not been altered since.[145]

B.2.2 Visa Debit and MasterCard Debit ("scheme debit")

Visa Debit and MasterCard Debit are frequently referred to as "scheme debit" systems. In Australia, scheme debit cards are different from EFTPOS cards in several respects:[146]

- Scheme debit cards are signature debit cards (i.e. a customer signs a receipt to authorise a transaction). EFTPOS transactions are authorised by PIN.

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141 Datamonitor, Payment Cards in Australia 2007 (Jun 2007), pp. 43-44.

142 Frontier Economics, Why does Australia have negative interchange for EFTPOS? (9 Jul 2004), p. 9. The report was prepared for the Australian Merchant Payments Forum.

143 "Banks talk EFTPOS governance", *The Sheet News Bites,* 3 August 2007.

144 See Frontier Economics, Why does Australia have negative interchange for EFTPOS? (9 Jul 2004), p. 9; "A boost for EFTPOS", *Electronic Payments International*, January 1997.

145 Frontier Economics, Why does Australia have negative interchange for EFTPOS? (9 Jul 2004), p. 9

146 RBA, Reform of the EFTPOS and Visa Debit Systems in Australia – A Consultation Document (Feb 2005), p. 5. (As a further point of clarification, a scheme debit card also has EFTPOS functionality. In other words, banks either issue an EFTPOS-only card or a scheme debit card with EFTPOS functionality as well as scheme debit functionality. Typically, a consumer can decide to use a scheme debit card as either an EFTPOS card or a scheme debit card. To use it as an EFTPOS card, they press the "Savings" button on the POS terminal and to use it as a scheme debit card they press "Credit" on the POS terminal.)

- Scheme debit transactions are processed through the Visa and MasterCard credit card processing networks, while EFTPOS transactions are processed through the EFTPOS network.
- Scheme debit cards can be used in card-not-present transactions; examples include payments over the internet or telephone. EFTPOS cards cannot be used for these types of payments.
- Scheme debit cards cannot currently be used to obtain cash-back at the point-of-sale, whereas EFTPOS cards can.
- Finally, scheme debit cards are accepted internationally and offer the same protections as other Visa transactions (e.g. customers can receive charge-backs in cases of fraudulent use or where goods and services are not delivered as promised). EFTPOS cards are only accepted domestically and do not have these types of protections.

Visa Debit was first issued by credit unions and building societies in the 1980s. By contrast, MasterCard's debit product was launched in Australia in November 2005.

B.3 ISSUING AND ACQUIRING

The Australian banking sector consists of four "major" banks, several smaller regional banks, and hundreds of credit unions and building societies. Credit and debit issuing and acquiring activities are primarily carried out by the four major banks – Australia and New Zealand Bank (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Westpac. For example, in 2000, the RBA/ACCC Joint Study reported that approximately 85% of credit card transactions involved cards issued by the four major banks and that these same four banks accounted for 93% of credit card transactions acquired.[147]

In addition to the four major banks, there are several other issuers of note. These include St. George Bank (the fifth-largest bank in Australia), Citibank and GE Money.

147 RBA & ACCC, Joint Study (Oct 2000), p. 17.

APPENDIX C: ADDITIONAL DATA ON INCREASES IN CARDHOLDER FEES

Table 11 below provides detail on the fees of specific issuers. Since 2002, ANZ and Westpac have increased annual fees on at least one rewards card offering by over 50%, while St. George increased the annual fee for its low-rate MasterCard by 51%. Some issuers have increased annual fees by an even greater amount – for example, the annual fee on Citibank's Silver MasterCard/Visa card has increased by 130% since early 2002. Clearly, the interchange standard has left many cardholders facing significantly higher costs.

Table 11: Examples of Visa/MasterCard products with increased annual fees

Issuer/Card Name	Fee Type	Change from (AU$)	Change to (AU$)	% change	Date
ANZ					
Qantas Visa	Annual Fee + Reward Programme Fee*	60 (27 + 33)	95 (40 + 55)	58%	Dec-02
Qantas Gold Visa	Annual Fee + Reward Programme Fee*	100 (67 + 33)	150 (95 + 55)	50%	Dec-02
Rewards Visa (formerly Telstra Visa)	Annual Fee + Reward Programme Fee	30 (19 + 11)	48 (26 + 22)	60%	Dec-02
First Free Days Visa	Annual Fee	26	30	15%	Oct-03
Commonwealth					
Standard MC/Visa with Rewards	Annual Fee	45	59	31%	Jan-03
Gold MC/Visa with Rewards	Annual Fee	82	114	39%	Jan-03
NAB					
NAB Gold Rewards	Annual Fee + Reward Programme Fee	121.30 (88.30 + 33)	145.50 (88.30 + 57.20)	20%	Jul-05
Westpac					
Standard MC/Visa	Annual fee	24	30	25%	Mar-03
Gold MC/Visa	Annual fee	65	90	38%	Mar-03
Altitude MC (Rewards)	Annual fee	49	75 (now 100)	53%	Mar-03
Altitude Gold MC (Rewards)	Annual fee	90	125 (now 150)	39%	Mar-03
Citibank					
Gold MC/Visa	Annual Fee	90	99 (now 119)	10%	Feb-02

Issuer/Card Name	Fee Type	Change from (AU$)	Change to (AU$)	% change	Date
Silver MC/Visa	Annual Fee	30	55 (now 69)	83%	Feb-02
St George					
MC Starts Low, Stays Low	Annual Fee	39	59	51%	Jul-02

Notes and Sources: Grant Halverson, "Australian interchange review: three years on", *Australian Banking & Finance*, 15 February 2007; Bank Media Releases; Cannex, Pricing and Product Features – as at 30 September 2005. *The Reward Programme Fee also began to be charged on every add-on card, where previously there had been no fee. Westpac's Altitude MasterCard annual fees have been raised since the introduction of the Altitude American Express.

APPENDIX D: ADDITIONAL DATA ON BANK-ISSUED AMERICAN EXPRESS AND DINERS CLUB CARDS

The American Express and Diners Club offerings issued by the major banks in Australia since 2003 are summarised in Table 12 below.

Table 12: Recent Bank-issued American Express and Diners Club offerings in Australia, 2003 to present

Issuer	Card	Date Introduced	Companion card?	Details
ANZ	ANZ Rewards Diners Club	Sep-03	YES	Issued to ANZ Telstra Visa cardholders
ANZ	ANZ Frequent Flyer Diners Club	Sep-03	YES	Issued to ANZ Qantas Visa cardholders
Westpac	Altitude American Express	Feb-04	YES	Issued to Westpac Altitude MasterCard customers, now available as part of a package with Altitude MasterCard; also available in corporate version
NAB	NAB Ant American Express	Jul-04	NO	
NAB	Velocity NAB American Express	Nov-05	YES	Offered as part of a package with Velocity NAB Visa card, also available in corporate version (aimed at small businesses)
Westpac	Earth American Express	Jun-06	YES	Offered as part of a package with Earth MasterCard

Source: ANZ Press Release, "ANZ and Diners Club to launch new cards: Announce changes to reward programs", 12 September 2003, available at http://www.anz.com/australia/support/library/MediaRelease/MR20030912.pdf, accessed 27 July 2007; "American Express and Westpac announce card issuing deal", *The Asian Banker Journal*, 29 February 2004; "National launches new American Express card", *The Asian Banker Journal*, 15 July 2004; NAB Media Release, "Flying high with NAB and Virgin Blue", 15 November 2005, available at http://www.nab.com.au/About_Us/0,,76275,00.html, accessed 27 July 2007; "Westpac launches earth: the first 'value rewards' credit card", 5 June 2006, available at http://www.westpac.com.au/internet/publish.nsf/Content/WIMCMR06+Archive+media+release+05+June+2006b, accessed 27 July 2007; Bank websites.

Further details on these offerings are provided below:

- ANZ-Diners Club: In September 2003, ANZ announced that it would offer two new Diners Club charge cards to its existing Qantas Visa and Telstra Visa customers.[148] The cards were introduced at the same time that ANZ announced changes to its reward programmes for the Qantas Visa and Telstra Visa cards. The changes to the reward schemes halved the number of points earned on spending in excess of AU$1,500 per month (AU$2,500 for Gold cards) and capped the number of points that could be earned in a month. Customers affected by these changes were offered the ANZ Frequent Flyer Diners Club charge card (Qantas Visa cardholders) or the ANZ Rewards Diners Club charge card (Telstra Visa cardholders), which continued to offer one point per dollar spent with no cap, with no annual fee for the first year. The introduction of the cards was intended to "minimise the impact [of the RBA's regulations] on customers who spent higher amounts on their card". Customers were encouraged to use their Diners Club card to continue to earn points at a higher rate and were given the option of transferring their Diners Club balance to their Visa card, to be paid off over time. This had the effect of giving the Diners Club charge card most of the characteristics of a credit card.

- Westpac-American Express (Altitude): In February 2004, Westpac and American Express announced the introduction of the Altitude American Express credit card.[149] The Altitude American Express was initially offered as a companion card to qualified Altitude MasterCard cardholders (for an annual fee of AU$45, waived for the first year) and is currently offered in conjunction with the Altitude MasterCard; i.e. with each account, customers receive an American Express and a MasterCard. The Altitude American Express offers twice as many reward points per dollar spent as the Altitude MasterCard, but all other card attributes are identical.

- NAB-American Express (Ant Card): In July 2004, NAB and American Express announced the launch of the National Ant American Express Card with Rewards.[150] The Ant Card is the only standalone American Express that has been issued by one of the four major banks. At the time, NAB marketed the product as having "the best credit card reward program the National has ever offered". The card offers one point per dollar spent on purchases with no cap on points and the ability to redeem points for Qantas frequent flyer miles at a rate of one for one. At present, a version of the card is also available with no annual fee and a scaled-back reward programme.

148 Information on the ANZ Diners Club offerings is from: ANZ Press Release, "ANZ and Diners Club to launch new cards: Announce changes to reward programs", 12 September 2003.

149 Information on the Altitude American Express is from "American Express and Westpac announce card issuing deal", *The Asian Banker Journal*, 29 February 2004; Westpac website.

150 Information on the Ant Card is from "National launches new American Express card", *The Asian Banker Journal*, 15 July 2004; NAB website.

- NAB-American Express (Velocity): In November 2005, NAB launched the Velocity NAB Visa card and the Velocity NAB American Express card, which allow cardholders to earn Virgin Blue frequent flyer miles.[151] The cards, which at the time were the only Australian credit cards to offer points for Virgin Blue, are offered as a package; i.e. each account has a Velocity NAB American Express and a Velocity NAB Visa.[152] The American Express card earns higher rewards per dollar spent, but all other attributes are identical between the two cards. The product is also available as a corporate offering targeted at small businesses.

- Westpac-American Express (Earth): Most recently, in June 2006, Westpac issued a second American Express-branded product for the consumer segment. The Earth account provides cardholders with a MasterCard card and an American Express card, with higher points earned on purchases made with the American Express. Westpac has marketed Earth as a low-rate, low-balance transfer product with a high-value reward programme, allowing customers to get “the best of both worlds”.[153]

151 “Australia: Flying high with NAB and Virgin Blue”, *The Asian Banker Journal*, 15 November 2005.

152 Product details from NAB website, accessed 26 July 2007.

153 Westpac Media Release, “Westpac launches earth: the first ‘value rewards’ credit card”, 5 June 2006, available at http://www.westpac.com.au/internet/publish.nsf/Content/WIMCMR06+Archive+media+release+05+June+2006b, accessed 23 April 2008.

APPENDIX E: MATHEMATICAL MODEL OF THE IMPACT OF CHANGES IN INTERCHANGE FEES

E.1 INTRODUCTION

Even under circumstances in which a regulatory reduction in interchange fees has little effect on card usage, a regulatory reduction in interchange fees can have distributional effects such that final consumers as a group end up worse off. Roughly speaking, final consumers will tend to be worse off from a regulatory reduction in interchange fees if the extent to which issuing banks pass-through the reduction in interchange fee revenues (in the form of higher cardholder fees and reduced card benefits) is greater than the product of (a) the extent to which acquiring banks pass-through the reduction in interchange fee expenses to merchants in the form of reduced merchant service charges and (b) the extent to which merchants pass-through the reduction in merchant service charges to consumers.

This appendix demonstrates these points through a formal mathematical model. More specifically, the appendix analyses the distributional effects of exogenous changes in the level of interchange fees (IF) in a world with fixed levels of card membership and merchant acceptance and no surcharging. By assuming fixed levels of card membership and merchant acceptance, our model assumes away – deliberately and solely for purposes of analysis – the possibility of two-sided market effects in which IF are used to balance demands and to encourage optimal usage of the system. We assume no surcharging to reflect the fact that, in practice, relatively few merchants impose surcharges on payment card transactions even when surcharging is permitted. Using the simple model developed in this appendix, we demonstrate that, even in the absence of two-sided market effects, consumers as a group can be net losers from regulatory reductions in interchange fees over a wide range of plausible parameter values.

E.2 DESCRIPTION OF THE MODEL

To incorporate the fact that merchants typically do not operate in perfectly competitive markets in which they are pure price takers but instead have an element of market power, we assume for modelling simplicity that there is a unit continuum of merchants who are monopolistic sellers of different (unrelated) goods, but are otherwise identical. We also assume in this analysis that all merchants accept cards as a means of payment.

On the consumer side, we also assume there is a unit continuum of consumers, of which a fraction $t \in (0,1)$ uses a credit card for all their purchases, while the rest of consumers use cash only.

As noted above, because we are assuming the absence of two-sided market effects in this analysis, we assume that the fraction of consumers that uses a credit card is fixed and, in particular, does not vary with changes in the level of interchange fees. We also assume that the level of interchange fees does not affect the fraction of merchants that accept cards (and that this fraction is fixed at 1). We normalise merchants' costs to zero and assume that they charge the same price *p* for both card and cash transactions.

Card transactions are subject to *ad valorem* bank fees *f* and *m*, where *f* is the transaction fee paid by the cardholder to its issuing bank (or, if *f* is negative, received from its issuing bank) and *m* is the transaction fee paid by the merchant to its acquiring bank.[154] We assume that banks' costs are also equal to zero and that an *ad valorem* IF *a* is paid by the acquiring bank to the issuing bank for each transaction.

Consumers in this model are interested in buying only one unit of each merchant's good, and do so as long as the corresponding price – which, for the card-using consumers, includes the (possibly negative) card fee *f* – is below the consumers' willingness-to-pay.[155] We assume that the distribution of the consumers' willingness-to-pay is identical for the population of card-using and cash-using consumers and equal to the uniform distribution on the unit interval $[0,1]$.

We do not model explicitly the behaviour of the banks or the card schemes. Instead, we take the IF level as an exogenous parameter and assume that banks' acquiring and issuing fees are linear functions of the IF: $m = m_0 + r_m \cdot a$, and $f = f_0 - r_f \cdot a$, where the base rates (m_0, f_0) and the pass-through rates (r_m, r_f) are fixed numbers.

The timing of the model is as follows: given the IF level *a* and hence the bank fees *f* and *m*, merchants choose their price *p*; and then consumers decide whether to buy the merchants' goods or not.

The demand function faced by each merchant is thus[156]

$$D(p) = t \cdot [1-(1+f) \cdot p] + (1-t) \cdot (1-p)$$

To explain this demand function further, note that because consumers' willingness to pay ranges from 0 to 1, all consumers will purchase if the price they actually face equals 0 and no consumers will purchase if that price equals 1. Because willingness to pay is assumed to be distributed uniformly across consumers, the fraction of customers who purchase will equal 1 minus the price faced by the consumers.

In the case of card users (who account for a fraction *t* of all consumers), the net price they pay equals the price charged by merchants (*p*) times 1 plus the cardholder fee (*f*) – where the cardholder fee could be negative (as when issuers provide card users with rebates). In the case of cash customers (who account for a fraction (*1-t*) of all consumers), the net price they pay is just the price charged by merchants (*p*). The first term in the demand function shows the demand from card users while the second term shows the demand from cash customers.

Each merchant maximises profit

$$\pi(p) = t \cdot p \cdot (1-m) \cdot [1-(1+f) \cdot p] + (1-t) \cdot p \cdot (1-p).$$

154 We do not consider fixed annual card fees; given the assumption of fixed card memberships, such fees would be just lump sum transfers without any impact on the rest of the model.

155 If issuers offer interest-free periods or rewards linked to ticket value, *f* will be less than zero and the full price paid by card-using consumers will be less than the price paid by consumers who pay with cash.

156 Strictly speaking, the formula for the demand function and the ones that follow are only valid if $0 \le p \le 1$ and $0 \le (1+f) \cdot p \le 1$. These conditions are satisfied in all the cases of interest.

To explain this profit function further, the first term shows the net price realised by the merchant on card transactions – *p * (1-m)* – times the quantity demanded by card users; the second term shows the net price realised by the merchant on sales to cash customers – which is just *p* – times the quantity demanded by non-card users.

The profit maximising price is

$$p^* = \frac{1 - t \cdot m}{2 \cdot [1 - t \cdot m + t \cdot f \cdot (1-m)]}$$

The corresponding quantities demanded by card users and cash users are $Q^{card} = t \cdot [1 - (1+f) \cdot p^*]$ and $Q^{cash} = (1-t) \cdot (1-p^*)$, respectively.

Consumer surplus measures the difference between consumers' willingness to pay for the goods purchased and the amount actually paid. In this model, the consumer surplus of card users is $CS^{card} = Q^{card}[1-(1+f) \cdot p^*]/2 = (Q^{card})^2/2$ and, similarly, the consumer surplus of cash users is $CS^{cash} = (Q^{cash})^2/2$.

Merchants' profits are

$$\pi = \frac{(1 - t \cdot m)^2}{4[1 - t \cdot (m + m \cdot f - f)]}$$

The profits of the issuing and acquiring bank are $\pi^I = f \cdot p^* \cdot Q^{card}$ and $\pi^A = m \cdot p^* \cdot Q^{card}$, respectively.

The expressions for the equilibrium values of the various components of welfare (consumer surplus of card users and cash users, merchants' profits, acquirers' and issuers' profits) are quite complex. As a result, it is difficult to derive general comparative statics results, i.e. general propositions regarding how changes in IF or other parameters affect the welfare of the different constituencies (consumers, merchants and banks) and total welfare.[157] However, we can say that, for any reduction in IF, the following forces are at work:

- First, by assumption, a decrease in IF leads to lower merchant fees *m* and higher cardholder fees *f*.
- Second, the decrease in merchant fees *m* reduces merchants' marginal costs of serving card users hence, *ceteris paribus*, tends to reduce merchants' prices *p*.

157 For example, although total bank profits are typically increasing in the IF *a*, there also parameter values for which increases in IF lower bank profits in this model.

- Third, the increase in consumer fees leads to a downward shift of card users' demand curve (for any given price charged by merchants, fewer card users are willing to purchase); in addition, the demand faced by merchants becomes more elastic (a percentage increase or decrease in merchant prices has a larger percentage effect on quantity demanded by card users). The negative effect on the demand from card users reduces the effective weight that merchants place on serving card users, but at the same time it makes those users more price sensitive, with uncertain consequences on profit maximising prices. The following section reports the results of some numerical simulations of the model.

E.3 Results

As explained above, the purpose of the analysis in this appendix is to demonstrate that reductions in IF can reduce consumer welfare even in the absence of two-sided market effects. We show in this analysis that, for wide and plausible ranges of parameter values, a reduction in IF will indeed result in harm to card users that exceeds any gain to cash customers, implying a net reduction in consumer welfare.

Table 13 through Table 16 present some illustrative results from the model. The tables present consumer welfare, merchant profits, bank profits and total welfare for three different values of interchange (0.05, 0.025, 0) and for varying levels of the proportion of consumers using credit cards (0.25, 0.5 and 0.75) and for varying assumptions regarding issuer pass-through rates (0.3 and 0.7) and acquirer pass-through rates (0.75 and 1). In each table, the base rate of the consumer fee (f_0) is equal to -0.01 (recall that a negative value for the consumer fee implies that card users receive a rebate on purchases) and the base rate of the merchant fee (m_0) is equal to 0.03. We have tried to select parameter values that reflect the empirical evidence discussed in the text.

For the parameter values shown, which are designed to cover a range of plausible values, a reduction in IF has the following main effects in this model:

1) merchant prices decrease, thus leading to higher quantity demanded and higher consumer surplus for cash-using consumers;

2) with respect to retail purchases by card users, the decrease in merchant prices is offset by the increase in card fees, leading to an increase in the net price faced by card users, lower quantity demanded and lower consumer surplus for these consumers;

3) the negative impact on the consumer surplus of card users outweighs the positive impact on cash users: a reduction of the IF thus leads to lower total consumer surplus;

4) even though merchant prices decline, the equilibrium value of total sales decreases (because the negative effects on card user demand outweigh the positive effects on demand by cash users);

5) issuers' profits always decrease (as expected), while acquirers' profits may increase or decrease; however, for the parameter values shown, the impact on total bank profits is negative

6) even though the value of retail sales decreases in these scenarios because of the reduction in demand by card users, merchants' profits increase as a result of the reduction in merchant service charges.

Table 13: Simulation results – consumer surplus

Fraction of consumers that use cards (t)	Acquiring bank pass-through rate (r_m)	Issuing bank pass-through rate (r_f)	Interchange fee (a)		
			0.05	0.025	0
0.25	0.75	0.3	0.125096	0.125048	0.125017
	0.75	0.7	0.125195	0.125082	0.125017
	1	0.3	0.125111	0.125053	0.125017
	1	0.7	0.125223	0.125090	0.125017
0.50	0.75	0.3	0.125131	0.125065	0.125022
	0.75	0.7	0.125267	0.125111	0.125022
	1	0.3	0.125152	0.125072	0.125022
	1	0.7	0.125306	0.125123	0.125022
0.75	0.75	0.3	0.125100	0.125049	0.125017
	0.75	0.7	0.125206	0.125085	0.125017
	1	0.3	0.125117	0.125055	0.125017
	1	0.7	0.125236	0.125094	0.125017

Source: CRA International. The base rate of the consumer fee (f_0) is equal to -0.01 and the base rate of the merchant fee (m_0) is equal to 0.03.

Table 14: Simulation results – merchant profits

Fraction of consumers that use cards (t)	Acquiring bank pass-through rate (r_m)	Issuing bank pass-through rate (r_f)	Interchange fee (a)		
			0.05	0.025	0
0.25	0.75	0.3	0.247247	0.247998	0.248733
	0.75	0.7	0.248432	0.248599	0.248733
	1	0.3	0.246446	0.247600	0.248733
	1	0.7	0.247615	0.248197	0.248733
0.50	0.75	0.3	0.244512	0.246005	0.247468
	0.75	0.7	0.246924	0.247221	0.247468
	1	0.3	0.242910	0.245210	0.247468
	1	0.7	0.245289	0.246417	0.247468
0.75	0.75	0.3	0.241797	0.244022	0.246207
	0.75	0.7	0.245481	0.245866	0.246207
	1	0.3	0.239393	0.242829	0.246207
	1	0.7	0.243028	0.244661	0.246207

Source: CRA International. The base rate of the consumer fee (f_0) is equal to -0.01 and the base rate of the merchant fee (m_0) is equal to 0.03.

Table 15: Simulation results – bank profits (issuers and acquirers)

Fraction of consumers that use cards (t)	Acquiring bank pass-through rate (r_m)	Issuing bank pass-through rate (r_f)	Interchange fee (a)		
			0.05	0.025	0
0.25	0.75	0.3	0.002723	0.001988	0.001263
	0.75	0.7	0.001471	0.001365	0.001263
	1	0.3	0.003524	0.002385	0.001263
	1	0.7	0.002288	0.001767	0.001263
0.50	0.75	0.3	0.005448	0.003976	0.002525
	0.75	0.7	0.002943	0.002731	0.002525
	1	0.3	0.007050	0.004771	0.002525
	1	0.7	0.004579	0.003534	0.002525
0.75	0.75	0.3	0.008173	0.005964	0.003788
	0.75	0.7	0.004417	0.004097	0.003788
	1	0.3	0.010576	0.007156	0.003788
	1	0.7	0.006871	0.005302	0.003788

Source: CRA International. The base rate of the consumer fee (f_0) is equal to -0.01 and the base rate of the merchant fee (m_0) is equal to 0.03.

Table 16: Simulation results – total welfare

Fraction of consumers that use cards (t)	Acquiring bank pass-through rate (r_m)	Issuing bank pass-through rate (r_f)	Interchange fee (a)		
			0.05	**0.025**	**0**
0.25	**0.75**	**0.3**	0.375066	0.375033	0.375012
	0.75	**0.7**	0.375098	0.375046	0.375012
	1	**0.3**	0.375081	0.375039	0.375012
	1	**0.7**	0.375125	0.375054	0.375012
0.50	**0.75**	**0.3**	0.375090	0.375045	0.375016
	0.75	**0.7**	0.375135	0.375063	0.375016
	1	**0.3**	0.375112	0.375053	0.375016
	1	**0.7**	0.375173	0.375074	0.375016
0.75	**0.75**	**0.3**	0.375070	0.375035	0.375012
	0.75	**0.7**	0.375104	0.375048	0.375012
	1	**0.3**	0.375086	0.375040	0.375012
	1	**0.7**	0.375135	0.375057	0.375012

Source: CRA International. The base rate of the consumer fee (f_0) is equal to -0.01 and the base rate of the merchant fee (m_0) is equal to 0.03.

EXHIBIT K

Document Redacted

EXHIBIT L

14 December 2009

Expert Report of Gregory John Houston

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'benchmark' was further reduced to 0.50 percent of transaction value from November 2006.[8]

3.2. Regulation of Debit Card Payment Networks

The principal regulatory requirements imposed by the RBA on the Visa and MasterCard debit networks in Australia concerning the setting of interchange and/or point-of-sale merchant rules include the following:[9]

- effective November 1, 2006, the RBA imposed a standard on interchange fees that effectively capped the interchange fees for Visa debit card transactions at a weighted average of 12 cents per transaction; MasterCard provided the RBA an undertaking to abide by the same limitation;[10] and
- effective January 1, 2007, the RBA required Visa to remove any rules that prohibited merchants from charging debit cardholders a fee or surcharge; MasterCard provided the RBA an undertaking to abide by the same limitation.[11]

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8 This benchmark does not apply to the three-party networks. [redacted]

9 See: http://www.rba.gov.au/PaymentsSystem/Reforms/DebitCardSystemsAus/regulatory_decisions.html.

10 The RBA also implemented a standard for EFTPOS interchange, originally capped at 5 cents per transaction with a floor at 80 percent of the cap, paid to the acquirer. In November 2009, the RBA amended this standard to cap the weighted average of any multilateral interchange fees in the EFTPOS system at 12 cents per transaction, paid to the issuer, effective January 2010.

11 This standard and the associated undertaking also required the removal of any requirement that merchants who accept a network's credit cards also accept its debit cards, or *vice versa*.

4. Merchant Surcharging of Card Transactions

Merchants in Australia have had the option of imposing surcharges on customers who choose to use credit cards since January 2003. However, as I discuss below, the vast majority of Australian merchants have chosen not to surcharge, and those that do so are much more likely to surcharge third-party cards than four-party cards.

4.1. Third-Party Analysis of Surcharging

Relatively little data has been published in relation to the incidence and level of surcharging by Australian merchants, and the insights that can be provided from that data are limited. Perhaps the most oft-cited research is that undertaken by East & Partners. East & Partners is a firm that conducts market research in the corporate and investment banking markets of the Asia Pacific region. It undertakes a bi-annual survey of merchants with card-based receivables in which it asks a variety of questions, including whether merchants impose a surcharge on credit card transactions.

In December 2008, East & Partners extended its survey to include a number of other questions in relation to surcharging behavior which culminated in the publication of a one-off report ('Merchant Payments Report') in February 2009. In this report, East & Partners concluded (amongst other things) that:

- on average, 18.4 per cent of Australian merchants with annual turnover in excess of AU$1 million applied a surcharge on credit card payments;[12]
- merchants with higher turnover were more likely to apply a surcharge, and larger merchants appeared to be surcharging 'with a margin';[13]
- the incidence of surcharging and the average surcharge applied tended to be higher amongst 'merchants whose consumers prefer to pay by credit card' – a reflection that 'higher credit card transaction volumes increase the probability of surcharging';[14]
- the majority of merchants applied percentage based surcharges rather than fixed dollar amounts, and there was considerable variation in the level of surcharges; and
- the average surcharge imposed by merchants with annual turnover in excess of AU$1 million was 1.9 per cent of transaction value, with merchants sometimes levying different surcharges on Visa and MasterCard versus American Express and Diners Club.[15]

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12 East & Partners, *Merchant Payments: Market Analysis Report*, February 2009, p. 18.

13 East & Partners, *Merchant Payments: Market Analysis Report*, February 2009, p. 18.

14 Amongst those merchants surveyed by East & Partners that imposed a surcharge, credit card payments accounted for, on average, 45.6 per cent of annual receivables, compared to 22.3 per cent amongst merchants that did not surcharge. See: East & Partners, *Merchant Payments: Market Analysis Report*, February 2009, p. 21.

15 East & Partners concluded that:

> 'Variation in transaction fees on different card types is reflected in the incidence of surcharging and the level of surcharge applied. Visa and MasterCard transactions are normally surcharged at similar rates of 1.8 percent and 1.7 percent of transaction value respectively. On the other hand, the average surcharge on more expensive American Express and Diners Cards are 2.5 and 2.1 percent respectively.'

In interpreting these results it is important to be mindful that the survey was limited to those businesses that accept credit cards and only those merchants with a turnover in excess of AU$1 million. The fact that the survey was limited to merchants with turnover exceeding AU$1 million means that it likely overstated the incidence of surcharging since, by most accounts (including East & Partners' analysis), larger merchants surcharge more often.[16]

It is also important to be mindful that the data in the February 2009 Merchant Payments Report only reveal if a merchant surcharges *at least one type of credit card.*[17] The data do not disclose the relativity of surcharging of Visa, MasterCard, American Express and Diners Club credit cards. This is significant, since East & Partners indicates that surcharging of American Express and Diners Club cards is much more common than surcharging of Visa and MasterCard cards.[18] The RBA also observed during its 2008 review that surcharging appears to be more prevalent for American Express and Diners Club.[19]

In order to gain a better understanding of the types of merchants that surcharge, I sought clarification from East & Partners of the data underlying the tabulations contained in its 2009 Merchant Payments Report. East & Partners provided information to me in early December 2009 in a report entitled *Australian and UK Credit Card Surcharging Perspectives.* Using the information contained in this report, I am able to make the following observations about acceptance rates, the incidence of surcharging and the average surcharge applied by those merchants that accept Visa, MasterCard, American Express and/or Diners Club cards relative to those merchants that accept Visa and MasterCard cards only:

- surcharging is much more prevalent amongst those merchants that accept American Express and/or Diners Club cards:
  - despite the fact that only 26 percent of merchants accept at least one of American Express or Diners Club, 93 percent of those merchants apply a surcharge to at least one card;[20] and

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See: East & Partners, *Merchant Payments: Market Analysis Report*, February 2009, p. 22.

I note that this statement is incorrect given that the average surcharges identified by East & Partners are *averages* across *all cards* accepted by merchants, rather than the surcharge applied for each individual card type. The rates of surcharging reported for Visa and MasterCard transactions are therefore inflated by the surcharges applied by those merchants that also accept and surcharge American Express and Diners Club cards.

16 This is also consistent with the results of the field work that I have undertaken with my colleagues, described below, and the expectation of the RBA, described above.

17 See: East & Partners, *Merchant Payments Analysis Research Questionnaire*, p. 4 (asking merchants if they are "Currently applying a surcharge" but not asking which brand or brands are surcharged).

18 See: East & Partners, *Merchant Payments: Market Analysis Report*, February 2009, p. 22.

19 RBA, *Reform of Australia's Payment System, Preliminary Conclusions of the 2007/2008 Review*, April 2008, p. 20. The RBA did not provide a reference for this conclusion, although it is consistent with the findings of the field work described in the following section.

20 See East & Partners, *Australian and UK Credit Card Surcharging Perspectives*, November 2009, Tables 7 and 10. Table 7 indicates that 26.1 percent of all merchants (approximately 595) accept either American Express or Diners Club cards. Table 10 indicates that 65.5 percent of those merchants that accept American Express or Diners Club cards (approximately 390) apply a surcharge to at least one card. Given that 18.4 percent of all merchants apply a surcharge (approximately 419), this means that 93 percent of merchants that apply a surcharge accept one of American Express or Diners Club.

  - of the 2,279 merchants in the survey, 1,684 accept only Visa and MasterCard (ie, they do not accept either American Express or Diners Club), and just 1.8 percent of those 1,684 merchants apply a surcharge;[21]

- surcharging is more prevalent among institutional and corporate merchants than small to medium enterprises (SME) and micro merchants, with a much higher proportion of institutional and corporate merchants that accept either American Express or Diners Club cards applying a surcharge than SME and micro merchants:
  - approximately 26.5 percent of institutional[22] and corporate[23] merchants apply a surcharge, whereas only 16.2 percent of SME and 13.8 percent of micro merchants apply a surcharge;[24] and
  - of those institutional and corporate merchants that accept American Express or Diners Club cards, approximately 65.6 percent[25] apply a surcharge while only 4.5 percent[26] that do not accept either American Express or Diners Club cards (ie, accept Visa or MasterCard only) apply a surcharge;[27] and
- the average surcharge applied by those merchants that accept at least one of American Express or Diners Club is 2.3 percent, and the average surcharge applied by those merchants that accept Visa and MasterCard cards only is 1.4 percent.[28]

I noted above that one of the main limitations of the survey undertaken by East & Partners is that it does not distinguish either the incidence of surcharging on, or the average surcharge applied to, Visa and MasterCard transactions *vis-à-vis* American Express and Diners Club transactions. Rather, the survey results simply indicate the proportion of merchants that apply a surcharge to *at least one type of credit card transaction* and the average rate applied across all cards accepted. However, the more detailed results provided by East & Partners points to a significantly *lower* incidence of surcharging of Visa and MasterCard cards than the average incidence of surcharging of 18.4 percent reported in the Merchant Payments Report.[29] In particular, the more detailed data indicates that surcharges were imposed by just 1.8 percent of the 1,684 merchants that accepted only Visa and MasterCard cards (and not American Express or Diners Club). The relatively low incidence of surcharging of Visa and

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21 See East & Partners, *Australian and UK Credit Card Surcharging Perspectives*, November 2009, Table 10.

22 The equivalent estimate for institutional merchants is 29 percent.

23 The equivalent estimate for corporate merchants is 23.5 percent.

24 See East & Partners, *Australian and UK Credit Card Surcharging Perspectives*, November 2009, Tables 6 and 10.

25 The equivalent estimate for institutional merchants is 64.7 percent while the estimate for corporate merchants is 67 percent.

26 The equivalent estimate for institutional merchants is 5.3 percent while the estimate for corporate merchants is 3.7 percent.

27 See East & Partners, *Australian and UK Credit Card Surcharging Perspectives*, November 2009, Tables 6 and 10.

28 See East & Partners, *Australian and UK Credit Card Surcharging Perspectives*, November 2009, Table 12. Note that only 30 or so merchants accept Visa and MasterCard cards only and apply a surcharge. Note also that the average surcharge applied by merchants is that applied across all cards accepted.

29 The RBA also observed during its 2008 review that surcharging appears to be more prevalent for American Express and Diners Club. RBA, *Reform of Australia's Payment System, Preliminary Conclusions of the 2007/2008 Review*, April 2008, p. 20.

MasterCard credit cards by these merchants is also supported by the results of the field work that I have undertaken in conjunction with my colleagues, which are set out in section 4.2 below.[30]

I note that some of the conclusions set out by East & Partners in its Merchant Payments Report and further more detailed report for NERA are broadly consistent with observations that other parties have made in the past. For example, the Issues Paper and Preliminary Conclusions paper prepared by the RBA as part of its review of credit and debit card networks in 2007/08 (2008 Review), the RBA noted that merchants often applied differential surcharges to four-party and three-party credit cards. It estimated that the average surcharge imposed by merchants for Visa and MasterCard transactions was around 1 percent and for American Express and Diners Club cards was around 2 percent. The average surcharge rates estimated by East & Partners are somewhat higher than these levels at 1.4 percent for merchants that accept Visa and MasterCard cards only and 2.3 percent for merchants that accept Visa, MasterCard and at least one of American Express or Diners Club cards, respectively.

A number of the submissions to the RBA's 2008 Review also concurred with East & Partners' view that some merchants were engaging in excessive surcharging, ie, imposing surcharges that recovered revenue that exceeded the cost of accepting credit card transactions. Visa and American Express made submissions to this effect, and the Allen Consulting Group has also suggested that merchants often surcharge where consumers have little choice of payment instrument. The Consumer Action Law Centre has also argued that the way in which surcharging has been applied in some markets raises competition concerns, including the low-cost airfare market and the taxi industry. Concerns were also raised in submissions made to the House of Representatives Standing Committee on Economics, Finance and Public Administration in its review of the RBA's regulations conducted in 2006. In its report, the Committee noted that:

> '...surcharging has not yet become commonplace, particularly in highly competitive industries. Unsurprisingly, the committee heard that surcharging has only become common in industries where organizations have market dominance. While the committee is supportive of the rights of merchants to surcharge, the committee doubts whether surcharging will ever become widespread. Many merchants actually prefer being paid by card and therefore would not want to discourage its use by surcharging.
>
> The committee was concerned by evidence which suggested that some merchants are profiteering from the ability to surcharge.... Surcharging – and in particular

[30] These results are also directionally consistent with an earlier report by East & Partners in 2007 for the Friedman Law Group (FRANKEL11627-11688). This reported that "the prevalence of surcharging is considerably higher among those merchants who accept AMEX and Diners cards than among merchants who accept Visa and MasterCard." (p. 38) According to this survey, just 2.4 percent of merchants that accepted Visa imposed a surcharge and 1.7 percent of merchants that accepted MasterCard imposed a surcharge, while 16.9 percent of those merchants that accepted American Express imposed a surcharge (with 10.4 percent only surcharging American Express cards) and 10.7 percent of merchants that accepted Diners Club imposed a surcharge (with 5.6 percent surcharging only Diners Club cards). See: Table 35. A survey by Cannex in 2004 indicated that 4 percent of merchants imposed a surcharge "all the time," 7 percent imposed a surcharge "all or most of the time" and 19 percent stated that they applied a surcharge "some of the time." Cannex – *Card Reforms in Australia monitoring of market effects*, October 2004, p.28. However, the Cannex survey did not report data by card brand, so it does not shed light on the prevalence of surcharging of Visa and MasterCard, as opposed to American Express.

> excessive surcharging – occurs in markets not subject to high levels of competition.'[31]

The surcharging practices of Australian domestic airlines are potentially illustrative. Qantas Airways (Qantas), one of the largest domestic carriers, imposes a surcharge of AU$7.70 per passenger for domestic flights (and AU$25 for international flights) on all credit card purchases made through its website.[32] Although the existence of the surcharge is disclosed in small font at the bottom of the second and third screens that a customer must navigate to purchase a ticket,[33] the surcharge is not included in the advertised price,[34] and it is not until the fifth screen when payment details are entered that the surcharge is added to the ticket price and displayed prominently. Further information about the surcharging practices of Australia's domestic airlines is contained in Appendix B.

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31 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Review of the Reserve Bank of Australia and Payments System Board Annual Reports 2005 (First Report)*, June 2006, p. 63.

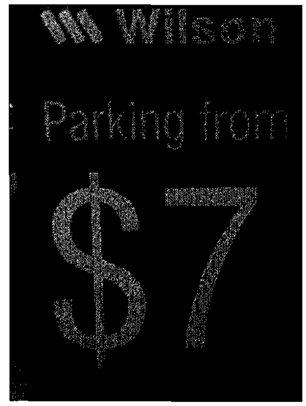
32 http://www.qantas.com.au.

33 To purchase a ticket, a customer must navigate through five screens, selecting flights and providing various data along the way.

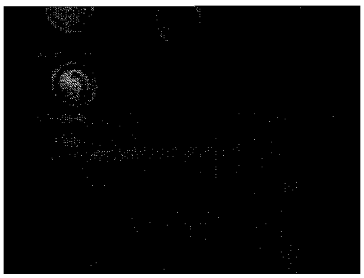
34 Moreover, credit card surcharges are not included in Qantas' advertised fares, which will in many cases be responsible for drawing customers to the website in the first place. In May 2009, changes to Australia's principal competition law, the *Trade Practices Act 1974* (TPA), made it illegal to omit unavoidable surcharges from advertised prices. Specifically, the *Trade Practices Amendment (Clarity in Pricing) Bill 2008* ('Clarity in Pricing Amendment') inserted an amended section 53C into the TPA and, in doing so, introduced significant changes to the practice of 'component pricing'. Following that amendment, where a business makes a representation about a part of the price that a consumer will pay for a product or service, it must also specify, as a prominent single price, the total figure that the consumer will pay, to the extent that it can be calculated. Under the amended legislation, businesses may still make representations that the price is '*$x plus taxes and charges*', but such representations must be accompanied by the final total selling price and must also satisfy other specified criteria. For example, if a business imposes a calculable surcharge to card-based payment mechanisms, and offers no other ways for its customers to pay, that surcharge must be disclosed in its advertised prices or on its in-store price lists.

Ostensibly, the legislation would have required Qantas to disclose its surcharges in its advertised prices, at the time customers purchasing a ticket online within a week of their departure date had no other option but to pay a surcharge (customers purchasing ticket more than a week before their departure date have the option of using BPAY, which does not attract a surcharge). However, it chose instead to waive the surcharge for transactions made using MasterCard debit cards, thereby allowing it to refrain from disclosing the AU$7.70 impost from its advertisements. Transactions made using MasterCard debit cards are likely to comprise the minority of Qantas' online card receivables. In 2007, the RBA estimated that Visa and MasterCard debit card transactions comprised only 6 percent of the total value of payments made by Australian households. Although separate data are not available for MasterCard debit card transactions, the fact that it is a relatively new entrant suggests that it would comprise the minority of that share. See: Emery et al (2007), p. 144.

These surcharging practices resulted in the Australian Consumers Association giving Qantas its top 'Shonky award' for 2009, presented to companies making 'dodgy or dubious claims about their products'. See: Burke, Kelly, 'Choice Gives Qantas a Rap over the Knuckles for Shonky Credit Card Fee' *Sydney Morning Herald*, October 29, 2009, available at http://www.smh.com.au/travel/travel-news/choice-gives-qantas-a-rap-over-the-knuckles-for-shonky-credit-card-fee-20091028-hkzy.html.



The surcharging practices of some centrally located city car-parks also merit discussion. A number of car parks based in Sydney's central business district surcharge credit cards, but do not disclose those additional charges until the customer pays for the service prior to exiting the car park. For example, the car park operated by Wilson Parking in the basement of NERA's Sydney office advertises 'parking from $7' on a sign placed on the street (see photograph opposite).[35] A complete list of hourly rates is then advertised at the bottom of the entrance ramp, at which point customers acquire a ticket from an electronic dispenser (which raises the barrier arm and enables entry into the car-park). However, the existence of the surcharge is *not disclosed* on the list of prices at the bottom of the entry ramp.



It is not until the customer subsequently comes to pay that the existence of a 2 percent surcharge on all credit card transactions is disclosed on the electronic payment machine (see photograph opposite). Although there is the option of using an alternative payment method (eg, cash), if the customer wants to pay using a credit card it has no choice but to pay the extra charge. Moreover, the customer does not at that point in time have the option of purchasing the service, or going elsewhere, since it has *already consumed* the service, ie, the car has already been parked and charges incurred. The only available recourse is to park elsewhere on the next occasion.

The surcharges imposed by Sydney taxis are also illustrative. Approximately 95 percent of Australian taxis impose a 10 percent surcharge (described as a 'service fee') for every payment made using a credit card, charge card or debit card. Clearly this conduct is not intended to steer customers from paying with credit cards to paying with debit cards, since debit card sales attract the same surcharge. Rather, the surcharge is more likely to reflect the significant market power possessed by the industry's payment network Cabcharge in the provision of non-cash taxi fare payment processing services. Indeed, the Australian Competition and Consumer Commission (ACCC) recently brought proceedings against Cabcharge alleging that it had misused its market power in breach of section 46 of the *Trade Practices Act 1974*.[36]

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35 The car-park is located at 201 Sussex Street in the central business district of Sydney.

36 Section 46 prohibits corporations with a substantial degree of market power from using that power to engage in conduct for certain anti-competitive purposes. The ACCC has alleged that Cabcharge used its market power in the provision of non-cash taxi fare payment processing services and taxi specific payment products to refuse to enter into agreements with competing suppliers of processing services that would have allowed Cabcharge's payment products to be processed through alternative EFTPOS terminals. The ACCC has also alleged that Cabcharge used its market power to supply a significant number of taxi meters and fare schedule updates either free of charge or below cost for anti-competitive purposes in relation to taxi meters and processing services.

See: http://www.accc.gov.au/content/index.phtml/itemId/879006/fromItemId/622289.

To gain further insight into the frequency and nature of surcharging by Australian merchants, I have, in collaboration with my Sydney- and Melbourne-based colleagues, undertaken some field work. I set out the results of that field work in the following section.

4.2. Field Work

The purpose of the field work was not to undertake a comprehensive evaluation of *all* Australian merchants. Rather, the objective was to undertake more targeted field work to examine the surcharging practices of Australian merchants in major consumer retail sectors, including merchants in similar lines of business as the bulk of the named plaintiffs in MDL 1720.[37]

4.2.1. Background to field work

The first step of the field work involved developing a sample of supermarkets; pharmacies; department stores; gas stations; clothing and shoe stores; home furnishings and décor stores; consumer electronics stores; car parking; and car rental agencies that was representative of the population in each of these categories. Given the results of other surcharging studies[38] which suggested that surcharging was more prevalent amongst larger merchants, I also ensured that the sample included the largest merchants within each category. This selection process resulted in the identification of 96 stores located in both Sydney and Melbourne.[39] A more detailed description of the methodology used to select these stores is contained in Appendix A.

To collect the relevant information, Sydney- and Melbourne-based colleagues visited each of the 96 selected stores. Each sought to make two purchases – one with an American Express charge card, and another using either a MasterCard or Visa credit card. If a store did not accept American Express, only a MasterCard or a Visa card transaction was completed. Appendix A.4 of this report contains a summary table that provides further information on:

- the name of the business;
- whether the business accepted credit cards and, if so, which cards;

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37 I understand that the named plaintiffs who are seeking to bring a class action and the individual plaintiffs include the following merchants and associations: Affiliated Foods Midwest (supermarkets), Ahold USA Inc. (supermarkets); Albertson's Inc. (supermarkets); Bi-Lo LLC (supermarkets); Capital Audio Electronics Inc. (consumer electronics); CHS Inc. (convenience stores/gas stations/farm stores); Coborn's Inc. (supermarkets); Crystal Rock, LLC (spring water/coffee); D'Agostino Supermarkets Inc. (supermarkets); Delhaize America, Inc. (supermarkets); Discount Optics Inc. (optical wholesaler); Eckerd Corp. (pharmacies); Hy-Vee, Inc. (supermarkets); Jetro Cash & Carry Enterprises LLC (wholesale foods); Kroger (supermarkets); Leon's Transmission Service Inc. (auto repair); Meijer, Inc./Meijer Stores Limited Partnership (supermarkets); Parkway Corporation (car parks); Pathmark Stores Inc. (supermarkets); Payless ShoeSource Inc. (footwear); Photos Etc. Corp. (photography); Publix Supermarkets Inc. (supermarkets), QVC, Inc. (home shopping); Rite Aid Corp. (pharmacies); Raley's (supermarkets); Safeway, Inc. (supermarkets); Supervalu Inc. (supermarkets); Traditions Ltd. (furniture); Wakefern Ford Corp. (supermarkets); Walgreens (pharmacies); National Association of Convenience Stores; National Community Pharmacy Association; National Cooperative Grocers Association; National Grocers Association; National Association of Truck Stop Owners, and National Restaurant Association.

38 See for example, East & Partners, *Merchant Payments: Market Analysis Report*, February 2009, p. 18.

39 The surcharging data were collected by making actual purchases at merchants, with the exception of airline data which were obtained by viewing the airlines' websites.

- whether the business imposed a surcharge on credit cards;
- which credit cards were surcharged, eg, Visa, MasterCard or American Express;
- the level of surcharges for each card.

In addition to the retail sectors described above, I also examined the websites of five of Australia's domestic airline carriers[40] (see Appendix B) to determine the prevalence of surcharging in this industry. Combining these results with the field work undertaken by my colleagues takes the sample size to 101 merchants.

The remainder of this section sets out the results of the field work.

4.2.2. Field work results

Table 4.1 summarizes the results of the field work and the review of airline websites and sets out both the acceptance rate and the prevalence of surcharging in each of the aforementioned retail sectors.

Table 4.1: Merchant Surcharging Field Work Results

		Visa/MasterCard				AMEX			
		Acceptance Rate		Surcharges		Acceptance Rate		Surcharges	
Store Type	No. of Stores	No. of Stores	Percent	No. of Stores	Percent	No. of Stores	Percent	No. of Stores	Percent
(1)	(2)	(3)	(4) (3)/(2)	(5)	(6) (6)/(3)	(7)	(8) (7)/(2)	(9)	(10) (10)/(7)
Retail									
Supermarkets	14	14	100%	1	7.1%	11	79%	0	0.0%
Pharmacies	17	17	100%	0	0.0%	14	82%	0	0.0%
Consumer Electronics	9	9	100%	0	0.0%	8	89%	1	12.5%
Shoes & Clothing	28	28	100%	0	0.0%	24	86%	4	16.7%
Home Furnishing & Décor	4	4	100%	0	0.0%	2	50%	0	0.0%
Department Stores	8	8	100%	0	0.0%	7	88%	0	0.0%
Other									
Airlines	5	5	100%	5	100.0%	5	100%	5	100.0%
Rental Car	5	5	100%	1	20.0%	5	100%	1	20.0%
Parking	5	5	100%	4	80.0%	5	100%	3	60.0%
Gas Stations	6	6	100%	0	0.0%	6	100%	1	16.7%
Total	**101**	**101**	**100%**	**11**	**10.9%**	**87**	**86%**	**15**	**17.2%**
Retail	*80*	*80*	*100%*	*1*	*1.3%*	*66*	*83%*	*5*	*7.6%*
Other	*21*	*21*	*100%*	*10*	*47. 2%*	*21*	*100%*	*10*	*47.6%*

The information contained in this table indicates that Visa and MasterCard are more widely accepted than American Express, with all businesses accepting Visa and MasterCard relative to an 86 percent acceptance rate for American Express cards. The results in this table also demonstrate that the incidence of surcharging of American Express cards is *higher* than that for Visa and MasterCard credit cards, with 17.2 percent of merchants that accepted American

[40] The five domestic carriers include Jetstar, Qantas, Rex Regional Express, Tiger Airways and Virgin Blue.

Express imposing a surcharge on these cards compared to 10.9 percent for Visa and MasterCard credit cards.

The somewhat lower rate of acceptance of American Express cards and the higher incidence of surcharging is consistent with the third-party analysis of surcharging described in section 4.1, including the assessment of the RBA in its 2008 review.[41] This serves to reinforce the conclusion that the average rates of surcharging estimated by East & Partners in its February 2009 report have been inflated by the prevalence of surcharging of American Express, and do not provide a meaningful indication of the prevalence of surcharging of MasterCard and Visa.

It is worth noting in this context that the average rates of surcharging of all types of card are influenced heavily by the high prevalence of surcharging in certain sectors. The most notable example is the domestic airline industry, in which every carrier surcharges purchases made online with any credit card. If the five domestic airlines are removed from the sample, the incidence of surcharging falls dramatically. Of the remaining 96 businesses, only 6.3 percent surcharge MasterCard and Visa card transactions, and 12.2 percent surcharge purchases made with an American Express card.

Focusing on the retail sector, it is clear that the incidence of surcharging MasterCard and Visa card transactions by retail outlets (1.3 percent) is materially lower than that which is observed to occur in other sectors (47.2 percent).

The following sections provide further detail on the sector-based results of the field work.

4.2.2.1. Airlines

I noted in the preceding section that the five prominent domestic carriers in Australia all levy surcharges on passengers purchasing flights on their respective websites using a Visa, MasterCard, American Express or Diners Club card. Of the five domestic carriers, Regional Express is the only carrier that imposes a differential surcharge on transactions made using credit cards and levies those surcharges on a percentage of the transaction value. The surcharges levied by Regional Express range from 1.76 percent for Visa and MasterCard transactions to 3.96 percent for American Express transactions. The remaining four carriers, Qantas Airways (Qantas), Jetstar, Virgin Blue and Tiger Airways (Tiger), all levy a flat surcharge on domestic flights purchased using Visa, MasterCard, American Express and Diners Club credit cards, irrespective of whether the passenger purchases a one way or a return flight. The surcharge levied by these four carriers ranges from AU$3 (Virgin) to AU$7.70 (Qantas).[42]

The flat nature of the surcharge levied by Qantas, Jetstar, Virgin Blue and Tiger means that the percentage of the transaction value accounted for by the surcharge will vary depending on the cost of the flight. For example, if the flight were to cost AU$1,000, an AU$7.70 surcharge would be equivalent to 0.8 percent of the transaction value while if the flight were to cost AU$50 the AU$7.70 surcharge would be equivalent to 15.4 percent of the transaction

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41 RBA, *Reform of Australia's Payment System, Preliminary Conclusions of the 2007/2008 Review*, April 2008, p. 20. The RBA did not provide a reference for this conclusion, although it is consistent with the findings of the field work.

42 The surcharges levied by both Tiger and Jetstar is AU$6.

value. Drawing on information contained in the Qantas Group Annual Report of 2009, Qantas' and Jetstar's average revenue (net of the AU$7.70 surcharge) per passenger per domestic flight was AU$169.80 over 2008/09.[43] When expressed as a percentage of the average cost of a one-way flight, the AU$7.70 surcharge payable for Qantas flights is equivalent to 4.5 percent[44] of the value of a one-way flight and 2.3 percent[45] of a round-trip flight.

4.2.2.2. Rental cars and car parks

To determine the prevalence of surcharging by rental car chains my colleagues rented cars from five of the top car rental chains in Australia (Avis, Budget Rent a Car, Hertz, Thrifty Car Rental and Europcar). Of the five rental car chains visited, only one (Hertz) imposed a surcharge. The 0.8 percent surcharge levied by Hertz was applied to both American Express and Visa and MasterCard transactions.

The prevalence of surcharging by car parks was also tested by my colleagues using the car parking services offered by the two prominent car parking chains in Sydney: Wilson Parking and Secure Parking. In this context, three alternative Wilson Parking car parks were visited while two alternative Secure Parking car parks were visited. Across the three Wilson Parking car parks visited, the same surcharge of 2 percent was levied on American Express, Visa and Master Card transactions. For the Secure Parking chain, the results were mixed with one operator levying a surcharge of 3 percent on Visa and MasterCard transactions and no surcharge on American Express transactions while the other operator did not levy any surcharge.

4.2.2.3. Supermarkets

In the supermarket sector, purchases were made at each of the ten chains identified in the comprehensive *Inside Retailing Directory* with multiple purchases being made at two of Australia's largest chains, Woolworths (Safeway)[46] and Coles. Of the ten supermarket chains, only Aldi surcharged Visa and MasterCard (it did not accept American Express). However, in 2007 Aldi was estimated as having only a 6 percent share of nationwide grocery sales.[47] In other words, the overwhelming majority of consumers shop at supermarkets that do not

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[43] Qantas Group Annual Report, 2009. The $169.80 was calculated as follows:

- On page 84 of the annual report, Qantas states that net passenger revenue for travel generated by the Qantas Group (Jetstar and Qantas) over 2008/09 was AU$11,604 million.
- On page 20 of the annual report, Qantas states that 45 percent of its revenue is domestic. Applying this to the $11,604 million revenue results in an estimate of domestic revenue of AU$5,222 million
- On page 154 of the annual report, Qantas states that 29,419,174 domestic passengers were carried by the Qantas Group over 2008/09. This translates to an average per passenger per flight estimate of AU$177.50.
- If the AU$7.70 surcharge is then deducted the equivalent average price net of the surcharge is AU$169.80.

[44] This has been calculated by dividing AU$7.70 by AU$169.80.

[45] This has been calculated by dividing AU$7.70 by AU$339.60 (AU$169.80 + AU$169.80).

[46] In 1985, Woolworths Ltd, an Australian listed company, acquired the Australian outlets of Safeway Inc. In 2008 Woolworths announced that it would be rebranding the Safeway chain in Victoria and replacing this brand with the Woolworths brand (see Woolworths Media Release, *Farewell to Safeway. Welcome to Woolworths*, August 22, 2008). I understand that this rebranding is being undertaken progressively and at the time of preparing this report there were still a large number of Safeway stores in Victoria.

[47] ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries*, July 2008, p. 48.

surcharge MasterCard or Visa card transactions. For example, purchases were made at three Coles supermarkets and three Woolworths supermarkets – none of which surcharged MasterCard or Visa. Between them, Coles and Woolworths accounted for 55-60 percent of retailers' shares of grocery sales in 2007.[48]

4.2.2.4. Other retail outlets

To determine the prevalence of surcharging by pharmacies, consumer electronics stores, clothing and shoe stores, home furnishings and décor stores, department stores, or gas stations, my colleagues purchased items at:

- 17 pharmacies – the pharmacies visited by my colleagues included seven of the largest franchise operations in Australia (Amcal, Soul Pattinson, Priceline, Guardian, Chemmart, Terry White Chemists and Chemist Warehouse) and three smaller chains (My Chemist, Pulse and Chemist Works). For the largest franchise operations two alternative stores were visited;
- nine consumer electronics stores that were identified as being the largest merchants in that retail segment, ie, Betta, Bing Lee, Crazy Johns, Dick Smith Electronics, Harvey Norman, JB Hi Fi, Retravision, Strathfields and the Good Guys;
- 28 selected clothing and shoes stores;
- four home furnishings and décor stores that were identified as being the largest merchants in that retail segment,49 ie, Domayne, Fantastic Furniture, Freedom Furniture and IKEA;
- eight of the largest department stores in Australia, ie, Best & Less, Big W, David Jones, Dimmeys Stores, Harris Scarfe, Kmart, Myer and Target; and
- six gas station chains, which between them accounted for over 90 percent of the market in 2007,[50] ie, Coles Express/Shell, Woolworths/Caltex, BP, Mobil, Caltex and United Petroleum.

Of the 72 outlets visited, none of the merchants levied a surcharge on either MasterCard or Visa credit cards. The findings were somewhat different for American Express transactions, where the incidence of surcharging was 10 percent. The surcharges in this case were levied by:

- the consumer electronics store JB Hi-Fi, which imposed a 1.9 percent surcharge on purchases made with American Express cards;
- four of the twenty eight clothing and shoes stores, which imposed a surcharge of 2-3 percent on American Express transactions; and
- one gas station, which imposed a surcharge of $1-$2 on American Express transactions.

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48 ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries,* July 2008, p. 48.

49 As explained in Appendix A, neither Harvey Norman nor Super A-Mart was included in the sample. Harvey Norman was omitted because it had already been surveyed in the consumer electronics category. Super A-Mart was not surveyed because its stores are located in regional areas that were not practicable to visit.

50 ACCC, *Petrol prices and Australian consumers: Report of the ACCC inquiry into the price of unleaded petrol,* December 2007, p. 76.

4.2.3. Summary and Conclusions

Although Australian merchants have been able to impose surcharges on Visa, MasterCard, Diners Club and American Express transactions since January 1, 2003, both the East & Partners survey data of December 2008, nearly six years later, and my own field work in late 2009 indicate that the substantial majority of Australian retail merchants still have elected not to surcharge either Visa or MasterCard transactions. The field work undertaken by my colleagues indicates that only 10.9 percent of merchants surcharge Visa and MasterCard, and that figure drops substantially (to 1.3 percent) if only retail outlets are considered. Surcharging for American Express transactions was more common, with 17.2 percent of the businesses that accepted American Express (86 percent of all businesses studied) imposing a surcharge (or 7.6 percent for retail outlets).

Relatively little third-party analysis has been published in relation to the incidence and level of surcharging by Australian merchants, and the insights that can be provided from the existing data are limited. For example, although the February 2009 report prepared by East & Partners contains some useful information, few conclusions can reasonably be inferred from it because of the survey methodology that was employed, and the way that the results have been reported. However, there appears to be reasonably widespread concurrence with the conclusion of the field work that the majority of merchants in Australia do not surcharge Visa and MasterCard transactions, and that Visa and MasterCard cards are surcharged less often than American Express and Diners Club cards.[51]

The field work results are also consistent with the growing body of opinion that some merchants are imposing surcharges so as to extract additional revenue. For example, it is highly *unlikely* that airlines are imposing such surcharges on online purchases in order to steer customers towards other forms of payment.

The Australian experience is also directionally consistent with the experience in other countries where the 'no surcharge' rule has been removed. For example, in the United Kingdom merchants have been permitted to surcharge since 1991.[52] Notwithstanding that surcharging has been an available option for nearly two decades in the United Kingdom, the prevalence of surcharging of Visa and MasterCard transactions still remains very low. According to the results of a survey undertaken by East & Partners in August 2009 involving 505 merchants with an annual turnover in excess of £2 million, 89.9 percent[53] of the merchants accepted only Visa or MasterCard (ie, they did not accept either American Express or Diners Club cards), and just 1.1 percent of those merchants applied a surcharge.[54,55]

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51 I understand that certain of plaintiffs' experts have pointed to the prevalence of surcharging in Australia in asserting that US merchants have been harmed due to prohibitions on surcharging. However, as set forth above, the figures on the overall prevalence of surcharging overstate the extent of surcharging of Visa and MasterCard. With respect to the claims of the individual plaintiffs in the supermarket and pharmacy lines of business, it is also noteworthy that my field work found no surcharging at the leading Australian chains in those lines of business.

52 Credit Cards (Price Discrimination) Order 1990, SI 1990 2159.

53 East & Partners, *Australian and UK Credit Card Surcharging Perspectives,* November 2009, Table 16.

54 East & Partners, *Australian and UK Credit Card Surcharging Perspectives,* November 2009, Table 20.

55 The aggregate measure of surcharging across American Express, Diners Club, Visa and MasterCard credit cards is 4.8 percent. See: East & Partners, *Australian and UK Credit Card Surcharging Perspectives,* November 2009, Table 20.

A survey conducted after surcharging was permitted in Sweden has also found that only a small minority of merchants, 5 percent, chose to impose surcharges.[56] A similar theme arises in the Netherlands, where surcharging has been allowed since 1997.[57]

Gregory John Houston
Sydney, NSW
December 14, 2009

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[56] IMA Market Development AB, *Study Regarding the Effects of the Abolition of the Non-Discrimination Rule in Sweden*, February 2000, pp. 18-19.

[57] ITM Research, *The Abolition of the No-discrimination Rule*, March 2000, pp. 7-8.

Appendix C. Materials Relied Upon

The table sets out the materials that I have relied upon in the preparation of this report.

	Document Details
1	ACCC, *Petrol prices and Australian consumers: Report of the ACCC inquiry into the price of unleaded petrol*, December 2007
2	ACCC, *Report of the ACCC inquiry into the competitiveness of retail prices for standard groceries,* July 2008
3	Burke, Kelly, 'Choice Gives Qantas a Rap over the Knuckles for Shonky Credit Card Fee' *Sydney Morning Herald*, October 29, 2009, http://www.smh.com.au/travel/travel-news/choice-gives-qantas-a-rap-over-the-knuckles-for-shonky-credit-card-fee-20091028-hkzy.html
4	Cannex, *Card Reforms in Australia monitoring of market effects*, October 2004
5	Credit Cards (Price Discrimination) Order 1990, SI 1990 2159
6	Deposition of Stephen McCurdy (Amex 30(b)(6)), March 24, 2009
7	East & Partners in 2007 for the Friedman Law Group (FRANKEL11627-11688)
8	East & Partners, *Australian and UK Credit Card Surcharging Perspectives*, Custom Market Analysis Report prepared for NERA Australia, November 2009
9	East & Partners, *Merchant Payments Analysis Research Questionnaire*
10	East & Partners, *Merchant Payments: Market Analysis Report*, February 2009
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EXHIBIT M

Document Redacted

EXHIBIT N

Parties

The Commerce Commission ("the Commission")

Visa International Service Association and Visa Worldwide Pte Limited ("Visa")

("the Parties")

Background

A The Commission has brought proceeding CIV-2006-485-2535 in the High Court against Visa and other defendants ("the proceeding"). In the proceeding the Commission seeks relief against Visa in respect of certain conduct alleged to have been engaged in by Visa.

B The Commission has agreed to settle the claims made against Visa in the proceeding in so far as they relate to alleged conduct by Visa prior to the date of this Agreement ("the Visa claims"), on the terms set out in this Agreement.

Agreement

1 Definitions

1.1 In this Agreement:

1.1.1 "New Zealand-acquired transaction" means a Visa branded payment card transaction for payment at the point-of-sale (including card present and card not present sales) that a merchant submits for processing and payment to a New Zealand bank or to any other entity carrying on business in New Zealand as an acquirer;

1.1.2 "Visa maximum rate" means an interchange rate or schedule of interchange rates set by Visa in accordance with clause 3.1.3 above;

1.1.3 "Visa rules" means the Visa Worldwide Supplemental Operating Regulations, Visa International By-Laws and the Visa International Operating Regulations, and any other document issued or approved by Visa, or to which Visa is a party, that sets out rules or requirements in respect of the operation of the Visa scheme that are applicable in New Zealand.

2 Settlement of claims

2.1 This Agreement is entered into by the Parties in full and final settlement of the Visa claims.

2.2 The Parties will take such steps as may be necessary or desirable to give full effect to this Agreement.

3 Visa commitments in relation to interchange

3.1 Visa will modify the Visa rules as they apply in New Zealand to provide for the following arrangements in respect of interchange with respect to New Zealand acquired transactions initiated with a New Zealand issued Visa branded payment card:

3.1.1 issuers and acquirers in New Zealand will be permitted to bilaterally negotiate the interchange rates applicable to New Zealand-acquired transactions (subject to any Visa maximum rate). Any bilaterally agreed interchange rate will be notified by the issuer to Visa;

3.1.2 a New Zealand issuer may determine the interchange rates applicable to its New Zealand-acquired transactions (subject to any bilateral agreements, and subject to any Visa maximum rate). An issuer must notify any such rates to Visa (together with any bilaterally agreed rates to which clause 3.1.1 applies);

3.1.3 Visa will set maximum interchange rates for all New Zealand-acquired transactions with respect to New Zealand issued Visa branded payment cards, which may not be exceeded by any effective rate applicable under the interchange rates notified by a New Zealand issuer, including any bilaterally-agreed interchange rate. New Zealand issuers will be responsible for ensuring that the effective rates applicable under the interchange rates notified by them under clauses 3.1.1 and 3.1.2 do not exceed the Visa maximum rates. (To avoid doubt, the effective rate for each transaction is assessed by applying the relevant issuer rate or bilateral rate to that transaction, and that rate must not result in an interchange amount in respect of that transaction in excess of the amount payable in respect of that transaction pursuant to the Visa maximum rates);

3.1.4 Visa will publish the maximum interchange rates which it sets, on Visa's website and in such other manner as Visa deems appropriate;

3.1.5 Visa will require each issuer to publish the interchange rates notified by it to Visa under clause 3.1.2 on the issuer's website, and will provide a link from Visa's website to the relevant page(s) on the issuer's website. Visa will also, subject to consent from an issuer, publish on Visa's website the interchange rates notified to it by that issuer under clause 3.1.2;

3.1.6 all transactions are to be processed and settled at the interchange rate notified by the issuer under clause 3.1.2 or (where applicable) at a bilaterally agreed rate notified by the issuer under clause 3.1.1. To avoid doubt, New Zealand issuers and acquirers are responsible for ensuring that the correct interchange rate is applied to transactions between their institutions;

3.1.7 if there is neither an issuer rate nor a bilaterally agreed rate notified to Visa that applies to a transaction, then no interchange will be applied to the relevant transaction.

3.2 To give effect to clause 3.1, Visa will modify the Visa rules as they apply in New Zealand in the manner set out in schedule 1 no later than 15 September 2009. Those modifications will come into effect no later than 17 April 2010. Subject to clause 3.3, Visa may amend the provisions set out in the schedule.

3.3 Visa will not modify the Visa rules (including the provisions set out in the schedule) in a manner inconsistent with clause 3.1.

4 Visa commitments in relation to other aspects of the Visa scheme

4.1 Visa represents and warrants to the Commission that:

4.1.1 Visa participation is, and will remain, open to all New Zealand entities, including financial institutions and other entities, on application to Visa;

4.1.2 applications will be considered by Visa applying criteria which are directed solely to confirming that the applicant has the capability (for example, capital/financial strength, systems, risk practices – that is, credit, fraud and operational risk), operational readiness and skills to provide intended services without bringing undue credit, reputational or other risks to Visa, and the ability to support its proposed card activities and business plan. Minimum capital and collateral may be required. Applications will be determined by Visa alone, and existing issuers and/or acquirers will not participate in any way in the making of such decisions;

4.1.3 New Zealand acquirers need not also be issuers, and vice versa;

4.1.4 Visa has no objection to participation in the scheme by any New Zealand entity, including entities other than financial and related institutions, provided such entity meets the relevant criteria referred to above.

4.2 Visa represents and warrants to the Commission that the Visa rules as they apply in New Zealand do not prevent merchants from steering by offering discounts, promotions or financial incentives to encourage a customer to use an alternate form of payment (including as between Visa and Eftpos, or cards from different schemes, or different types of Visa cards). Visa will not adopt any rule to such effect after the date of this Agreement.

4.3 Visa will not, with effect from the date of this Agreement:

4.3.1 enforce any Visa rule which prohibits or prevents surcharging by merchants in respect of New Zealand-acquired transactions; or

4.3.2 require or encourage acquirers to include any provision to that effect in any merchant agreement, or to take steps to enforce any such provision in an existing merchant agreement.

4.4 Nothing in clause 4.3 prevents Visa from providing in the Visa rules that if a merchant applies a surcharge for payment by any Visa card, the surcharge amount must be clearly disclosed to the cardholder at the time of purchase and must bear a reasonable relationship to the merchant's cost of accepting Visa products for payment. To avoid doubt, any such requirement imposed by Visa will not prevent merchants from applying such a surcharge on a flat rate basis, to some or all Visa branded payment cards.

4.5 Visa will no later than 15 September 2009:

4.5.1 advise all New Zealand acquirers that Visa will not enforce any Visa rules prohibiting or preventing surcharging by merchants in respect of New Zealand-acquired transactions;

4.5.2 confirm to all New Zealand acquirers that Visa does not prohibit merchants from steering at the point of sale by offering discounts, promotions or financial incentives to encourage a customer to use an alternate form of payment (including as between Visa and Eftpos, or cards from different schemes, or different types of Visa cards);

4.5.3 advise all New Zealand acquirers that they are not required to include any provision of the kind referred to in clauses 4.5.1 and 4.5.1 in any merchant agreement, or to take steps to enforce any such provision in an existing merchant agreement; and

4.5.4 require New Zealand acquirers to communicate such information to merchants. The text of the member letter to be sent by Visa to New Zealand acquirers for the purposes of this clause is set out in schedule 2.

4.6 Visa will, no later than 15 September 2009, take appropriate steps binding on Visa to ensure that the Visa rules as they apply in New Zealand do not prohibit or prevent surcharging by merchants in respect of New Zealand-acquired transactions. Visa will not subsequently modify the Visa rules as they apply in New Zealand to prohibit or prevent surcharging by merchants in respect of New Zealand-acquired transactions.

5 Disposal of proceedings

5.1 The Commission will promptly following the date of this Agreement:

5.1.1 seek leave to discontinue the proceeding as against Visa, and will discontinue the proceeding as against Visa once leave is granted to the Commission to do so. This discontinuance will be on the basis that neither party seeks an order for costs against the other;

5.1.2 amend its statement of claim so that no relief is sought modifying or affecting the future operation of the Visa rules.

5.2 The Commission will not commence any new proceedings against Visa in respect of the Visa claims.

5.3 Visa acknowledges that this Agreement is not intended to settle or otherwise affect the Commission's claims against any other party in the proceeding.

5.4 Visa will pay NZ $2.6 million to the Commission on or before 15 September 2009 in respect of costs incurred by the Commission in connection with these proceedings. [ ]

5.5 To avoid doubt, nothing in this Agreement affects the ability of the Commission to bring proceedings against Visa in respect of any conduct engaged in by Visa after the date of this Agreement (apart from conduct that Visa is expressly required to engage in by this Agreement), or in respect of any aspect of the Visa scheme that is in force after the date of this Agreement.

5.6 To avoid doubt, nothing in this agreement amounts to an admission of wrong-doing or liability by Visa in respect of the Visa claims.

[ ]

THE COMMISSIONER OF COMPETITION
Applicant

-and-

VISA CANADA CORPORATION et al.
Respondents

Court File No. CT-2010-010

THE COMPETITION TRIBUNAL

WITNESS STATEMENT OF ELIZABETH BUSE
(Sworn April 9, 2012)

BLAKE, CASSELS & GRAYDON LLP
Barristers & Solicitors
199 Bay Street
Suite 4000, Commerce Court West
Toronto, Ontario M5L 1A9

Robert Kwinter LSUC #26251D
Tel: 416-863-3283

Randall Hofley LSUC #31633L
Tel: 416-863-2387 and 613-788-2211 (Ottawa)

Lawyers for the Respondent,
Visa Canada Corporation