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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.

BETWEEN:

THE COMMISSIONER OF COMPETITION

Applicant

- and -

**VISA CANADA CORPORATION and
MASTERCARD INTERNATIONAL INCORPORATED**

Respondents

- and -

**CANADIAN BANKERS ASSOCIATIONS and
THE TORONTO-DOMINION BANK**

Intervenors

REPLY EXPERT REPORT OF ALAN S. FRANKEL, Ph.D.
April 23, 2012

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1. Introduction and Overview

1. I previously submitted a report in this matter dated March 9, 2012 ("Frankel Report"), concerning the Respondents' Merchant Restraints,[1] i.e., their No-Surcharge Rules, No-Discrimination Rules and Honour-All-Cards Rules. In that report, I explained the bases for my main opinions that:

- The relevant market in which to evaluate MasterCard and Visa's Merchant Restraints is no broader than the market for credit card network (acceptance) services in Canada;
- Both MasterCard and Visa possess and exercise market power; and
- The Merchant Restraints influence upward and discourage the reduction of the Card Acceptance Fees paid by merchants and have an adverse effect on competition.

2. On April 10, 2012, the Respondents and an Intervenor (The Toronto-Dominion Bank) submitted several reports by experts who (collectively) disagree with some of my opinions, and who contend that the Merchant Restraints have a variety of beneficial effects and justifications.[2] Although they claim ultimately to reach different conclusions than those described in my report, they frequently agree with me about some of the underlying economic features of the marketplace that support my conclusions. In this reply report, I will describe the main areas of agreement and disagreement, and why, after reviewing their claims and support (where it exists) for such claims, my opinions remain unchanged.[3] My qualifications are described in my initial report. The materials upon which I relied in preparing this reply report are listed in the Appendix.

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1 Defined terms herein have the meaning ascribed to them in my report dated March 9, 2012, unless otherwise indicated.

2 Expert Report of Jeffrey Church, April 10, 2012 ("Church Report"); Expert Report of Peter T. Dunn, April 10, 2012 ("Dunn Report"); Expert Report of Kenneth G. Elzinga, April 10, 2012 ("Elzinga Report"); Expert Report of Benoît Gauthier, April 9, 2012 ("Gauthier Report"); Impact Analysis: Removal of Certain Network Rules on the Canadian Payment System, April 10, 2012 (Report of Balaji Jairam) ("Jairam Report"); and Expert Report of Michael S. Mulvey, April 4, 2012 ("Mulvey Report"). For simplicity, when I refer to "Respondents' experts" or their reports collectively, I include Mr. Jairam and his report as well in that description.

3 I focus specifically on the report submitted by Professor Kenneth Elzinga, which contains the largest volume of direct responses to my initial report, but I also address some aspects of the other reports. I do not attempt to address every error or opinion in the Respondents' experts' reports with which I disagree, and my failure to address any statement of fact or opinion does not imply that I necessarily agree with it. In this reply report, I follow the practice of not including internal citations in quoted material.

3. **Relevant market.** In my initial report, I explained why the application of a standard approach to market definition, the Hypothetical Monopolist Test, and other economic evidence supports the conclusion that the relevant market in this case is no broader than the provision of Credit Card Network Services (or "Card Acceptance Services") in Canada, not a broad market that includes all methods of payment, as argued by MasterCard and Visa.[4] The Respondents' experts generally agree with the use of the Hypothetical Monopolist Test, but Professor Elzinga suggests that the proper application of that test instead supports the broad relevant market claimed by the Respondents.[5] His main arguments are that it is inappropriate to define separate markets on each "side" of the credit card networks (or "platforms") – merchant card acceptance services on one side and card issuing services on the other – coupled with an assertion that the Respondents' card networks "compete" with other forms of payment.[6] In Part 2 of this reply report, I explain that the former argument is incorrect and the latter argument is unsupported and insufficient to conclude that the relevant market includes other forms of payment. Moreover, even under his own "total price" approach to applying the hypothetical monopolist test to the facts of this case, Professor Elzinga makes fundamental errors that cause him, for example, to overstate the hypothetical price increase by a factor of 20 to 40 and to rely on the effects of assumed merchant surcharges where, in fact, such surcharges are forbidden by the Merchant Restraints.[7]

4. **Market power.** In my initial report, I explained that both MasterCard and Visa possess and exercise substantial market power.[8] I based that conclusion on structural evidence, such as market shares and entry conditions and the effects of the Merchant Restraints at issue in this case, as well as direct evidence, including the Respondents' ability – uninhibited by significant competitive constraints – to control pricing in the market through changes in their Interchange Fees and network fees, their ability to exploit inelastic market demand made more inelastic by the challenged conduct, and their systematic and extensive value-based pricing (price discrimination). Professor Elzinga claims that the Respondents do not possess "undue" market power.[9] He bases this opinion largely on his conclusions that the

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4 Frankel Report, paras 54-55.

5 Church Report, para 60; Elzinga Report, paras 144-150.

6 Elzinga Report, paras 145-147.

7 Elzinga Report, para 149.

8 Frankel Report, Part 4.

9 Elzinga Report, para 18.

relevant market includes all types of payment, his claim that potential entry disciplines MasterCard and Visa pricing, and his claim that each network has substantial excess capacity and can be expected to exhibit a high "supply elasticity" in response to price increases.[10] In Part 3 of this reply report, I explain why the Respondents possess substantial market power, Professor Elzinga's unsupported claims notwithstanding.

5. **Anticompetitive effects of the Merchant Restraints.** The Respondents' experts offer a variety of opinions concerning both what I have termed the anticompetitive effects of the Merchant Restraints, as well as what they suggest are justifications for the Respondents' enforcement of the Merchant Restraints. In Part 4 of this reply report, I address the former, and in Part 5, I address the latter.

6. In my initial report, I explained that the Merchant Restraints suppress competition that would otherwise occur among merchants, and therefore among providers of payment services, at the point of sale. The evidence shows, for example, that:

- the ability of merchants to surcharge has a different economic effect than the ability of merchants to offer only discounts;
- at least some merchants would be likely to surcharge the Respondents' credit card brands in the absence of the Merchant Restraints, and surcharging would likely become increasingly common (especially if Card Acceptance Fees were slow to decline) as the public became more accustomed to the practice;
- surcharging would cause some of the merchants' customers to choose alternative, lower cost payment types;
- surcharging merchants would offer lower prices to customers who did not use credit cards, would incur lower average net costs, and would therefore charge lower average prices overall; and
- in the absence of the Merchant Restraints, surcharging and selective refusal of credit cards by merchants would impose an economic constraint on the level of Card Acceptance Fees.

7. To support these conclusions, I rely on the available economic evidence, including international evidence, as well as repeated acknowledgements of these economic effects by the Respondents and their experts in other venues. The Respondents' experts in this

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[10] Elzinga Report, paras 157, 168-169, 178-179.

case essentially agree with much of my analysis of the underlying economic features of the marketplace. For example, they agree that (with existing Merchant Restraints) merchants have inelastic demand for Card Acceptance Services and that the networks respond by charging high prices to merchants (via Interchange Fees),[11] and they agree that surcharges for credit card use are perceived differently by consumers and have different actual effects than mathematically equal discounts for use of other payment methods.[12]

8. They appear to be sceptical, however, about some of the conclusions which follow logically from those economic facts. Professor Elzinga also suggests that the reduction in merchant costs resulting from increased use of lower cost payments (and recoupment of payment costs through credit card surcharges) is unlikely to result in lower posted retail prices.[13] I explain below why their arguments and claimed evidence (including a survey of Canadian consumers) do not alter my original conclusions. I also explain that Professor Elzinga's speculative claim that merchants will "pocket" the savings from lower payment costs is contradicted both by economic analysis and by his own claims about discounts.[14]

9. **Justifications.** The Respondents' experts also offer a wide variety of reasons why they claim the Merchant Restraints are beneficial to the Canadian public and, thus, should not be viewed as having an adverse effect on competition. For example, they claim that the Merchant Restraints *protect consumers* from merchants that otherwise would engage in the exercise of market power, deception (or "bait-and-switch"), "price gouging" or imposition of "excessive" surcharges, and price discrimination.[15] In Part 5 of this reply report, I explain that these claims are inconsistent with the Respondents' defences of their own pricing practices and that no justification has been established for the Respondents' regulation of merchant pricing practices throughout Canada. These claims also cannot be reconciled with the fact that MasterCard and Visa allow some merchants and service providers to apply surcharges (termed "convenience fees"), which has expanded card acceptance and regarding which the Respondents' experts identify no economically harmful effects. Professor Elzinga claims that

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[11] Elzinga Report, para 255.

[12] Church Report, para 88; Elzinga Report, para 225; Mulvey Report, para 40.

[13] Elzinga Report, para 106; Witness Statement of Elizabeth Buse, April 9, 2012 ("Buse Report"), paras 23-24.

[14] Elzinga Report, paras 100-102.

[15] Church Report, paras 52-54; Elzinga Report, para 227; Jairam Report, p. 8, paras 63-99; Mulvey Report, para 56; Dunn Report, para 34; Buse Report, paras 18-22.

high Card Acceptance Fees should actually be viewed as discounts to cardholders, so that any reduction in merchant fees is actually an increase in (net) prices to consumers.[16] This both mischaracterizes the economic effects of Card Acceptance Fees and surcharges and ignores his own "total price" standard.[17] In any event, re-characterizing the effects does not alter the competitive economic analysis of these effects.

10. Many other justifications for the Merchant Restraints are offered by the Respondents' experts. They argue, for example, that the Merchant Restraints:

- protect the Respondents' Interchange Fee systems;[18]
- protect merchants from competitive strategies that rival merchants might employ if freed from the Merchant Restraints.[19] (The Respondents' experts simultaneously, and confusingly, suggest that the Merchant Restraints preserve competition among merchants.);[20]
- prevent merchants from "free riding;"[21]
- protect the profitability of small banks;[22]
- protect the value of the Respondents' "brands;"[23]
- help the Respondents maximize the use of their networks;[24]
- reduce the extent of the "underground economy;"[25]
- reduce the likelihood that merchants will surcharge debit cards;[26] and

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16 Elzinga Report, paras 230, 234, 244.

17 Some of the Respondents' experts also contend that elimination of the Merchant Restraints will increase consumer search costs, but that could be said of the elimination of a successful price fixing cartel as well and does not constitute an appropriate competitive justification. Mulvey Report, para 56; Jairam Report, para 93.

18 It is unclear whether the Respondents' experts dispute that removing the Merchant Restraints will lead to lower Interchange Fees than otherwise, but they suggest that any such effect would be undesirable because, they argue, the Respondents' Interchange Fees serve a procompetitive "balancing" role. Church Report, para 41; Elzinga Report, para 54.

19 See, e.g., Jairam Report, paras 19, 20, 84, Elzinga Report, para 47.

20 See, e.g., Elzinga Report, para 29.

21 Church Report, para 51; Elzinga Report, para 227.

22 Jairam Report, para 20.

23 Church Report, paras 52-54; Elzinga Report, para 227; Mulvey Report, para 56.

24 Church Report, para 9; Elzinga Report, para 227.

25 Jairam Report, para 20.

26 Jairam Report, para 20.

- increase the pace of innovation.[27]

11. I endeavour in Part 5 to address this list of claims to the extent relevant.

12. To summarize, the Respondents' experts in general, and Professor Elzinga in particular, contend, without any support, that the Canadian credit card industry is, in effect, perfectly competitive at every stage. No price increase by MasterCard or Visa (or even a hypothetical monopoly credit card network) can cause harm, they argue, because any additional revenue will be entirely competed away. At the same time, they contend that the retail sector is characterized by pervasive market power and market failure, with merchants generally willing and able to exploit their own customers. This is an inversion of reality. MasterCard, Visa, and their experts deny that the Merchant Restraints have significant effects and yet they *justify* the Merchant Restraints based on their claimed significant effects. In fact, the anticompetitive effects of the Merchant Restraints are clear and direct, while the claimed benefits do not withstand scrutiny.

2. Relevant Market

13. In my initial report, I explained in detail the analytical and factual bases for my conclusion that the relevant market in which to evaluate MasterCard and Visa's Merchant Restraints is no broader than the market for credit card network (acceptance) services in Canada. I based my conclusion on:

- functional differences between credit cards and other payment methods;[28]
- application of the well-recognized Hypothetical Monopolist Test;
- the commercial necessity for many merchants to accept both MasterCard and Visa credit cards in a type of critical loss analysis;
- the effect that the Merchant Restraints have of narrowing what might otherwise be a broader relevant market;
- pricing evidence that, in effect, has performed the Hypothetical Monopolist Test in actuality; and

27 Jairam Report, para 20.

28 Professor Elzinga claims that credit cards provide benefits to cardholders and to merchants not provided by alternative payment methods, including, for merchants, the prospect that the merchant will lose sales by declining to accept credit cards. Elzinga Report, paras 25 to 29.

- an explanation that network rules sufficiently insulate the Canadian credit card acceptance marketplace from international competition so as to limit the relevant geographic market to Canada.

14. Contrary to the claims of Professor Elzinga, in analyzing the relevant market, I considered the "two-sided" nature of the credit card industry and explained that it is still economically appropriate to define a market for Card Acceptance Services that is separate from card issuing services.

15. Professor Elzinga agrees that the geographic market is limited to Canada. He argues, however, that Card Acceptance Services are sold in the same relevant product market as card issuing services, and that credit card services are supplied in the same relevant market as other payment methods. As explained below, I disagree with Professor Elzinga's arguments on these issues.

2.1. The mere existence of alternatives is insufficient to include them in the relevant market

16. Professor Elzinga suggests that it is a "mistake" to exclude "non-card payment systems," such as electronic fund transfers, cheques, cash and other forms of payment, from the relevant market "because consumers regard these means of payments as substitutes."[29] Professor Elzinga fails to show, however, that consumers view alternative means of payment as *sufficiently good substitutes* to make it appropriate to include these other payment methods in the same relevant market as credit cards. Similarly, Professor Elzinga claims that that the Respondents "compete" with other "card and non-card payment mechanisms in Canada" without showing that they compete *sufficiently* closely to be included in the same relevant product market.

17. To use Professor Elzinga's example, he notes that there is a relevant market for beer.[30] Presumably, even beer drinkers sometimes consume other beverages such as wine, soft drinks or water. Yet the mere availability and use of these substitutes by consumers and even by beer drinkers obviously does not lead to a finding that there is an "all beverages" market or, alternatively, that beer is not an appropriate relevant market.

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29 Elzinga Report, paras 24, 157, 201.

30 Elzinga Report, para 159.

18. Professor Elzinga points to statements made by MasterCard and Visa executives for the purpose of this proceeding, for example, that "MasterCard considers its 'competitive positioning' against other forms of payment as one of the factors when establishing default interchange rates," and that "Visa has actively studied the substitutability of other forms of payment and used the results to guide its business strategy ... Visa Canada views eCommerce/mobile alternative payment providers like PayPal as a significant competitive threat."[31] Even if taken at face value, none of these self-serving statements supply insight into whether alternative payment types sufficiently constrain MasterCard and Visa pricing so as to be considered part of the relevant product market.

2.2. Professor Elzinga's Flawed Application of the Hypothetical Monopolist Test

2.2.1. Merchants Could Not Defeat a 5 to 10 Percent Increase in Credit Card Acceptance Fees

19. Professor Elzinga ultimately recognizes that the fact that other payment methods exist is insufficient to warrant their inclusion in the relevant market. He explains that "[a] properly defined relevant market should include all substitutes that supply a *meaningful constraint on the pricing* of a prospective monopolist."[32] But even that is not correct: the qualifier "meaningful" is too vague to be used in defining a relevant market. The Hypothetical Monopolist Test, which Professor Church refers to as "the standard approach" to market definition,[33] takes a more specific form, as Professor Elzinga recognizes:

> "This procedure defines a relevant market as the smallest set of products over which a hypothetical single provider could profitably impose a significant increase in price. To apply the test, one considers a candidate set of firms and products and asks if a hypothetical monopolist over the products could sustain a small but significant non-transitory increase in price – and profit from the endeavor. If there is sufficient substitution away from the candidate products to other products that renders the price increase unprofitable, then the initial set of firms and products is too narrow to be a market. More products – specifically those products that are the closest substitutes for the initial products – should be included and the process repeated until a collection of firms and products is found that could sustain a small but significant non-transitory increase in price that is profitable.

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31 Elzinga Report, para 141, fn 102.

32 Elzinga Report, para 152 (emphasis added).

33 Church Report, para 60.

> The Commissioner puts it this way: 'Under the hypothetical monopolist test of a proposed relevant market, the question is whether a hypothetical monopolist in the market could profitably raise its price by a small but significant amount (usually taken to be 5%), for a non-transitory period of time. If customers would substitute other products in sufficient amounts to render such a price increase unprofitable, then the proposed relevant product market should be expanded to include such substitutes.'"[34]

20. In fact, that is precisely what I did in my initial report. I began with the narrow set of products identified by the Commissioner (Credit Card Network Services) and analyzed whether a hypothetical "single provider" of those services "could profitably impose a significant increase in price."[35] Because the answer to that question is affirmative, the analysis stops at that point and confirms my opinion that the market is no broader than Credit Card Network Services; no additional "closest substitutes" need to be added to the candidate market to reach the point where a hypothetical monopolist could profitably increase prices.

21. As I explained in my initial report, my application of the Hypothetical Monopolist Test to the facts of this case is conservative, and more favourable to the Respondents, in the sense that I used current prices as opposed to the prices that would prevail in a competitive market. My analysis demonstrated that a hypothetical monopolist of Credit Card Network Services could increase prices from current levels without needing to account for any market power that the Respondents may already be exercising. In fact, as I explained in detail in my initial report, the Respondents are currently exercising significant market power. Without the Merchant Restraints, Card Acceptance Fees would be lower than they are today. Because I conclude that even increases from current prices would not be defeated by substitution to other forms of payment, then it must certainly be the case that an increase from the lower prices that would prevail in a competitive market would also not be defeated by substitution to other forms of payment. In other words, this complication, the "cellophane fallacy," does not play a role in defining the relevant market.

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34 Elzinga Report, paras 142-43. Professor Elzinga agrees that "[t]his is an accurate statement of this market definition test." (Elzinga Report, para 143)

35 Given the existence of the Merchant Restraints, one could examine whether an even narrower relevant market could be defined for acceptance of either MasterCard or Visa branded cards, but my opinion concerns whether the market is "no broader" then Card Acceptance Services in Canada.

2.2.2. Interchange Fees and the "Total Price of a Transaction"

22. Professor Elzinga does not dispute that the ability of merchants to react to higher Card Acceptance Fees would be insufficient to render a hypothetical price increase unprofitable. Instead, he states that an increase in Interchange Fees "may not" result in any increase in the "total price of a transaction,"[36] which he defines as "the sum of what the merchant pays the acquirer (Card Acceptance Fees) plus what the cardholder pays the issuer (essentially fees less rewards)."[37] Professor Elzinga describes the credit card networks and Issuers as essentially perfectly competitive, so that any increase in network fees or Interchange Fees would inevitably be competed away in the form of lower cardholder fees or enhanced cardholder rewards.[38] Were Visa, for example, to increase its "total price" to earn "a monopolistic margin," Professor Elzinga claims, without any evidence, that a "rival payment mechanism" or a "rival network" not only theoretically *might*, but actually "*would* successfully undercut the assumed anticompetitive pricing of the Visa system."[39] Competition on the issuing side is so perfect, he contends, that the only way an increase in Interchange Fees could be profitable to the Respondents and their member banks would be if the Respondents also suppressed competition for cardholders as well as for merchants.[40]

23. In other words, Professor Elzinga simply *assumes* that neither higher Interchange Fees nor higher network fees charged to merchants can cause harm because the incremental profits are certain to be dissipated entirely due to competition from rival networks or other "payment mechanisms." Yet, elsewhere, Professor Elzinga argues that this would only be the result "*if* an increase in an interchange rate were passed along to the merchant through the merchant discount and the same amount were passed along to the cardholder in the form of enhanced rewards or reduced fees."[41] In other words, Professor Elzinga's own theory requires the perfect pass-through of any increase in Interchange Fees to cardholders in the form of increased rewards or benefits. In fact, Interchange Fees are *not* "passed along" in the same amount from merchants to cardholders.

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36 Elzinga Report, para 59.

37 Elzinga Report, para 57.

38 Elzinga Report paras 219-21. Professor Church makes a similar, equally unsubstantiated claim suggesting perfect competition among networks. Church Report, para 8.

39 Elzinga Report, para 220 (emphasis added).

40 Elzinga Report, para 221.

41 Elzinga Report, para 59 (emphasis added).

24. As I explained in my initial report, the evidence shows that Card Acceptance Fees fully adjust to cover the Interchange Fees and network fees (and changes in those fees) imposed by MasterCard and Visa.[42] On the cardholder "side," however, the evidence shows that only a portion of the proceeds from Interchange Fees flow to cardholders in the form of rewards. Indeed, nearly one-third of Canadian cardholders do not receive *any* rewards on any credit card, and rewards cards generate significantly less on average to Canadian cardholders than the 1 percent assumed by Professor Elzinga, and far less than the 1.6 to 1.8 percent that merchants pay (on average) in Interchange Fees.[43] In fact, Professor Elzinga concedes that "[n]o doubt this is true" that "cardholders will not receive the full amount" of the Interchange Fees paid by merchants, but he is content that "that *some* portion of interchange revenue is passed on to consumers."[44] As stated in a 2009 internal email from a representative of

25. Professor Elzinga argues we should look at both sides of the market and rely on the "total price" as a measure of a network's competitiveness. Thus, if the Respondents' conduct causes Card Acceptance Fees to increase, but only a fraction of those higher fees finds its way to cardholders, then the net effect of the conduct is the same directionally as the effect on merchants – an increase in Professor Elzinga's "total price."

26. In a proceeding against MasterCard, the European Commission considered and rejected (appropriately in my view) the very approach advocated by Professor Elzinga:

42 Frankel Report, Part 4.2.1.

43 Frankel Report, para 84. See also, Part 5.5, *infra*.

44 Elzinga Report, para 67 (emphasis in original). Professor Elzinga goes on to claim that *merchants* benefit from paying higher Interchange Fees because of an indirect feedback effect from their rewards-enriched cardholders. It is economically untenable to claim that a merchant would benefit by paying a 1.8 percent fee to give its own customer, say, a 0.5 percent discount, when the merchant could always offer the full 1.8 percent to its own customer or spend only 0.5 percent to offer a 0.5 percent discount. Professor Elzinga's argument amounts to a claim that merchants around the world that clamour for lower Interchange Fees do not comprehend what is in their own interest.

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"Carrying out a SSNIP test on the sum of the prices charged to cardholders implies that the distinct demand of cardholders for payment cards and the distinct demand of merchants for acquiring services are amalgamated into one single demand. This suggestion is conceptually unconvincing and also contradicts MasterCard's reasoning regarding Article 81(3) of the Treaty where it justifies the very existence of an interchange fee in its system by relying on the different nature of demand of cardholders due to different price elasticities, which – in MasterCard's view – creates a need to 'balance' those different demands."[46]

2.2.3. Professor Elzinga's Implementation of the Hypothetical Monopolist Test Illustrates the Adverse Effects of the Merchant Restraints

27. Professor Elzinga concedes in his report that merchants, in effect, cannot shift payment volume from a higher cost (to the merchant) network to lower cost payments.[47] In other words, merchants' elasticity of demand for Credit Card Network Services is inelastic. But that is a result of the Merchant Restraints. Rather than concede that this supports a finding of a narrow relevant Credit Card Network Services market, however, Professor Elzinga addresses an entirely different question: would *cardholders* change their payment choices – in the face, not of increases in Card Acceptance Fees, but of merchant surcharging – sufficiently to deter the Respondents from increasing the "total price of a transaction."

28. In effect, he attempts to determine whether the relevant market might be broader than Credit Card Network Services where merchants are able to surcharge; that is, *in the absence of the Merchant Restraints.*[48] Indeed, if merchants could add surcharges to transactions initiated with the Respondents' credit cards, then increases in the Respondents' network fees or Interchange Fees leading to increases in Card Acceptance Fees would tend to increase both the proportion of merchants that surcharge and the average amount by which those merchants surcharge. In turn, that would reduce the volume of transactions (at merchants that already accept the Respondents' credit cards). This new source of competition with respect to Card Acceptance Fees at the point of sale, in a world in which surcharging were

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46 Provisional Non-Confidential Version, Commission Decision of 19 December 2007 Relating to a Proceeding Under Article 81 of the EC Treaty and Article 53 of the EEA Agreement (Comp/34.579 MasterCard, Comp/36.518 EuroCommerce and Comp/38.580 Commercial Cards) to be notified to MasterCard Europe S.p.r.l,, MasterCard Incorporated and MasterCard International Incorporated, para 264.

47 Elzinga Report, para 146 ("[E]ven if the hypothetical monopolist test were to be applied only to the merchant side of this two-sided market, the relevant decision maker is not the merchant but the consumer. While a merchant decides whether to accept Visa or MasterCard credit card as a method of payment across the board, consumers are the ones who decide whether to use a credit card or an alternative payment mechanism when making a specific purchase.").

48 Elzinga Report, paras 147-50.

possible, might lead to a conclusion that, for example, debit card acceptance services competed in the same relevant market as credit card acceptance services. But that world does not now exist.

29. As a result, in the real world, the downward price pressure created by the potential of surcharging by merchants is absent, and Card Acceptance Fees are higher as a result of the Merchant Restraints. In short, Professor Elzinga has simply explained why enforcement of the Merchant Restraints adversely affects competition and has an upward influence on prices: the substitution effect he relies on to claim that the relevant market is broader is precisely the behaviour that the Merchant Restraints prohibit.

2.2.4. Professor Elzinga Uses the Wrong Price in Performing the Hypothetical Monopolist Test

30. Even in his (counterfactual) world in which merchants are allowed to surcharge the Respondents' credit card transactions, Professor Elzinga uses the wrong hypothetical price increase. Professor Elzinga claims that a "2% price increase" by the networks on a $100 transaction at retail would equal $2.[49] This example does not reflect a 2 percent price increase in Credit Card Network Services according to either Professor Elzinga's definition or mine. According to Professor Elzinga, the relevant price that should be used to analyze the competitive issues in this case is the "total price," which he defines as merchant fees plus cardholder fees, less rewards (which he assumes, incorrectly, to be worth an average of one percent of the transaction amount). 2 percent of that amount is not the same as 2 percent of the retail transaction associated with the credit card purchase. Mathematically, Professor Elzinga claims that:

$$\text{(Total Price)} = \text{(Merchant Fees)} + \text{(Cardholder Fees)} - \text{(Cardholder Rewards)} \quad [1]$$

31. To illustrate with round numbers, suppose merchants pay, on average, 2.0 percent of the transaction value to accept a MasterCard or Visa credit card transaction:

$$\text{(Merchant Fees)} = \text{(Transaction Amount)} \times 2.0\% \quad [2]$$

and cardholders all have no-fee credit cards:

49 Elzinga Report, para 149.

(Cardholder Fees) = 0 [3]

and cardholders earn Professor Elzinga's assumed 1.0 percent of the transaction value as a reward:

(Cardholder Rewards) = (Transaction Amount) x 1.0% [4]

32. Substituting [2], [3] and [4] into equation [1] generates the simple result that:

(Total Price) = (Transaction Amount) x 2.0% - (Transaction Amount) x 1.0%

or,

(Total Price) = (Transaction Amount) x 1.0%. [5]

33. In this example, if the average retail credit card transaction amount were $100, the merchant pays $2.00, but under Professor Elzinga's assumptions the cardholder receives $1.00 of this amount, leaving the $1.00 difference as the "total price."

34. The Hypothetical Monopolist Test asks the following question: what would happen if the price increased by, say, five percent?[50] In Professor Elzinga's formulation, then, the appropriate price increase for the Hypothetical Monopolist Test would be:

Hypothetical Monopolist Test Price Increase = (Total Price) x 5.0%

= (Transaction Amount) x 1.0% x 5.0% [6]

35. Using Professor Elzinga's assumed figures, a 5% price increase for Credit Card Network Services would be $0.05, not the $2.00 that Professor Elzinga uses in his example.

Hypothetical Monopolist Test Price Increase = (Transaction Amount) x 1% x 5%

= $100 x 1% x 5% = $0.05. [7]

50 Professor Elzinga describes a five to ten percent price increase. I focus on a five percent increase in order to keep the example simple.

Similarly, a 5% price increase using the price to the merchant as I have defined it would be $0.10 (the merchant price, which is equal to the $100 transaction x 2.0% merchant fee, times a 5.0% price increase). In other words, Professor Elzinga overstates the amount of the hypothetical price increase *by a factor of 20 to 40.* Instead of a 5 to 10 percent price increase, he bases his conclusion that the relevant market includes other payment methods on a hypothetical price increase of 100 to 200 percent.

36. This extreme, distorted application of the Hypothetical Monopolist Test is meaningless, both because substitutes that might constrain a hypothetical monopolist's price increase to something less than 200 percent of the current price tell us nothing useful about market definition, and because, in fact, merchants are forbidden by the Merchant Restraints from imposing any surcharge at all.

2.3. Professor Elzinga Fails to Address the Extreme Implications of a Credit-Plus-Debit or an All-Payments Relevant Market

37. As I explained in my initial report, an implication of the Hypothetical Monopolist Test is that a hypothetical monopolist of a smaller set of products would be unable to exercise market power, i.e., profitably implement a five to ten percent price increase. In this case, Professor Elzinga suggests that the relevant market includes at least all debit and credit card services and likely all payment methods and services, such as electronic fund transfers and cheques, as well as cash.

38. The implication of even a "debit and credit card" market is thus that a merger to monopoly among all credit card firms in Canada (e.g., a merger of Visa, MasterCard and American Express) could not cause any competitive harm; any increase in Professor Elzinga's "total price" by a credit card monopolist would be defeated by enough substitution to debit cards so as to make the credit card price increase unprofitable. The idea that no harm would follow from a merger of all credit card operations in Canada into a single firm, due to the existence of debit cards, is simply not plausible, and Professor Elzinga neither addresses nor defends such a notion. Professor Elzinga's claim that the relevant market includes *all* payment methods, including cash, means that a hypothetical merger of all credit and debit card payment providers (e.g., a merger of Visa, MasterCard, American Express and Interac) and all cheque account providers into a single entity would not be anticompetitive, as the resulting payment services monopolist could not increase its fees ("total prices" or otherwise) without inducing so many

customers to migrate to cash transactions to render price increases unprofitable. Needless to say, Professor Elzinga offers no substantive economic defence of this proposition either.

3. Market Power

39. In my initial report, I explained the bases for my conclusion that both MasterCard and Visa possess substantial market power. I relied on indirect structural evidence, including MasterCard's and Visa's leading market shares in the highly concentrated market; the effect the Merchant Restraints have in allocating particular transactions to either MasterCard or Visa and minimizing competition for those transactions at the point of sale; and the difficulty of entry that makes actual or potential entrants into the industry unable to constrain MasterCard and Visa from exercising market power. I also relied on direct evidence, including the ability of MasterCard and Visa to set a price floor under the level of Card Acceptance Fees and control the level of that floor by adjusting their Interchange Fees and network fees; the inelastic demand by merchants for Card Acceptance Services; and the extensive degree of price discrimination by which MasterCard and Visa attempt to extract as much of the "value" merchants obtain from accepting credit cards as possible.

40. Professor Elzinga implies at times that MasterCard and Visa are essentially perfectly competitive, both because of competition between them and among their members, and because of actual or potential competition from alternative payment networks and methods. Yet, in specifically addressing the Respondents' market power, he merely contends that MasterCard and Visa do not possess "undue" market power.[51] Professor Elzinga contends that:

> "Market power matters when a firm's market power threatens competition by insulating the firm's pricing decisions from the restraining influence of competing firms. Unless a firm's market power is so great that its pricing decisions are free from the restraining influence of rival firms – existing competitors as well as new entrants – the firm's market power is of no consequence to antitrust or competition regulators".[52]

41. As I explained in Part 2 of this reply report, in connection with market definition, (and will explain further in the remainder of this report), contrary to the unsupported allegations

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[51] Elzinga Report, para 18.

[52] Elzinga Report, para 133.

of Professor Elzinga, the actions of MasterCard and Visa do diminish competition, and their rules do tend to insulate them from "restraining influence of rival firms."[53]

42. Professor Elzinga claims that the Respondents lack market power for the following reasons:

- "Visa and MasterCard compete vigorously between themselves,"[54] and "compete for merchant acceptance" and, therefore, it is a mistake *in computing market shares* not to consider alleged "vigorous competition between the Visa and MasterCard networks;"[55]
- market shares should be computed on the basis of a relevant market that also includes debit card services, or debit card services plus cheques, cash, and automatic funds transfer services;[56]
- competition exists "among issuers;"[57]
- entry barriers are not "insurmountable;"[58] and
- each network in the market possesses substantial "excess capacity" and exhibits a high "supply elasticity."[59]

43. I addressed the relevant market in Part 2. In the remainder of this part, I address the other reasons provided by Professor Elzinga which he claims imply the Respondents lack market power.

3.1. Market Shares *Understate* Market Power in the Presence of the Merchant Restraints

44. Professor Elzinga claims that it is an error, even when computing *market shares*, not to "take stock of" what he contends is "the vigorous competition *between* the Visa and MasterCard networks in every aspect of the payment card business," including with respect to

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[53] Elzinga Report, para 133. Professor Elzinga's claim, moreover, is incorrect insofar as it ignores the cellophane fallacy. Firms with market power will tend to increase price until the point at which rival firms restrain any further increases.

[54] Elzinga Report, para 18.

[55] Elzinga Report, paras 140, 197, 214, p. 101, fn 176.

[56] Elzinga Report, paras 152-153.

[57] Elzinga Report, para 140.

[58] Elzinga Report, paras 173-174.

[59] Elzinga Report, paras 166-171.

competition by networks for Issuers, competition among the Issuers, and "competition *between* Visa and MasterCard for merchant acceptance."[60] Professor Elzinga asserts at least four times in his report that the networks "compete" for merchant acceptance.[61] But he fails to refer to any evidence of such competition.[62]

45. As I explained in my original report, even economists who have consulted for MasterCard and Visa have recognized that most major merchants find it competitively necessary to accept both MasterCard and Visa branded credit cards.[63] Cardholders cannot be assumed to carry both a MasterCard and a Visa, and credit cards bearing the Respondents' brands cannot, in general, be processed using rival credit card networks.

46. Merchants cannot steer their customers to lower cost brands or types of payment sufficiently to constrain MasterCard and Visa to reduce their fees. Professor Elzinga does not dispute this. The consequences, however, are that the Merchant Restraints have the economic effect of allocating transactions to particular networks and enhancing each Respondent's market power beyond what might be apparent from the Respondents' market share alone. In effect, each of the Respondents possesses what Visa consultants have termed a "bottleneck monopoly" over each merchant.[64] This bottleneck monopoly provides MasterCard and Visa with market power that is even greater than what would be indicated by their already significant market shares.

47. Professor Elzinga neither addresses nor refutes my analysis of the fact that market shares *understate* MasterCard's and Visa's market power.

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[60] Elzinga Report, para 140 (emphasis in original).

[61] Elzinga Report, paras 140, 197, 214, p. 101, fn 176.

[62] Professor Elzinga does describe competition between the networks and among the networks' member banks for merchant "cobrand" arrangements. Elzinga Report, para 217. But cobrand arrangements are a way that a small percentage of typically larger merchants can earn revenue (to at least some extent) from their ability to help generate credit card accounts for an issuing bank. They do not represent competition between MasterCard and Visa over Card Acceptance Services.

[63] Frankel Report, Part 3.5.

[64] Frankel Report, para 91.

3.2. Competition Among Member Banks Does Not Eliminate the Respondents' Market Power

48. I discussed competition among Issuers in connection with market definition. Although such competition has gradually dissipated some of the profits earned by the Respondents' member banks resulting from the exercise of the Respondents' market power over merchants, the magnitude of rewards is far less than Interchange Fees paid by merchants. In fact, because not all of the Interchange Fees are dissipated to cardholders, issuing banks profit from Interchange Fees and card networks engage in what I describe in my initial report (at paragraph 148) as a "perverse" form of competition, where networks with lower prices are characterized in the industry as being at a "competitive disadvantage" and networks with higher prices are characterized as having a competitive advantage and better able to grow at the low price network's expense.

49. On the other hand, competition among Acquirers generally *does* constrain the amount that any one Acquirer can profitably charge to a merchant, at least with respect to the Acquirer's own margin. This is one reason why a hypothetical monopolist of Card Acceptance Services could profitably increase Card Acceptance Fees. But competition among Acquirers can only accomplish so much; each Acquirer faces the same network-set Interchange Fees and network fees as every other Acquirer, and each must include the Merchant Restraints in its contracts with merchants.

3.3. MasterCard and Visa's Price Discrimination Reflects their Substantial Market Power

50. In my initial report, I pointed to the Respondents' pervasive price discrimination, and their own descriptions of setting Interchange Fees to capture as much as possible of each merchants' value of accepting credit cards, as additional direct evidence of their market power. Professor Elzinga acknowledges that "it is technically true that some degree of market power is required for a firm to engage in price discrimination."[65] But he argues that price discrimination is pervasive and typically innocuous. He cites articles which warn that the fact of price discrimination "*by itself*" should not be relied upon to infer market power,[66] and that a firm should not "be presumed to possess market power *simply* because it offers discriminatory

[65] Elzinga Report, para 250.

[66] Elzinga Report, para 259 (emphasis in original).

prices."[67] I do not rely simply on the observation that MasterCard and Visa set different fees for different merchants and card types, unrelated to cost differences, to infer their market power. Rather, I rely on their systematic price discrimination on behalf of themselves and their member banks as part of a comprehensive analysis of market structure, market power, and the competitive consequences of Merchant Restraints and other competitive imperfections in the marketplace.

51. Professor Elzinga explains that price discrimination can be efficient. But the sources he cites explain that price discrimination can be more efficient than pricing under a "nondiscrimininating *monopoly*".[68] He cites Professor Carlton's textbook for the proposition that "Ramsey pricing is an important example of differential pricing" of the type he suggests is followed by MasterCard and Visa.[69] However, the cited section of Professor Carlton's textbook describes strategies for regulating the pricing of "*natural monopolies*."[70]

52. Professor Elzinga suggests that nothing can or should be inferred from the Respondents' systematic price discrimination throughout the entire retail sector in Canada. Yet, ironically, as I will discuss in Part 5 of this reply report, Professor Elzinga cites the alleged dangers of price discrimination *by individual merchants* as a justification for the Merchant Restraints.

3.4. Potential Entry Does Not Prevent Respondents from Exercising Market Power

53. I explained in my initial report that "entry into the relevant market is difficult and insufficiently likely to prevent the exercise of market power."[71] Professor Elzinga agrees that building a new general purpose credit card network in Canada would be costly.[72] There has not been new entry in Canada for several decades. As Professor Elzinga notes, the U.S. network Discover Card has made efforts to expand its merchant acceptance in Canada to serve its U.S. cardholders.[73] But Discover has not attempted yet to compete fully in Canada. Even if Discover

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67 Elzinga Report, para 259 (emphasis added).

68 Elzinga Report, para 258 (emphasis added).

69 Elzinga Report, para 255 and fn 220.

70 Dennis W. Carlton and Jeffrey M. Perloff, Modern Industrial Organization (4th ed 2005), pp. 700-02 (emphasis added).

71 Frankel Report, Part 4.1.3.

72 Elzinga Report, para 173.

73 Elzinga Report, para 178.

began issuing credit cards in Canada today, that would constitute a twenty-seven year lag between network creation and first issuance in Canada. There is no indication that the threat of entry by Discover Card in Canada has constrained the Card Acceptance Fees of MasterCard or Visa. Professor Elzinga also suggests that there is no "legal prohibition" on entry into the credit card market by Interac. However, he offers no analysis of Interac's governance or the incentives of its large bank members to compete with MasterCard and Visa, when the banks themselves benefit from the Respondents' high Interchange Fees.

54. Professor Elzinga explains that there is a lot of money potentially available to a successful new credit card network.[74] He argues that the potential profits ought to be sufficient to entice entry. Indeed, in recent years there have been a number of entrants and entrepreneurs who have attempted to gain a foothold with various payment systems and, for example, mobile "m-commerce" applications. However, many of these electronic wallet applications are not competitors to Visa or MasterCard. Rather, they merely serve as a convenient way to access an existing credit card account, not an attempt to replace the accounts themselves.

55. The Competition Bureau's Merger Enforcement Guidelines ("MEGs") recognize that the potential for entry can, in certain cases, prevent incumbents from exercising market power.[75] But the mere possibility of entry is generally considered insufficient to infer that an incumbent lacks market power. The MEGs, for example, explain that for the potential for entry to deter the exercise of market power, such entry must be "viable," and it must be "likely, timely and sufficient in scale and scope" to deter the incumbents from exercising market power.[76] None of these characteristics are applicable to this matter.

56. In fact, the Respondents' Merchant Restraints make it more difficult for a low cost entry strategy to succeed and therefore less likely for such entry to occur. As long as cardholders are treated the same at the point of sale whether they use a high cost card or a low cost card, cardholders will have no incentive to choose the low cost card. Indeed, if issuers of high cost cards share even a small amount of the additional revenue resulting from higher Interchange Fees with cardholders, the latter will be "steered" to use the high cost cards even if the merchant and cardholder together would be jointly better off with use of an entrant's low cost

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74 Elzinga Report, para 175.

75 Competition Bureau's Merger Enforcement Guidelines ("MEGs"), Part 7.

76 MEGs, Part 7.2

card product. Moreover, merely introducing a new network in the presence of the Merchant Restraints would not necessarily have any material impact on the level of Card Acceptance Fees, because the Merchant Restraints have led to a form of "perverse competition" where low cost payments providers find themselves at a competitive disadvantage unless they raise their merchant fees.[77]

3.5. "Excess Capacity" and the "Supply Elasticity of Other Firms" Does Not Prevent Respondents from Exercising Market Power

57. Professor Elzinga contends in his report that I have ignored the fact that existing credit card networks possess substantial excess capacity. He claims that this excess capacity is a measure of these networks' "supply elasticity" – the extent to which they will "expand their output promptly in order to take advantage of... [anticompetitively] higher prices."[78]

58. The problem with Professor Elzinga's analysis of supply elasticity is that it is offered in a conceptual vacuum. This is not a situation of a factory simply ramping up production to take advantage of a competitor's price increase by capturing a larger customer base. The effects of the Merchant Restraints must be considered. For the past several years, the cost of accepting a MasterCard transaction has exceeded the cost of accepting a Visa transaction. In a healthy competitive market, Visa might be able to take advantage of its lower price and excess capacity to indirectly expand its transaction volume at MasterCard's expense (as merchants used differential surcharges to steer more transactions to Visa).[79] With the Merchant Restraints in place, however, merchants' ability to engage in such a strategy is restrained and the differential price is not visible to consumers. Banks can choose to increase their issuance of MasterCard cards and encourage their use, driving up average overall Card Acceptance Fees, without suffering negative reactions from their cardholders relative to banks issuing more Visa cards. Moreover, as I explained in Part 2, above, this is true whether the focus is on Card Acceptance Fees or Professor Elzinga's "total price."

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77 Frankel Report, para 148.

78 Elzinga Report, para 166.

79 For example, without the Merchant Restraints in place, some merchants would be expected to impose higher surcharges for MasterCard transactions than for Visa transactions because of MasterCard's higher merchant fees, potentially steering transaction volume from MasterCard to Visa.

4. Anticompetitive Effects of the Merchant Restraints

59. In my initial report, I explained the bases for my opinions that the Merchant Restraints have anticompetitive effects. In particular, I explained that the Merchant Restraints influence upward and discourage the reduction of Card Acceptance Fees, and have an adverse effect on competition.[80] I also explained that the ability for merchants to surcharge credit card transactions has a different effect than an ability only to offer discounts, and that the Merchant Restraints result in higher retail prices paid by all consumers.[81]

60. The Merchant Restraints result in higher Card Acceptance Fees by prohibiting what would otherwise be economically significant sources of competition that would constrain network and bank pricing. This happens in a logical way that I explained in detail, and which has been acknowledged by the Respondents or their experts in other proceedings.[82] In this case, the Respondents' experts focus primarily on defending the effects of the Merchant Restraints, but they also claim or suggest that some or all of the anticompetitive effects of the Merchant Restraints are unlikely to occur, or that the form of the relationships among participants in the industry does not fit their prototype of a "resale price maintenance" case. In this part of my reply report, I review the main elements of my economic analysis of the competitive effects of the Merchant Restraints. I explain where the Respondents' experts' opinions agree with or support my analysis, and, where they disagree, why their claims do not alter my opinions.

4.1. Merchant Surcharging Would Likely Increase With the Level of Card Acceptance Fees, and Would Tend to Become More Commonplace Over Time

61. In my initial report, I explained that the likelihood of merchants surcharging increases with the level of Card Acceptance Fees. [redacted] I noted in my initial report that,

80 Frankel Report, Part 5.1.

81 Frankel Report, Parts 5.2 and 5.3.

82 Frankel Report, paras 124, 126, 132-36.

83 Frankel Report, para 126.

84 Frankel Report, para 126.

in Australia, the average level of Card Acceptance Fees was significantly higher for American Express and Diners Club transactions than for MasterCard and Visa transactions, which caused many merchants in that country to surcharge the former but not the latter.[85] Visa executive Elizabeth Buse confirms this fact.[86] As I have noted, average Card Acceptance Fees for MasterCard and Visa transactions in Canada are similar to the level of Card Acceptance Fees for American Express in Australia.[87]

62. I also explained that, because the Merchant Restraints have long been in effect, it will likely take time for the practice of surcharging to become accepted as a routine and common part of the retail marketplace.[88] Merchants are likely to be reluctant to be the first to surcharge among their most direct competitors, but once some merchants begin to surcharge credit card transactions, it will become easier for others to follow. I showed that the history in Australia supports this opinion. TD Bank's expert, Mr. Jairam, agrees with this assessment. He states that "[a]s consumers become more resigned to surcharging, a reduction in perceived risks will presumably lead to more widespread surcharging."[89]

4.2. Many Merchant Customers Would Choose Lower Cost Payment Methods to Avoid Paying a Surcharge

63. In my initial report, I reviewed the economic evidence from Australia, which supports my conclusion that, as one would expect, merchants that surcharge credit card transactions tend to induce changes in their customers' payment choices, with fewer customers choosing to use the surcharged cards.[90] Similar results were reported in a study of debit card surcharging in the Netherlands.[91]

64. The Respondents' experts do not dispute that surcharges in these countries have altered payment choice patterns by encouraging merchants' customers to complete fewer transactions using surcharged cards. Professor Mulvey, however, without elaboration, argues

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85 Frankel Report, para 130.

86 Buse Report, para 27.

87 Frankel Report, para 130.

88 Frankel Report, para 127.

89 Jairam Report, para 49.

90 Frankel Report, para 130.

91 Wilko Bolt, Nicole Jonker and Corry van Renselaar, Incentives at the Counter: An Empirical Analysis of Surcharging Card Payments and Payment Behaviour in the Netherlands, De Nederlandsche Bank Working Paper No. 196/2008 (December 2008).

that evidence from studies of experiences in Australia, the Netherlands and the United States "lack generalizability and are not applicable to the unique Canadian context."[92] I disagree. Apparently, so do the Respondents' experts, since Professor Elzinga, Mr. Jairam and Professor Mulvey himself all attempt to rely upon evidence from foreign jurisdictions as support for their opinions.

65. For example, in attempting to support his opinions, Professor Elzinga cites alleged unintended consequences arising from the Durbin Amendment in the United States, as well as payments regulation by the Reserve Bank of Australia.[93] Mr. Jairam similarly relies on information from the United States and Australia, along with surcharging experiences from the United Kingdom and the Netherlands.[94] Finally, Professor Mulvey relies on evidence from the Netherlands and Australia in support of his opinions.[95] MasterCard and Visa routinely claim that the payment card reforms undertaken in Australia have had harmful effects and should serve as a lesson for policymakers in other countries, including Canada.[96]

66. As for Canada, Mr. Jairam assumes that some merchants will surcharge, and states that "[o]verall, if widespread surcharging occurs, it will logically lead to a decline in the volume and value of credit card transactions as consumers migrate to other payment instruments."[97] Professor Elzinga agrees that widespread surcharging of Visa credit cards would cause "a reduction of transactions on the Visa network" and that this "helps explain why Visa and MasterCard are opposed to allowing surcharges to be imposed on cardholders using cards on the networks they have established."[98] As I explain below, the concern that surcharging on credit cards will cause customers to migrate to other payment options with a corresponding decline in the volume of credit card transactions provides a strong incentive for MasterCard and Visa to reduce their fees. It follows that by eliminating the strong incentive that

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92 Mulvey Report, para 18.

93 Elzinga Report, paras 97, 101.

94 Jairam Report, paras 19-20, 28, 48.

95 Mulvey Report, notes 4, 12, 13.

96 See, e.g., Testimony of Kevin Stanton, President, MasterCard Canada Inc., before the Senate of Canada, Standing Committee on Banking, Trade and Commerce, April 23, 2009, pp. 5:7-5:8; Testimony of Bill Sheedy, Regional President, North America and Head of Interchange Strategy, Visa Canada, before the House of Commons Standing Committee on Industry, Science and Technology, May 14, 2009, p. 17.

97 Jairam Report, para 19.

98 Elzinga Report, paras 193-4.

would result from the ability of merchants to surcharge on Visa and MasterCard credit card transactions, the Merchant Restraints influence upwards Card Acceptance Fees.

4.3. Card Networks Have a Strong Economic Incentive to Reduce the Incidence and Level of Surcharging, and Selective Acceptance, and Can Do So By Reducing Their Fees

67. As I will discuss further in Part 5, below, the Respondents' experts claim that if merchants widely surcharge credit card transactions in Canada, this will cause significant harm to MasterCard and Visa. Mr. Jairam concludes that widespread surcharging would "impact credit cards as a payment instrument."[99] Professor Elzinga explains that, with surcharges, "[t]he image of the Visa and MasterCard brand names would be diminished" and that "[n]o-surcharge rules protect the value of the networks' brands from being eroded."[100] Professor Mulvey similarly claims that surcharges "pose a great threat" to MasterCard and Visa's "brand value" and that "MC and VISA's defense of the No-Surcharge Rule is driven by a desire to defend brand equity: the firms' greatest asset."[101]

68. Because higher fees lead to more surcharging and because more surcharging leads to less usage of the cards that are subject to surcharges (at merchants that already accept the cards), it is logical that the Respondents will have an economic incentive to minimize surcharging.[102] I agree with the Respondents' experts that this explains why the Respondents enforce the Merchant Restraints to prevent surcharging and selective acceptance. But this means that, without the Merchant Restraints, the Respondents would have to act to preserve the volume of credit card transactions on their respective networks through the other principal tool available to them: lower Card Acceptance Fees.

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99 Jairam Report, para 19.

100 Elzinga Report, paras 194, 227.

101 Mulvey Report, paras 56, 62.

102 Frankel Report, Part 5.1.2.3.

70. In my initial report, I also cited evidence regarding American Express, which has significantly higher Card Acceptance Fees in Australia (fees which are similar to those of MasterCard and Visa in Canada). American Express' fees remained unregulated, but American Express agreed to permit surcharging of its cards. American Express is subject to significantly more surcharging by merchants than MasterCard and Visa, and has reduced its Card Acceptance Fees by more than MasterCard and Visa lowered their Interchange Fees despite the fact that latter were subject to direct regulation.

71. Professor Elzinga states in his report that he is "unpersuaded" by this evidence, arguing that I "provide[ ] no evidence that the elimination of those rules in turn caused the reduction in those fees."[104] Professor Mulvey similarly is sceptical about evidence that in Australia, Woolworths was able to use the threat of surcharging to negotiate substantially lower interchange fee rates.[105] But the Reserve Bank of Australia itself reviewed this evidence, and concluded that "the ability to surcharge provides a negotiating tool for merchants who might use the threat of surcharging to negotiate lower fees,"[106] and that "[e]vidence from card schemes and merchants indicates that the ability to surcharge is putting some downward pressure on interchange fees and merchant service fees in some areas."[107] American Express itself has explained that "[t]he effect of sustained competitive pressure on American Express, driven by price reductions in the dominant schemes, *and the effects of merchant surcharging – or the*

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104 Elzinga Report, para 95.

105 Mulvey Report, para 60.

106 Reserve Bank of Australia, A Variation to the Surcharging Standards: A Consultation Document, December 2011, p. 2.

107 Reserve Bank of Australia, Reform of Australia's Payments System: Conclusions of the 2007/08 Review, p. 18.

threat of surcharging – have prevented the three-party schemes from achieving anything more than a transitory high-water mark increase in market share."[108]

4.4. Surcharging Has a Different Economic Effect Than Discounts

72. In my initial report, I explained that the Respondents have long recognized and explained that the ability for merchants to surcharge credit card transactions has a different effect in the marketplace than their ability merely to offer discounts for alternative payment methods or brands, notwithstanding claims sometimes made by the Respondents and their consultants that the two practices are equivalent.[109] Professor Elzinga repeats the claim that surcharges and discounts generate "exactly the same outcome."[110] But, as I explained in Part 4.3 above, one of the main *justifications* offered by the Respondents' experts for the Respondents' Merchant Restraints is that widespread surcharging of credit card transactions poses a vastly different and greater threat to the Respondents' "brand equity" than the ability of merchants' to offer discounts for the use of preferred payment methods and brands.

73. If the negative economic consequences of surcharges to MasterCard and Visa are greater than discounts, and higher Card Acceptance Fees lead to more surcharging, as I have shown, then it follows logically that there will be a more significant economic constraint on the level of Respondents' Card Acceptance Fees when merchants can respond to high fees by surcharging credit card transactions than when they are forbidden from doing so.

74. This should not be a controversial conclusion; as I explained,

75. Nevertheless, the Respondents' experts now contend that discounts are "more effective" at "moving" or "steering" merchants' customers to use lower cost forms of payment.[111] This is a peculiar and counterintuitive contention. In fact, very few Australian merchants attempt to steer their customers to low cost payment methods by offering discounts, while at the same time, surcharging has become widespread in Australia. Where surcharges are permitted, the

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108 American Express Australia Limited, "Review of Payment System Reforms: A Submission to the Reserve Bank of Australia," August 2007, p. 12 (emphasis added).

109 Frankel Report, Part 5.2.

110 Elzinga Report, para 186.

111 Elzinga Report, para 191; Gauthier Report, p. 17; Mulvey Report, para 16.

public has come to understand that when they use credit cards that impose higher costs on merchants, they may face fees.

76. The Respondents' experts base their claim about the relative "effectiveness" of surcharges and discounts on a survey conducted by Mr. Gauthier and the design to which Professor Mulvey contributed (the "Gauthier-Mulvey survey").[112] However, the Gauthier-Mulvey survey is misleading and does not provide reliable evidence of the relative effects of surcharging and discounting.

77. The main purpose of the Gauthier-Mulvey survey appears to be to shed light on the following question: "[i]n altering credit card use, what is the comparative effectiveness of discounting, surcharging, and other strategies?"[113] However, contrary to the assumption made by the Respondents' experts, "altering credit card use" is not the relevant economic goal when it comes to permitting merchants to surcharge credit card transactions. In fact, "altering credit card use" is a means to an end. That ultimate goal is to permit merchants to use surcharges, or the threat of surcharges, to better align the incentives of the merchants and their customers and receive lower Card Acceptance Fees. With the Merchant Restraints in place, if a credit card customer perceives even a slight advantage in using a credit card at the point of sale, that will be the choice made by the customer, even if that choice imposes significantly higher costs on the merchant (and thus other customers through higher retail prices) and even if the benefit to the credit card user is exceeded by the costs imposed on others. With a surcharge, a merchant can become indifferent to payment choice. Either the customer uses cash or a debit card, and pays the lower posted price, or the customer uses a more costly credit card, but the merchant receives the surcharge in addition to the posted price. Thus, continued use of a credit card is not a "failure" of surcharging to have its desirable economic effects. A "success" with surcharging does not occur only when a customer chooses a lower cost payment, as assumed by the Respondents' experts, but also when the customer's value of using a credit card exceeds the surcharge, and so completes the transaction using a credit card.

78. Furthermore, the Gauthier-Mulvey survey cannot shed much light, if any, on the relative effects of surcharging and discounting, as no context for these topics was provided to the survey respondents. Survey respondents were told that "[t]he results of this study will be used to make decisions that affect the everyday life of every Canadian" and that "[s]ince only a

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[112] Gauthier Report, p. 1. Mulvey Report, para 19.

[113] Gauthier Report, p. 2.

limited number of people will be involved in the study, your participation is extremely important."[114] But respondents who lacked a credit card, and thus stand to benefit most (relatively) from elimination of the Merchant Restraints, were not questioned at all about their preferences.[115] Survey respondents who did possess credit cards were asked a series of questions, including questions designed to determine whether they would prefer, on one hand, to be offered a discount when using cash, cheque, or debit cards (or, alternatively, "standard" credit cards) instead of credit cards (or, alternatively, "premium" credit cards), or, on the other hand, to be charged a surcharge for use of a credit card (or for a premium credit card). No context was supplied about the store's assumed posted retail prices in these scenarios.

79. It is unsurprising (and not worth the cost of conducting a survey) to find that a consumer would prefer to pay a lower price than a higher price. The only choices presented to survey respondents were (a) pay the posted price for the product, or receive a discount when using a lower cost payment method, such as cash or debit, versus (b) pay the posted price, plus an additional amount if using a credit card. The assumption in these questions apparently is that the posted price is the same in either case. What the survey designers failed to advise respondents, however, is that in order to profitably offer discounts to all customers using payment methods other than credit cards, merchants would have to increase the posted price. [redacted] The reaction of survey respondents might have been quite different if the choice presented was (a) pay a price that has been increased by 2 percent, or receive a 2 percent discount from that elevated price for paying with cash or debit, versus (b) pay a lower price with an additional 2 percent fee if electing to pay with a credit card.

80. Further, no context was provided to survey respondents (such as average Card Acceptance Fees) when asked how the surcharges would make them feel. No context was provided as to the existence of a debate about these subjects, or about the assumed legality of surcharges and their compliance with MasterCard and Visa rules in the scenarios presented.

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114 Gauthier Report, Appendix B, Survey questionnaire introduction (CONSIGNE).

115 Gauthier Report, p. 3.

116 [redacted]

81. For these reasons, I find that the survey sheds little light on the relevant economic issues. What little light it does shed, moreover, is consistent with my conclusions.

82. Professor Mulvey notes that "[d]iscounts ... yield the most positive levels of consumer sentiment. Comparatively, consumers love discounts and display little affection for other steering mechanisms" and that "[s]imply put, Canadian consumers hate the idea" of surcharges.[117] The natural conclusion from this is that merchant surcharges pose a greater competitive threat to the Respondents' payments volume and the level of their Card Acceptance Fees. Indeed, the ratio of Gauthier-Mulvey survey respondents who, for example, stated that they would continue to use credit cards, relative to those who said they would switch to cash, was less for the surcharge scenario than for the discount scenario. Specifically, the survey discloses that when faced with a 1% discount on the use of cash, cheques or debit cards, 21% of respondents would nevertheless continue to pay with a credit card.[118] However, when faced with a 1% surcharge on the use of a credit card, only 8% would continue to pay using a credit card.[119] Even with the flawed methodology employed in the Gauthier-Mulvey survey, the results demonstrate the effectiveness of surcharging over discounts.

83. The Respondents' experts, however, focus exclusively on the total percentage of survey respondents who said they would switch to cash. Because a significantly larger percentage of respondents claimed they would use neither cash nor credit, but rather would "walk out" of the store, the Respondents' experts conclude that discounting is more "effective." If, as the Gauthier-Mulvey survey reports, about one-third of "standard" credit card customers would walk out of a merchant's store if the merchant assessed a surcharge for credit card use, then the Respondents should have nothing to worry about by permitting surcharges – few merchants could possibly benefit from imposing a small credit card surcharge if doing so required the sacrifice of one-third of their sales. Yet, in Australia, close to one-third of merchants surveyed *do* surcharge at least some credit card transactions.[120] Typically, these surcharges are assessed on the more costly American Express and Diners Club cards which have comparable fees to those of MasterCard and Visa credit cards in Canada.

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117 Mulvey Report, paras 24, 32.

118 Gauthier Report, p. C-48.

119 Gauthier Report, p. C-57

120 See: Reserve Bank of Australia, "Review of Credit Card Surcharging: A Consultation Document" (June 2011) at 2.

4.5. The Merchant Restraints Increase Merchant Prices and Force All Consumers to Bear Those Higher Prices

84. Professor Elzinga and the Respondents' other experts claim that "merchants will pocket all or some of the hypothetical reduction in interchange rates (or, for that matter, the surcharge)".[121] In Professor Elzinga's claimed "two-sided" market in which the "total price" is all that matters in assessing the competitive effects of the Respondents' conduct, merchants and the fees they pay constitute one of the "sides" he claims is relevant to the analysis. If all that matters is the total amount of fees paid by cardholders and merchants, then a reduction in merchant fees is beneficial in that computation irrespective of how merchants respond to their lower payment costs when setting their own retail prices. The same is true looking only at merchants, which are, in fact, the relevant consumer of Credit Card Network Services in the same way that they are the relevant consumer of retail real estate.

85. Nevertheless, as I explained in Part 5.3 of my initial report, it is a basic feature of competitive economics that lower marginal costs, such as occurs with lower payment costs, can be expected to be reflected by merchants in lower prices. The ability for merchants to surcharge credit card transactions can be expected to reduce their net cost of accepting payments in three ways. First, surcharging encourages the use of lower-cost payment methods, such as debit cards.[122] Second, the threat of increased surcharging and shifts of transaction volume to lower cost payment methods pressures networks to reduce their Card Acceptance Fees. Third, net merchant payment costs for accepting credit card transactions fall dramatically if the merchant chooses to surcharge those transactions.

86. I explained in my initial report that the "equivalence" argument – that surcharges are economically equivalent to discounts – concedes the point that retail prices adjust to reflect net payment costs.[123] Even if, initially, retailers attempt to simply add a surcharge without

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121 Elzinga Report, para 100.

122 As Mr. Jairam notes, most Canadians do not "revolve" a balance on their credit card account, but rather pay their balance in full each month. Jairam Report, para 43. Such customers might nevertheless choose to pay using a credit card to get Professor Elzinga's assumed 1 percent reward, rather than using a debit card, despite the roughly 2 percent higher fee (as a percentage of the transaction amount) that this imposes on the merchant, and even if the customer's transaction account had an ample balance. But such a customer would have far less of an economic incentive to use a credit card if the merchant assessed a 2 percent surcharge for use of a credit card.

123 Frankel Report, para 165.

reducing their prices, competition among retailers will erode their prices and re-establish the competitive equilibrium.

87. In his report, Mr. Jairam ignores this basic fact of competitive economics, and assumes that retail prices are fixed, so that a surcharge, for example, as established by an online retailer, will simply add to the total price.[124] Professor Elzinga identifies three reasons why he claims, "merchants will pocket all or some of the hypothetical reduction in interchange rates." First, "[m]any merchants," he claims, "have some degree of market power," so that they "may not pass the entire savings on in the form of lower prices."[125] As I explained in Part 3, Professor Elzinga asserts that MasterCard and Visa themselves lack "undue" market power. He essentially considers them to be perfectly competitive (or contestable) providers of network services whose prices can be undercut if they tried to raise prices by even a small amount. Yet, he assumes that the broad retail merchant sector in Canada is typified by significantly less competition than the credit card network industry. This assumption is neither credible nor supported by any evidence.

88. Second, Professor Elzinga cites an article written by Visa consultants Howard Chang, David Evans and Daniel D. Garcia-Swartz which claims to show that it is "doubtful" that small reductions in cost would "quickly" be "passed on to consumers."[126] Professor Elzinga claims that the Chang-Evans article also establishes that price reductions in Australia were "anemic" and that "merchants have tended not to pass through the reduction in the merchant discount in the form of lower prices" in that country.[127] But the economic literature on pass-through often finds that there is essentially 100 percent pass-through of cost changes.[128]

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[124] Jairam Report, para 20.

[125] Elzinga Report, para 100.

[126] Elzinga Report, para 101, citing 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," Interchange Fees: the Economics and Regulation of What Merchants Pay for Cards, Competition Policy International (2011), p. 71.

[127] *Ibid.*

[128] See, e.g., Johan Stennek and Frank Verboven, "Merger Control and Enterprise Competitiveness: Empirical Analysis and Policy Recommendations," Working Paper No. 556, The Research Institute Of Industrial Economics (May 2001), p. 75 ("It seems fair to say that the literature on the effects of excise taxes and intermediate goods prices finds that pass-on is close to 100 percent, at least when one considers a sufficiently large time horizon (10 weeks or more)... [I]ndustry-wide pass-on is more or less complete..."). Published in European Merger Control, Do We Need an Efficiency Defense?, Ilzkovitz, Fabienne; Meiklejohn, Roderick, eds.; 2006, pp. ix, 326, Published on behalf of the Commission of European Communities. Cheltenham, U.K. and Northampton, Mass.: Elgar.

Moreover, Chang et al. based their conclusions about retail price effects from lower merchant fees in Australia on a survey of merchants who were asked if they changed their retail shelf prices in response to what Chang et al. estimate was a 0.21 percent reduction in merchant costs.[129] It is not surprising that merchants did not indicate that they would immediately change all of their posted prices in response to an incremental reduction in their overall costs, but economists expect such cost reductions to be reflected in prices over time. Moreover, a credit card surcharge of 2 percent creates a net cost difference that is ten times as great as that reviewed by Chang et al. in Australia.

89. In responding to an illustration of these effects offered by Professor Carlton, Professor Elzinga himself accepts that retail prices fully adjust. Professor Carlton gave an example in which a merchant posted a price of $101 without surcharges and with 50% credit card use, but would instead offer a posted price of $100 with a $2 surcharge for credit cards if the Merchant Restraints were eliminated. Professor Elzinga argues that, with discounts, the merchant would achieve the "exact same outcome" with a posted price of $102 and a discount of $2. But in order to make that argument, Professor Elzinga must acknowledge that in order to discount, the retailer would have to first increase the posted price from $100 to $102 so as to fully reflect payment costs.

90. One of the competitive effects of no-surcharge rules is a cross-subsidy between users of credit cards and users of other payment methods. Customers who use cash or debit cards pay the same amount as customers who use credit cards. But while the latter might obtain a reward (such as Professor Elzinga's assumed 1 percent rebate), the former do not. Moreover, because customers who do not have credit cards (or reward cards) tend to be relatively less wealthy, and those getting the most lucrative rewards tend to be more wealthy, there is a regressive element to this cross-subsidy. This feature of no-surcharge rules has long been recognized, and is (or ought to be) an inescapable conclusion.[130]

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129 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," Interchange Fees: the Economics and Regulation of What Merchants Pay for Cards, Competition Policy International (2011), p. 71.

130 See, e.g., Scott Schuh, Oz Shy, and Joanna Stavins, "Who Gains and Who Loses from Credit Card Payments? Theory and Calibrations." Federal Reserve Bank of Boston Public Policy Discussion Paper No. 10-03, July 2010.

91. But Professor Elzinga attempts to argue that there is, in fact, no cross-subsidy, and that, properly measured, credit cards do not even cost merchants more than debit cards. He argues that certain "lending costs" associated with providing the credit function of credit cards benefit merchants – by relieving merchants of the need to supply credit themselves – and thus ought to be subtracted from Card Acceptance Fees to make an "apples to apples" comparison with the costs to merchants of accepting debit cards or cash.[131]

92. Professor Elzinga's counterfactual restatement of one of the basic facts of the marketplace at issue – the cost to merchants of accepting credit cards – is wholly inappropriate. Merchants do not extend credit to cardholders, issuers do. Professor Elzinga disregards the fact that cardholders often finance such credit at high interest rates. He also fails to note that as Mr. Jairam concedes, most Canadians pay their credit card balances in full each month.[132] In any event, most merchants historically never offered credit cards, but when they did so, in addition to incurring costs, they obtained the revenue from their credit card operations. If Professor Elzinga thinks it appropriate in comparing payment costs to adjust the existing level of merchant fees by subtracting the costs that merchants do not incur to provide credit, it would also be appropriate to add to their costs the finance charges, annual fees, late fees, and other revenue that the merchants do not receive. But the entire exercise is irrelevant and economically meaningless. When a merchant's customer chooses to use a high-cost credit card to obtain a reward of 1 percent instead of an Interac card, resulting in a merchant cost that increases by 2 percent, it makes no sense to claim that the merchant is no worse off because it was relieved of operating a hypothetical credit card lending business in which it may or, more likely, may not have any interest.

4.6. The Merchant Restraints Constitute Price Maintenance

93. The economic substance and effects of the Merchant Restraints constitute a form of price maintenance in respect of the price paid by merchants for Credit Card Network Services. In my initial report,[133] and in my published writings,[134] I explained that the Merchant Restraints are a form of price maintenance that increases prices paid by merchants and their customers. I also describe in detail in my initial report and in this reply report how the Merchant

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131 Elzinga Report, paras 111-114.

132 Jairam Report, para 43.

133 Frankel Report, para 138.

134 Frankel, Monopoly and Competition, p. 344.

Restraints have an adverse effect on competition, including by constraining competition with respect to Card Acceptance Fees.

94. The Respondents' experts contend that the contractual arrangements between MasterCard and Visa and their respective Acquirers do not fit the prototypical textbook scenario for "resale price maintenance." But, according to Professor Elzinga, "[p]rice maintenance is understood by economists as a business practice whereby an upstream firm constrains its customers' downstream prices."[135] From an economic perspective, that is precisely what the Merchant Restraints do. MasterCard and Visa establish and publish rules that they require each Acquirer (the customers of Visa and MasterCard with respect to the supply of Credit Card Network Services) to impose on their merchant customers that accept the Respondents' respective brands of credit cards and to which Acquirers supply Credit Card Network Services. These rules include the Merchant Restraints, which influence upwards the price paid by merchants for Credit Card Network Services and have an adverse effect on competition.

95. Specifically, as I explain in my initial report, the Merchant Restraints result in higher prices for Credit Card Network Services for merchants than would otherwise prevail in the absence of the Merchant Restraints.[136] Indeed, as discussed above and in my initial report, the Respondents and their experts have repeatedly acknowledged the economic reality that allowing merchants to surcharge intensifies competition over the level of Card Acceptance Fees.

5. Justifications Offered For The Merchant Restraints

96. Both in this proceeding and in other venues, the Respondents and their economic consultants and experts have offered a wide variety of claimed justifications for enforcing the Merchant Restraints. As I have noted, they sometimes deny that no-surcharge rules have any economic effect (due to the availability of discounting as an alternative), while simultaneously defending the no-surcharge rule based on claims that the effects of surcharging are very different from those of discounts.

97. In this part, I review claims by the Respondents and their experts that the Merchant Restraints are justified. Their main arguments involve the common theme that merchants' interests are adverse to the interests of the merchants' customers, while the

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[135] Elzinga Report, para 76.

[136] Frankel Report, para 138.

interests of MasterCard, Visa, and their member banks are aligned with those of the merchants' customers. The Respondents and their experts characterize the issues surrounding Interchange Fees and surcharges as if it were a zero-sum game between merchants and their customers. Lower Interchange Fees, they contend, are a "wealth transfer" from consumers to merchants.[137] Surcharges similarly are portrayed as "profiteering" or "price gouging" by merchants at the expense of their own customers. Such characterizations are misleading and incorrect. Moreover, many of the purported justifications turn reality on its head, for example, by claiming that merchants typically have market power, but that the Respondents do not, or that alleged price discrimination by merchants justifies the Merchant Restraints, while price discrimination by MasterCard and Visa is innocuous.

98. I have touched on many of these issues already in my initial report and earlier in this reply report, and my opinions concerning these purported justifications and the bases for them thus incorporate what I have already said about these topics.

5.1. Claims of Merchant Market Power, "Gouging" and Price Discrimination

99. Many of the justifications offered for the Merchant Restraints focus on the argument that it is not MasterCard and Visa (with their combined 92 percent of credit card transaction volume in Canada)[138] that threaten the public with the exercise of market power. Rather, it is claimed, it is the individual operators of the 1.3 million merchant locations[139] at which those cards are accepted that pose such a threat. The Respondents' experts contend that *merchants* who would surcharge must possess market power[140] which, in the absence of the Merchant Restraints, would manifest itself in the form of "gouging,"[141] "profiteering"[142]

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137 Jairam Report, para 20; Buse Statement, paras 24, 36.

138 Nilson Report #991, March 2012, p. 7.

139 http://www.cba.ca/contents/files/statistics/stat_cc_db038_en.pdf

140 Jairam Report, paras 47, 63, 65; Church Report, paras 12, 84, 85; Dunn Report, paras 3, 47, 65; Elzinga Report, para 100.

141 Mulvey Report, para 56. This echoes a claim that has been made by the Respondents in various venues. See, e.g., Response by MasterCard Worldwide to the Issues for the 2007/08 Review, August 31, 2007, p. 16 (The 'no surcharge' rule... protects consumers from price gouging by merchants that have market power."); Comments by Mr. Bruce Mansfield, Executive Vice President, Australia and New Zealand, Visa International, Public hearing of the House of Representatives Standing Committee on Economics, Finance and Public Administration, Sydney, 15 May 2006, p. 2 ("It is worse in the case of those merchants who actually seek to make a profit by means of surcharging and are effectively gouging cardholders, some of whom may have no choice but to use their cards.").

142 Mulvey Report, para 56.

exploitation,[143] and "excessive"[144] surcharges, and "price discrimination."[145] This argument is not relevant to the question of whether the Merchant Restraints influence upwards Card Acceptance Fees and have an adverse effect on competition. But even if it were, the Respondents and their experts have not established that merchants would systematically engage in economically inefficient conduct, let alone that any inefficiencies generated by particular merchants would be of such magnitude as to justify the economy-wide suppression of price competition among payment providers at the merchants' points of sale, as required by the Merchant Restraints.

100. The Respondents' experts do not establish that a substantial fraction of the merchant sector in Canada possesses significant market power.[146] Moreover, "price gouging" and "profiteering" are not terms of art in economics.[147] The claim that merchants that surcharge may "gouge" or "profiteer" appears to be grounded in an assumption by the Respondents' experts that any surcharge that is greater than the Card Acceptance Fee paid by a merchant for a card transaction is inherently "excessive."[148]

101. This is a peculiar assertion for the Respondents' experts to make, considering that Card Acceptance Fees paid by merchants to accept the Respondents' cards in Canada are *an order of magnitude or more* above any costs associated with providing these services to merchants. Through their interchange and network fees, MasterCard and Visa set a floor to the level of Card Acceptance Fees charged by the entire banking industry to any individual Canadian merchant. They justify the level of the fees charged to merchants based on the merchants' *willingness to pay* – not on any measure of cost.[149] Indeed, MasterCard and Visa

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143 Elzinga Report, para 233.

144 Jairam Report, para 19, 20, 63, 99, 101; Dunn Report, para 34, 47, 64.

145 Elzinga Report, para 231.

146 In fact, they do not identify any Canadian merchants that have attained market power, let alone by anticompetitive means, or offer any argument that anticompetitive Merchant Restraints can be competitively justified even if an individual merchant possesses and exercises unilaterally acquired, lawful market power.

147 Typically, "price gouging" statutes restrict price increases on "essential commodities" following a natural disaster when demand for those commodities spikes and supply may be disrupted. See, e.g., "Price Gouging Frequently Asked Questions," Florida Office of the Attorney General, http://myfloridalegal.com/__85256CC5006DFCC3.nsf/0/5D2710E379EAD6BC85256F03006AA2C5?Open&Highlight=0,gouging.

148 Dunn Report, paras 3, 47; Jairam Report, paras 20, 63, 74.

149 The cost of providing Credit Card Network Services to merchants is approximated by the acquirer margin when acquirers are competitive, or by the cost of accepting an Interac debit transaction.

concede that [redacted] [150] Yet, if a sandwich shop pays a Card Acceptance Fee of 1.9 percent (due to an interchange fee of 1.6 percent and network and acquirer fees that add another of 0.3 percent), and the merchant assesses a surcharge rounded up to 2 percent, MasterCard and Visa, and their experts, contend that it would be the merchant that would be engaged in "price gouging" and the exercise of market power.

102. Professor Elzinga, moreover, contends that price discrimination – charging higher prices to merchants with less elastic demand – is economically efficient and competitively innocuous *when done by MasterCard and Visa* with respect to fees paid by merchants.[151] Yet Professor Elzinga labels *any* surcharge *by an individual merchant of any size* "discrimination" or "price discrimination" that justifies rules to prohibit it.[152]

103. The Respondents' experts do not explain why the normal competitive process is insufficient to constrain pricing by merchants of all the goods and services that they sell. In particular, the Respondents' experts have offered no reason why competition among merchants in Canada is inadequate to constrain their credit card surcharges.

Mr. Dunn compares the level of Interchange Fees with a measure of *issuer* "costs" and argues that Interchange Fees are below those costs. Dunn Report, paras 3, 15-19. That is an economically meaningless comparison (and it plays no role in Professor Elzinga's defence of Interchange Fees or the Merchant Restraints). Issuers serve cardholders, not merchants. At one time, MasterCard and Visa both attempted to justify Interchange Fees on the basis that certain costs incurred by issuers reflected services they claimed were provided for the benefit of merchants. See, e.g., Alan S. Frankel and Allan L. Shampine, The Economic Effects of Interchange Fees, 73 Antitrust Law Journal 627, pp. 660-63. First Visa, then MasterCard abandoned these cost-based justifications for the existence and level of their Interchange Fees and ultimately adopted the "balancing" argument described by Professor Elzinga. As I described in my initial report, [redacted] Frankel Report, para 106 and fn 142.

150 [redacted] Commission Decision of 24 July 2002 relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA Agreement (Case No COMP/29.373 — Visa International — Multilateral Interchange Fee), Official Journal of the European Communities (2002/914/EC), L318/19. ("Visa does not consider its MIF as a price for specified services provided by issuers to acquirers or merchants."). See also: Bradley Examination December 8, 2011, pp. 1070-71, Qs. 3028-30 and Bradley Examination, December 9, 2011, p. 1233, Q. 3517.

151 Elzinga Report, para 255.

152 Elzinga Report, para 231.

104. The Respondents' experts also fail to establish why providing merchants with the ability to apply surcharges on credit cards somehow bestows market power upon merchants. If a merchant does possess market power, it could exercise that market power directly over all of its customers by raising prices, rather than imposing a credit card surcharge. It has been suggested by Visa consultants in other proceedings that a merchant with market power could profitably engage in price discrimination against credit card customers because, on average credit card customers have *less* elastic demand.[153] In this case, however, Professor Elzinga argues that credit card customers may have relatively *more* elastic demand.[154] Credit card customers cannot simultaneously be relatively elastic customers and relatively inelastic customers.[155]

105. Fundamentally, even if it were correct, an argument that the no-surcharge rule is intended to prevent some individual merchants from exercising their unilateral market power does not state a *competitive* defence of the no-surcharge rule. Even if a particular merchant possesses market power, there is nothing to suggest that such market power was obtained

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153 See, e.g., Visa International Service Association, Response to the Reserve Bank of Australia's Consultation Document and Report of Professor Michael Katz (Prepared by Network Economics Consulting Group Pty Limited), March 2002, p. 134 ("[O]ne strong possibility is that, even if they were already extracting monopoly rents, a surcharge would allow retailers to extract greater rents to the extent that surcharging serves as an effective form of price discrimination. For example, surcharging could be used to price discriminate against the less price-sensitive consumers – the fact that such consumers choose to pay using credit cards would signal to retailers that they are likely to be in this category."); David S. Evans and Richard Schmalensee, The Economics of Interchange Fees and Their Regulation: An Overview, in Interchange Fees in Interchange Fees in Credit and Debit Card Industries: What Role for Public Authorities? Federal Reserve Bank of Kansas City (2005), pp 92-93 ("[M]erchants could use surcharges as a mechanism for price discrimination.")

154 Elzinga Report, para 261, p. 123, fn 226. Professor Elzinga argues that the existence of credit cards might thus make merchant prices lower than they otherwise would be. Even if true (and he offers no evidence), it is not the existence of credit cards that is at issue, but rather anticompetitively high fees for accepting credit card transactions. Credit cards would still be available to consumers to facilitate purchasing "'big-ticket' items... or to stock up... when retail prices are attractive" or to "facilitate shopping over the Internet" if card acceptance fees were lower. Elzinga Report, para 189.

155 In the early days of the Respondents' credit card networks, it may have been true that possession of a general purpose credit card signalled something important about the economic and demographic characteristics of a customer (i.e., high income professional, etc.). But Mr. Gauthier reports that 87 percent of sampled adult Canadians now possess at least one general purpose credit card. Gauthier Report, Table C-7. Credit card use today signifies, at most, that a customer is not among the poorest or least creditworthy of citizens, but beyond that, likely conveys little information to most merchants. Credit card use can just as easily today reflect a liquidity constrained consumer between paycheques as it can a high income individual.

through anticompetitive conduct, or that the merchant's (assumed) price discrimination is inefficient or anticompetitive.

106. Finally, even if surcharging by an amount greater than the Card Acceptance Fee paid by the merchant could fairly be characterized as "excessive" and even if that justified intervention by the Respondents, there is a far less competitively restrictive alternative to a blanket prohibition on surcharging. In 2009, for example, MasterCard and Visa settled litigation brought by the New Zealand Commerce Commission under that country's competition laws. As a result, surcharging – and differential surcharging – is now permitted in New Zealand. But MasterCard and Visa retained the right under the settlement to require that "if a merchant applies a surcharge for payment by any MasterCard [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 MasterCard [Visa] products."[156] MasterCard and Visa apply a similar rule in Europe. For example, Rule 5.11.2 of MasterCard's rules requires that "[i]f a Merchant applies a surcharge for payment by Card, the amount or method of calculation of the surcharge must be clearly indicated to the Cardholder at the POI location and must bear a reasonable relationship to the Merchant's cost of accepting Cards."[157]

107. The fact that the no-surcharge rule applies in Canada even to the smallest merchants and those with no market power – clearly the vast majority of card accepting merchants – and permits no surcharges of any magnitude (even those reasonably related to card acceptance costs) make it unlikely that the primary intent and effect of MasterCard and Visa no-surcharge rules is to *protect* consumers from the exercise of market power. Instead, for the reasons I have explained, the no-surcharge rule reflects and exacerbates MasterCard's and Visa's substantial market power.

[156] MasterCard settlement agreement, GSSS0035_00012527; Visa settlement agreement, http://www.comcom.govt.nz/assets/Imported-from-old-site/TheCommission/MediaCentre/Judgments/ContentFiles/Documents/comcom-visainterchangesettlementagreement-aug2009.pdf, §4.3. and, §4.4 (of each agreement). The Reserve Bank of Australia is considering permitting MasterCard and Visa to enforce similar limits to surcharging in that country. Reserve Bank of Australia, A Variation to the Surcharging Standards: A Consultation Document, December 2011.

[157] MasterCard Rules, 7 December 2011, "Europe Region Rules", section 5.11.2 [MCW_CCB_00173940 at 4196] and Visa Worksheet, "Visa Europe" [VISA00303135].

108. Mr. Jairam, Mr. Dunn, and Ms. Buse note that in Australia and the United Kingdom, regulators have recently re-examined the issue of credit card surcharges.[158] In those countries, the Respondents made essentially the same arguments about "excessive" surcharging and opportunistic merchants. While the regulators are moving to permit some network controls on surcharging (such as permitting network rules requiring that a surcharge be reasonably related to the cost of the payment to the merchants), they have reaffirmed the general desirability of permitting credit card surcharges and have not moved to rescind that merchant freedom. After looking at the evidence presented by opponents of surcharging, along with the rest of the record, the Reserve Bank of Australia and the UK Office of Fair Trading have concluded that they made the correct decision in allowing surcharging, that surcharging has been procompetitive, and that surcharging is an effective means of disciplining banks and card networks' pricing to merchants.

109. The Reserve Bank of Australia "remains of the view that the benefits of the removal of the no-surcharge rules have been substantial" and that 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."[159] Similarly, the UK Office of Fair Trading has concluded that "[r]etailers should still be able to impose transparent surcharges to consumers who choose to use payment mechanisms which cost more to process"[160] and that transparent surcharges "will put pressure on traders, acquirer banks and card networks to reduce charges, by opening up the surcharges to competitive pressures."[161]

5.2. The "Bait-and-Switch" and "Free-Riding" Claims

110. Professor Elzinga claims that the Merchant Restraints prevent a merchant from engaging in a "bait-and-switch" tactic or "ploy."[162] He claims:

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158 Jairam Report, paras 101-103; Dunn Report, paras 46, 51, 63-64; Buse Report, para 22.

159 Reserve Bank of Australia, A Variation to the Surcharging Standards: A Consultation Document, December 2011, p. 10.

160 UK Office of Fair Trading, Payment surcharges: Response to the Which? super-complaint, June 2011, 1.18.

161 UK Office of Fair Trading, Payment surcharges: Response to the Which? super-complaint, June 2011, 7.3.

162 Elzinga Report, paras 86, 105, 225, 227, 230. Professor Elzinga states that he uses the term "as it is commonly used in economics" without providing a citation. Elzinga Report, p. 106, fn 186. The term has been used repeatedly by the Respondents in political and regulatory settings in recent years, including in Canada. See, e.g., Submission by Visa Inc. Regarding the Payment

> "Bait-and-switch occurs when a Visa (or MasterCard) cardholder enters a store that purportedly honors Visa (or MasterCard), decides to purchase an item with an advertised price of $100, and finds at the POS that the price is higher."[163]

However, Professor Elzinga fails to acknowledge that the price of $100 *is* available, for example, by using a debit card.[164]

111. As I previously noted, Professor Elzinga also characterizes surcharges as "free-riding" by merchants, which he criticizes, and he argues that preventing free-riding is a justification for the Merchant Restraints.[165] He defines free-riding as occurring "when an economic agent enjoys benefits for which others shoulder the costs" and he notes that "[f]or many years, free riding has been recognized as a form of market failure."[166] He goes on, however, to describe how MasterCard and Visa have, in effect (he argues) assembled "buying groups" of cardholders to whom MasterCard and Visa promise an assumed 1 percent reward, to be funded by the merchant.[167] The Merchant Restraints, he argues, are designed to ensure that the cardholder does not have to pay for this reward, but rather that the merchant will pay (so, of course, all of the merchant's customers will pay). The only source merchants have for the funds to pay Interchange Fees and Network Fees are the prices that they charge to all of their retail customers. As a representative of [redacted] acknowledged in a 2009 email discussing the impact of increased Interchange Fees on merchant pricing: [redacted]

System Board of the Reserve Bank of Australia's Assessment in the Preliminary Conclusions of The 2007/08 Review, p. 10; Testimony of William Sheedy, Regional President, North America and Head of Interchange Strategy, Visa Canada, House of Commons, Canada, Standing Committee on Industry, Science and Technology, Thursday, May 14, 2009, p. 22. In this case, see Response of Visa Canada Corporation, para 3 and MasterCard response, para 67.

163 Elzinga Report, para 227.

164 Some of the regulatory actions involving surcharges, whether for credit card use or, for example, airline "fuel surcharges" involve unavoidable fees. Mr. Dunn's firm has explained that, rather than merchants, credit card issuing banks in the United States have engaged in "bait-and-switch" conduct. Edgar, Dunn & Company, The US Consumer Credit Market: Trends and Perspectives, 28 March 2002, pp. 10-11.

165 Elzinga Report, paras 223, 227, 229.

166 Elzinga Report, para 229.

167 Elzinga Report, paras 234, 244-45.

168 [redacted]

112. In other words, Professor Elzinga's argument explains exactly why the *Respondents'* conduct – the Merchant Restraints – causes *merchants* to suffer from the effects of free-riding: cardholders "enjoy benefits" for which "others shoulder the costs" – the "others" in this case being merchants and, ultimately, all consumers, including the merchants' non-credit card customers.[169] As the [redacted] acknowledged in a 2009 document: [redacted]

113. Professor Elzinga apparently contends that "free-riding" and "bait-and-switch" occurs with any credit card surcharge, irrespective of whether the merchant has primarily repeat customers,[171] and irrespective of whether the surcharge is disclosed. In fact, he does not discuss at all why disclosure cannot serve as a remedy for the competitive problems he claims to identify. In other words, even if a gas station erected a large sign next to its posted price announcing that the posted price is the cash/debit price, and a 2 percent credit card surcharge will apply, Professor Elzinga would still consider that to represent bait-and-switch and free-riding. Similarly, a university might announce in its tuition notices and bills that it is now willing to accept MasterCard cards for tuition payments, but with a 2 percent surcharge to cover the cost to the university, and Professor Elzinga would label that as a merchant free-riding by using a bait-and-switch tactic. As the New Zealand example illustrates, even if one believes these issues to be potentially problematic, a disclosure requirement is practical and far less restrictive than a blanket prohibition. The "bait-and-switch" argument also does not account for any learning behaviour among consumers. Even if some consumers are surprised when surcharges are initially adopted, members of the public tend to become accustomed to the practice relatively quickly. For example, consumers have adapted quickly to the practice of surcharges on Automated Banking Machines when those have been permitted.

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169 Because retail prices will increase to cover credit card fees, the credit card customers do pay for some of the cost of their own rewards, and the extent of the costs they bear depends on the combination of Interchange Fees and rewards. Cash and debit card customers, however, are unambiguously worse off, as they are shouldering the burden of rewards they do not receive.

170 [redacted]

171 Contrary to the Respondents' economists' assumption that surcharging merchants will typically be those with only fleeting contact with its customers, in the Netherlands, surcharging is most frequent at sellers of food – with customers who typically make many repeat purchases. Wilko Bolt, Nicole Jonker, and Corry van Renselaar, Incentives at the counter: An empirical analysis of surcharging card payments and payment behaviour in the Netherlands, DNB Working Paper No. 196, December 2008, p. 11.

114. Professor Elzinga attempts with his "buying group" analogy to reverse the characterization of the effect that the Merchant Restraints have on price, from an *upward* influence (on Card Acceptance Fees) to a *downward* influence on the "net" prices that cardholders receive after factoring in the 1 percent reward ("discount") he assumes all cardholder receive.[172] Professor Elzinga suggests that it is odd for the Commissioner to "construe... as anticompetitive a rule that prevents a merchant from eliminating a *discount*."[173] Professor Elzinga, who begins by arguing that one should not look only at the merchant "side" of the two-sided marketplace (which suffers the direct harm from the Merchant Restraints and higher Card Acceptance Fees), thus ends by urging that one should look *only at the cardholder side*. The reason that Professor Elzinga must change his focus exclusively to cardholders to conclude that the Merchant Restraints are procompetitive is because the Merchant Restraints increase even the "total price" that he earlier argued was the only relevant price. However, it does not make sense to focus only on the indirect, "two-sided market" effects and ignore the more direct effects of the Merchant Restraints on merchants.

115. There likely will always be some fraud and deception in any marketplace. This is true even among credit card networks and card issuing banks, which in many jurisdictions have been subjected to regulation in respect of their disclosures and fees. But in competitive retail markets, competition among merchants can generally be relied upon to constrain prices (and other competitive terms and condition of sale) to reflect costs and protect consumers. A merchant that sets prices far above those of its competitors, or price discriminates significantly against a subset of customers (on a basis unrelated to cost differences), or disappoints customers at the point of sale after they have invested time and effort in purchases, will find itself losing too many sales over time to competitors for such strategies to succeed. As Visa consultant Benjamin Klein explains:

> "While retailers may sometimes supply incomplete and misleading information to consumers as part of the competitive retailing process, consumers are not tied to particular retailers. Consumers choose the places where they shop because of the overall average prices they expect to pay and the services they expect to receive, including whether the retailer employs a knowledgeable sales staff that provides reliable information. The retailing sector of the economy is highly competitive, with retailers competing intensively with one another to develop favorable reputations among consumers with regard to these and other dimensions. In this competitive

172 Elzinga Report, para 234.

173 Elzinga Report, para 234.

retail marketplace it is unlikely that retailers will survive if they consistently sell inferior products at relatively high prices because they are able to convince consumers on the basis of biased and misleading information."[174]

Contrary to the concerns expressed by the Respondents and their experts regarding the harm alleged to result from surcharging, Indeed, contrary to the suggestion that surcharging would result in a "bait and switch" for consumers,

116. In reality, the "consumer protection" justifications offered for the Respondents' no-surcharge rules are pretextual. To the extent that merchants deceive their own customers, such conduct could be controlled (if not by law) by much less restrictive alternatives than a complete prohibition on surcharging. Where Visa and MasterCard have permitted "convenience fees" (a euphemism for surcharges) by governments or universities accepting tuition payments with credit cards, the government or university can clearly inform its students of the payment options and attendant costs, including any credit card surcharge. (The Respondents' experts point to no market failures that have resulted from surcharges by Canadian or U.S. universities, yet MasterCard and Visa prohibit surcharges irrespective of the disclosures made by merchants, demonstrating that the no-surcharge rules do not serve any credible consumer protection function.

[174] Benjamin Klein, Competitive Resale Price Maintenance In The Absence Of Free Riding, 76 Antitrust Law Journal 431, 478-79 (2009).

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5.3. Competition Among Merchants and Among Banks

117. In my initial report, I explained that Visa consultants Klein et al. argued in an article that the sort of free riding by (and cross-subsidy to) holders of reward credit cards is innocuous, and occurs whenever merchants offer such "amenities" as parking, gift wrapping, extended store hours, delivery, or free coffee refills.[177] I explained that this view is backward, because individual merchants choose, in competition with one another, whether to offer those services for free, with a charge, or pursuant to some other arrangement. Professor Elzinga merely repeats the incorrect argument of Klein et al.[178] As I explained in my initial report, merchants sometimes offer such "amenities" at no additional charge, but sometimes they *do* charge for them separately. The key point is that merchants choose whether or not to do so in a competitive marketplace. The Merchant Restraints deny merchants that choice and restrict competition.

118. Mr. Jairam offers the unusual argument (for a competition law proceeding) that the Merchant Restraints protect merchants, particularly small merchants, and small banks *from* more vigorous competition.[179] However prescient his speculations might be, they do not state an alleged procompetitive effect of the Merchant Restraints. Quite the opposite is true.

119. Technically, under MasterCard and Visa interchange fee rules, individual merchants (via their Acquirers) and individual Issuers can establish customized, bilateral Interchange Fee arrangements. But this has been a largely empty offer. For example, I understand tha[redacted] representative testified on examination for discovery that [redacted] Individual issuing banks lack the economic incentive to offer a merchant a lower Interchange Fee than they would normally have, because the Merchant Restraints prevent the issuing banks from gaining any competitive advantage by doing so. In a normal market, a price-reducing competitor hopes to profit from its price reduction by expanding the volume of its sales. In the Respondents' credit card networks, a price-cutter suffers the lost revenue but receives no compensating expansion of payment volume.

177 Frankel Report, para 123, citing Klein et al., Competition In Two-Sided Markets, p. 617.

178 Elzinga Report, paras 81, 261.

179 Jairam Report, paras 19, 20, 84.

180 [redacted]

120. Absent the Merchant Restraints, however, Mr. Jairam is correct that new arrangements could emerge, including preferred acceptance arrangements, no-surcharge agreements for credit cards issued by preferred banks that offer the merchant a lower interchange rate, and so on – all the usual dynamism of a competitive marketplace that has been entirely suppressed by the Merchant Restraints. The settlements in New Zealand, in fact, involved an attempt to spur *intrabrand* competition along with interbrand competition, by eliminating Merchant Restraints and permitting differential surcharges according to the identity of the issuing bank.[181]

5.4. Certainty and Search Costs

121. The Respondents' experts contend that enhancing "predictability for cardholders," reducing "price uncertainty and search costs," and reducing the "added time and effort required to search for merchants who have chosen not to surcharge" justify the Merchant Restraints.[182] MasterCard and Visa similarly contend that their no-surcharge rules and honour-all-cards rules are necessary to provide cardholders with "certainty" that their cards will be accepted and at the same price as those generally advertised or posted by the merchant,[183] and that this is not only good for the networks' "brands," but is also good for the public.[184]

122. Again, the Respondents' experts do not explain why disclosure of the surcharge cannot serve as a remedy for the potential problems they claim to identify. In any event, "certainty" and reduced search costs are not appropriate benefits that can justify anticompetitively higher prices resulting from the Merchant Restraints. A perfectly functioning price-fixing cartel, after all, makes shopping easy: there is no sense in engaging in any search, because the price will always be the same. Yet few economists likely would suggest that one

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181 Peter R. Taylor, General Counsel, New Zealand Commerce Commission, "New Zealand's Market-Based Solution to Interchange Fees," http://www.comcom.govt.nz/cards-and-payments-australasia-2010-conference-15-march-2010/ ("Importantly, the schemes have agreed not to enforce any rules prohibiting merchants from surcharging or using other methods to steer customers towards other payment options, including between a particular scheme's issuers or card types.").

182 Elzinga Report, para 212; Mulvey Report, para 56; Jairam Report, para 93.

183 See, e.g., Response by MasterCard Worldwide to the Issues for the 2007/08 Review, August 31, 2007, p. 16 ("The 'no surcharge' rule provides for consistency of cardholder treatment, as consumers dislike being surcharged at some stores but not others.")

184 Visa Response, para 3; MasterCard Response, para 59; see also MasterCard Worldwide, "Backgrounder on Merchant Lawsuit," http://www.mastercard.com/us/company/en/newsroom/back_merch_law.html (visited 1/20/2009).

should weigh the reduced search costs and increased certainty as benefits before deciding to condemn a price-fixing agreement.

123. There is, of course, another way to reduce these alleged high search costs and inconvenience: MasterCard and Visa could reduce their fees in order to reduce the prevalence of merchant surcharging.

124. Interac does not have a no-surcharge rule.[185] If the Respondents' experts are correct, we should see countless examples of merchants imposing surcharges for use of Interac cards that exceed the merchants' cost of acceptance, evidence of "bait-and-switch" deception that has harmed the public, and a diminution of usage in the Interac system. The Respondents' experts do not identify any such conduct. The reason is not hard to explain: the fees to accept an Interac debit card transaction are very low, and most merchants are therefore happy to accept an Interac transaction without any surcharge.

5.5. The Claim That Merchant Restraints Protect MasterCard and Visa Interchange Fees

125. The main economic criticism of permitting credit card surcharges offered by Visa and its consultants in recent years has been that they permit individual, competing merchants to "undo" the effects of network-set Interchange Fees (which, again, are set at high levels unrelated to the cost of serving merchants):

- "Where merchants, unhindered by restrictions on surcharging, may simply pass on the costs of the merchant service fee (MSF), they can effectively undo the transfer between merchants and cardholders brought about by the interchange fee."[186]
- "[I]f merchants wished to eliminate any cross-subsidization of payment card users by cash and check users, they could accomplish this by charging a lower retail price to customers who use cash or checks. Payment card system rules permit merchants in the United States to offer such discounts. Merchants would thereby 'undo' any interchange fee that subsidized a payment card system's cardholders at the expense of cash and check payers with lower cash and check prices."[187]

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185 Jairam Report, para 83.

186 Visa International, Submission to RBA Payments System Review, 4 September 2007, p. 7.

187 Klein et al., pp. 618-19. I explained in Part 6.1 why discounts are not economically equivalent to surcharges.

126. In fact, it is precisely because the ability to surcharge costly credit card transactions "undoes" some of the effects of high Interchange Fees that surcharging is a competitively significant strategy and no-surcharge rules are anticompetitive.

127. Professor Elzinga does not address directly the fact that surcharges can "undo" high Interchange Fees, but rather focuses on defending the interchange fee system itself.[188] The premise of these defences is the assumption that the Interchange Fee is precisely set at a "delicate balance"[189] to achieve an economically "optimal," "efficient," or "competitive" level, so that any ability by merchants to effectively reduce the level or impact of Interchange Fees must be harmful.[190] But the premise is wrong and an inversion of reality: Interchange Fees are set at high levels by MasterCard and Visa *because* there is no effective competition over the level of these fees, in large part due to the Merchant Restraints. In fact, even economists who have consulted for Visa and have defended the Respondents' interchange fee practices have recently concluded that "an unregulated card network always sets the interchange fee too high."[191]

128. The Respondents and their consultants argue that Interchange Fees provide important benefits for the public. They note that credit cards comprise a "two-sided market" in which Interchange Fees admittedly are funded by merchants, but (they contend) all of these funds flow to cardholders as rewards and lower credit card fees as a result of competition among the networks' card issuing member banks. Thus, they argue, the combined "total price," the sum of the payments by merchants and by cardholders, is unaffected by the level of Interchange Fees. It is this "total price" that they contend is the relevant price for economic analysis.[192]

129. If these claims were true, that would mean that any effect of surcharging to reduce Interchange Fees would just shift revenue from cardholders to merchants (although the

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188 See, e.g., Elzinga Report, paras 47-71; Church Report, para 41.

189 MasterCard Response, para 57.

190 It is not credible that Interchange Fees are set as a "delicate balance" of economic forces. MasterCard and Visa did not change their interchange fee rates for decades in Canada despite substantial changes in technology, costs, and usage of credit cards. The Reserve Bank of Australia observed the same unchanging history of Interchange Fees in Australia, despite similar claims about the "balancing" role of Interchange Fees. Reserve Bank of Australia, Reform of Credit Card Schemes in Australia, A Consultation Document, December 2001, p. 33.

191 Jean-Charles Rochet and Julian Wright, Credit Card Interchange Fees, 34 Journal of Banking and Finance 1788 (2010), p. 1796.

192 As I have already noted, Professor Elzinga endorses the "total price" argument, but ultimately abandons it in focusing exclusively on cardholders.

Respondents' experts do not explain why they object to such a shift when the corollary – that the Merchant Restraints shift revenue from merchants to cardholders – is acceptable to them in their two-sided market framework). In fact, that is what MasterCard and Visa claim:

- "'If these changes were implemented by the Competition Bureau, the result would be to enrich merchants at the expense of consumers,' said Betty DeVita, President, MasterCard Canada."[193]
- "Of course, the Application is silent on the impact surcharging would have on prices consumers pay for payment services under this theory - if it did lead to lower interchange and lower merchant prices, it would also lead to higher costs for consumer credit card holders."[194]
- "[E]ven if the abrogation of the Visa Rules were to result in the reduction of the default interchange rate, the likely result would simply be a wealth transfer from cardholders to merchants, with no net increase in output or competition, and no benefit to consumers, as the Commissioner contends."[195]

130. These arguments are wrong. They assert, in effect, that this is a zero-sum game between merchants and "consumers" and the credit card networks' efforts are designed to shift "wealth" from merchants to "consumers." But the only source merchants have for the funds to pay Interchange Fees and network fees are the prices that they charge to all of their retail customers. Thus, all customers pay what amounts to a hidden retail sales tax, *some* of which ultimately flows back to *some* consumers (only those customers using credit cards and within that group, only those that have credit cards that offer rewards). Cardholders may be happy to obtain rewards and make choices in light of those rewards, but they do not know that they are funding rewards through higher prices on all purchases (whether or not made with cards) and cannot escape the higher retail costs even by using another payment method.

131. These arguments, in fact, ignore entirely the anticompetitive effects of Interchange Fees and the Merchant Restraints (including the effect these have on retail prices) and focus exclusively on the impact of the Restraints (or changes to the Restraints) on the terms of credit card accounts. As I have explained, merchants pay Card Acceptance Fees that are influenced upward by the anticompetitive effects of the Merchant Restraints. Even within the two-sided market framework proposed by Professor Elzinga, the "relevant" or "total price" is

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193 http://www.newswire.ca/en/story/670777/canadian-competition-bureau-s-decision-to-challenge-mastercard-s-no-surcharge-and-honour-all-cards-rules-would-hurt-consumers

194 MasterCard Response, para 86.

195 Visa Response, para 47.

claimed to be the sum of the fees paid by merchants and the fees paid by cardholders – not just payments made by cardholders and rewards provided to cardholders. But Interchange Fees and increases in Interchange Fees increase this "total price," while decreases in Interchange Fees reduce the total price. As I have explained, and Professor Elzinga acknowledges, not all Interchange Fees obtained by the Respondents' card issuing member banks flow to cardholders. MasterCard consultant Bob Stillman explains this in one of his claimed "truths" about Interchange Fees:

> "A reduction in interchange fees will reduce issuer profits. Issuing banks tend to be opposed to regulatory efforts to limit interchange fees, which implies that issuing banks believe that such regulation would reduce their profits. In theory, the opposition of issuing banks to interchange fee regulation could be due primarily to a concern that any significant reduction in interchange fees might trigger a "death spiral" (or, less colorfully, "negative network effects"). However, if instead the demand to hold and use cards is relatively inelastic – which is what the Australian data tend to suggest is the case, at least for countries where card use is mature – then the opposition of issuer banks is less likely to be based on concerns about negative network effects and more likely to be based on concerns that a reduction in interchange fees will reduce issuer margins."[196]

132. In fact, the study that Stillman coauthored on behalf of MasterCard reports that no more than three-quarters of interchange fee revenue flows through to cardholders based on the experience in Australia, while Visa consultants Chang, et al. concluded that 30-40 percent of interchange fee revenue flowed to cardholders.[197] These results are consistent with Professor Elzinga's statement that not all interchange fee revenue flows to cardholders, which, as I explained earlier, indicates that the "two-sided price" advocated by Professor Elzinga is also elevated by the Merchant Restraints.

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196 Robert Stillman, Seven Truths About Regulating Interchange, December 8, 2009.

197 Robert Stillman, William Bishop, Kyla Malcolm, and Nicole Hildebrandt, "Regulatory intervention in the payment card industry by the Reserve Bank of Australia," CRA International, 28 April 2008, p. 20 ("These figures imply that issuers have been able to recover about 74% of the loss in interchange revenues."); Howard Chang, David Evans and Daniel Garcia-Swartz, The Effect of Regulatory Intervention in Two-Sided Markets: An Assessment of Interchange-Fee Capping in Australia, 4 Review of Network Economics (2005) at 339 ("In the months that followed the introduction of the regulation (and likely in the months that preceded the regulation as well) [credit card card issuing banks] recovered between 30 and 40 percent of that loss through the imposition of higher fees."). The European Commission concluded that "The empirical evidence [in Europe] shows that if the interchange fee increases by 1 Euro only 25 cents are passed on to consumers in lower fees." European Commission, Competition DG, Interim Report I: Payment Cards, Sector Inquiry Under Article 17 Regulation 1/2003 on Retail Banking 45 (April 12, 2006) at vi.

133. Of those Canadians who have a credit card, 29 percent do not receive *any* rewards.[198] When rewards are provided, they generally are worth substantially less than the Interchange Fees earned by the card issuing bank. [199]

134. MasterCard and Visa argue that all costs of cash, cheques, and the like are incorporated into the merchants' retail prices, and, as I explained in my initial report, the same is true of the merchant's card acceptance costs. With the Merchant Restraints in place, Interchange Fees will tend to be higher, and this will tend to generate some additional rewards earned by users of credit cards. But all of the merchants' customers pay for these rewards. Moreover, merchants' customers pay more than the value of the rewards distributed to the cardholders, and these rewards encourage more use of the expensive credit cards. In the aggregate, consumers are harmed from these effects.

5.6. The Claim That Merchant Restraints Protect MasterCard and Visa "Brand Equity"

135. The Respondents' experts contend that the Merchant Restraints are not intended to have anticompetitive effects, rather they are intended to protect the value of the Respondents' "brand equity."[200] However, in practice, these amount to the same thing.

136. MasterCard, Visa, and their consultants argue that the Merchant Restraints are justified because merchant surcharging or refusal to accept some credit cards harms the value of the networks' respective "brands."[201] These claims miss the point. It is *beneficial* to the competitive process when the "brands" of high cost providers suffer or become associated with those high costs in the minds of consumers who make purchase decisions at the point of sale. It is *harmful* to the competitive process when restraints such as the Merchant Restraints inhibit that effect.

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[198] Carlos Arango, Kim P. Huynh and Leonard Sabetti, How Do You Pay? The Role of Incentives at the Point-of-Sale, Bank of Canada Working Paper 2011-23, October 2011, p. 7. See: http://www.bankofcanada.ca/wp-content/uploads/2011/10/wp2011-23.pdf)

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[200] Elzinga Report, para 227; Mulvey Report, para 54, 62.

[201] See, e.g., MasterCard Response, paras 3, 61, 67, 70, 72, 79; Visa Response, paras 29, 36 and Appendix A, paras 6, 9. See also Christian Von Weizsäcker, Comments Regarding "Reform of Credit Card Schemes in Australia II" Commissioned Report by Professor Michael L. Katz (August 2001), March 2002, p. 7.

137. Obviously, MasterCard and Visa would like cardholders to associate their brands with all of the claimed benefits of using those cards, including rewards for those who receive them, but none of the associated costs incurred by merchants and their customers when the Respondents' credit cards are used. The unchecked exercise of market power, after all, will typically increase a brand's value. What is good for the MasterCard and Visa brands and increases the "value" of those brands in this case does so by harming merchants and the public.

138. MasterCard goes so far as to claim that elimination of its Honour-All-Cards rule "could fundamentally undermine, and perhaps destroy the MasterCard system."[202] Yet, faced with its claimed impending destruction, MasterCard argues that it *still* would not reduce its Interchange Fees to deter merchants from refusing to accept some of its branded cards.[203] This is not logical as a matter of economics or common sense.

5.7. The Claim That the Merchant Restraints "Maximize Output"

139. The Respondents' experts contend that the Merchant Restraints cannot be anticompetitive or harmful, because they are intended to help the Respondents maximize the use of their networks, and so cannot be harming the public.[204] Professor Elzinga, in particular, contends that the Respondents have an economic incentive to "maximize volume" in their networks.[205] This incentive arises, he claims, because "[n]etwork revenues are based on the volume of transactions carried over the network."[206]

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202 MasterCard Response, para 87. MasterCard made similar claims in the United States in response to a lawsuit by merchants seeking to eliminate an element of its honour all cards rule there: the requirement that a merchant accepting MasterCard credit cards must also accept MasterCard branded signature-authorized debit cards. MasterCard asserted that the honour all cards rule is "the cornerstone of the entire payment card industry" and even that "[t]he Honor All Cards rule is the foundation without which a worldwide payment system such as MasterCard could not exist." MasterCard Worldwide, "Backgrounder on Merchant Lawsuit," http://www.mastercard.com/us/company/en/newsroom/back_merch_law.html (visited 1/20/2009). MasterCard asserted that "transaction charges merchants pay when accepting MasterCard-branded cards are not higher than they would be without the Honor All Cards rule, but lower." Id. Yet MasterCard settled the U.S. lawsuit, so that merchants can make separate acceptance decisions regarding MasterCard debit cards and credit cards. MasterCard was not destroyed in the United States, and its signature debit card interchange fee rates declined following the settlement. See, e.g., A Guide to the ATM and Debit Card Industry: 2006 Update, Federal Reserve Bank of Kansas City, 2006, pp. 16-17.

203 MasterCard Response, paras 84, 87.

204 Church Report, para 9; Elzinga Report, para 227.

205 Elzinga Report, paras 19, 54, 62.

206 Elzinga Report, para 224.

140. Professor Elzinga misses two key points. First, network revenues are not based solely on the volume of transactions, but also the price of those transactions. Enhanced market power permits higher prices, and firms generally can be assumed to seek to maximize their profit, not their "volume." Second, until very recently, MasterCard and Visa were joint ventures owned by their member banks. Those banks, which long controlled their networks, did not then and do not now have an economic incentive to maximize "volume" or "output" but rather their profits.

141. MasterCard and Visa contend that their Merchant Restraints (and their Interchange Fees) "maximize output" and therefore cannot be anticompetitive or harmful, while merchant surcharging or refusal of some credit cards will reduce output and therefore be competitively harmful.[207] This is incorrect. The networks' rules and Interchange Fees do not even necessarily increase usage of their own networks. But, in any event, usage of their individual networks is not the economically relevant measure of "output." Moreover, while market output, properly measured, can be a useful guide to economic efficiency, it does not necessarily answer the questions posed in a competition law dispute. A merger to monopoly accompanied by the implementation of an effective price discrimination scheme, for example, might simultaneously increase market output and significantly harm consumers.[208]

142. Economists sometimes rely on measurements of output when prices are difficult to measure or the effects of conduct on price are complicated by other factors.[209] The relevant measure of output is market output, however, not the output of a particular firm under investigation for anticompetitive conduct. For example, if a firm engages in exclusionary conduct, then its own output might increase even as market output decreases. As I have explained elsewhere, payment systems markets often are characterized by a form of exclusionary effect long known in economics as "Gresham's Law," popularized as "bad money drives out the good," but which I restated as "expensive forms of money tend to displace the inexpensive."[210] As I have explained, no-surcharge rules are designed to maximize the

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207 MasterCard Response, paras 7, 40-41, 68, 89, 96, 100; Schedule A, paras 2, 10; Visa Response, paras 3, 25, 29, 56; Appendix A, para 6, 8, 9, 11, 17.

208 See, e.g., Dennis W. Carlton and Jeffrey Perloff, Modern Industrial Organization (4th ed. 2005), p. 306 ("There is no ambiguity about the welfare effects of perfect price discrimination. Output is at the efficient, competitive level, but consumers are poorer than they are under competition.").

209 In simple cases, such as with price fixing, one would expect that higher market prices and lower market output will occur together. This is the "Law of Demand" in economics.

210 Frankel, Monopoly and Competition, p. 327.

exploitation of this tendency for the benefit of the credit card networks and card issuing banks, but at the public's expense.

143. The Merchant Restraints implemented by MasterCard and Visa do not necessarily even maximize the use of those networks, because some merchants that would accept the cards without the Merchant Restraints do not accept them with the restraints in place. This can be seen by the fact that even MasterCard and Visa have allowed surcharging in the form of so-called "convenience fees" where doing so promotes acceptance of credit cards with certain merchants and service providers that are otherwise unwilling to assume the higher costs of credit card acceptance (e.g., governments and universities). For example, as explained in the Witness Statement of Marion van Impe filed in this proceeding, the University of Saskatchewan negotiated with MasterCard and Visa to begin applying a surcharge in light of increases in the costs of credit card acceptance. Visa refused and is no longer accepted by the University, while MasterCard agreed and is now accepted subject to a 1% surcharge (or "convenience fee"):

> "As a result of the negotiations with Visa and MasterCard, the University announced in July 2010 that effective September 1, 2010, the University would continue to accept MasterCard for online tuition payments, subject to a 1% fee, but would no longer accept Visa credit cards for tuition payments because Visa does not allow universities to charge an additional fee.
>
> ...
>
> The University would like to resume acceptance of Visa credit cards for tuition payments and would like to accept Visa and MasterCard for in-person tuition payments. Nevertheless, the University would do so only if it had the ability to apply a surcharge to offset all or part of the costs of credit card acceptance."[211]

144. Similarly, Professor Elzinga's employer, the University of Virginia, explains that it accepts tuition payments with "MasterCard, Discover, and American Express" with a 2.75% "convenience fee."[212] Visa cards are not accepted for tuition payments by the University of Virginia, because "VISA's association rules will not permit the vendor to charge a percentage

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211 Witness Statement of Marion van Impe dated March 6, 2012, paras 30 and 36.

212 http://www.virginia.edu/studentaccounts/forms/Spring%202012%20Brochure.pdf.

service fee and would require UVA to charge the same fee for ALL transactions, including e-Check or paper check."[213]

145.

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146. Other merchants that currently do not accept either brand likely would do so if they could surcharge the cards.[216] In Australia, discount supermarket chain Aldi, for example, did not accept credit cards until surcharges were permitted.[217] Moreover, for reasons discussed previously, if merchants could surcharge and refuse particular high cost credit cards, MasterCard and Visa are likely to set interchange fee rates lower than otherwise. This will cause even more merchants at the margin to choose to accept MasterCard and Visa credit cards than otherwise.

147. The economically relevant measure of output in this case is the sale of goods and services by merchants in Canada. The Merchant Restraints cause merchant payment costs and prices to increase as I have explained. This reduces total retail sales (due to the Law of Demand). Both MasterCard and Visa claim that their practices increase their own output.[218]

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213. http://www.virginia.edu/studentaccounts/student_payment_studentFAQ.html.

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217 "Australia: Aldi Imposes Credit Card Surcharge," PaymentsNews, September 07, 2004, http://www.paymentsnews.com/2004/09/australia_aldi_.html. The surcharge, originally 1 percent, is now 0.5 percent. http://aldi.com.au/au/html/service/6050.htm.

218 MasterCard Response, para 7; Visa Response, para 3.

As I have explained, that may not be true, but even if it is, that would be irrelevant. The Merchant Restraints themselves have prevented competition from being more effective across payment methods, such as between credit cards and debit cards. If merchants could surcharge credit cards, debit cards would likely be a far better substitute than they are today. The Merchant Restraints narrow the product market and increase prices in that product market, while preventing merchants from shifting as many transactions to other forms of payment as they would absent the Merchant Restraints. It is no defence to point to the high "output" in the resulting credit card network services market. Market definition is a tool – and only that – to aid in determining whether market power might be exercised. It should not straightjacket an economic analysis of competitive effects. Professor Elzinga himself focuses exclusively on claimed "output" effects for MasterCard and Visa usage, whereas he contends the relevant market includes at least debit cards and likely all payment methods. In that broader "market", output unambiguously declines with increases in transaction costs generated by the Merchant Restraints.

5.8. Other Justifications

148. The Respondents' experts offer or suggest a variety of additional defences for the Merchant Restraints. For example, Mr. Jairam speculates that surcharging credit card transactions will increase the extent of the "underground economy."[219] He presents no support for this. Moreover, it strains credulity to think that a credit card surcharge will be the deciding factor for many individuals when contemplating whether to engage in unlawful transactions. Mr. Jairam also speculates that credit card surcharges will lead merchants also to surcharge debit card transactions, but he offers no explanation (or evidence) why they would want to surcharge what may be their lowest cost payment method.[220]

149. Mr. Jairam suggests that the pace of innovation might decline if merchants can surcharge and Interchange Fee rates decline.[221] As "evidence" for this he points to the abandonment in the U.S. of a mobile payment initiative ("ISIS") following enactment of the "Durbin Amendment" reduction of debit card interchange fees in the United States (which, in part, made innovations designed to reduce debit card acceptance costs less necessary in the marketplace). Similar arguments have been rejected repeatedly over the decades in other

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219 Jairam Report, para 20.

220 Jairam Report, para 20.

221 Jairam Report, para 20.

forums such as regulated utilities (i.e., claims by regulated monopolists that they require high returns to fund research and development). In any event, there remain many innovators competing for success in mobile commerce applications, such as Square, PayPal, Google, and others.

6. Conclusion

150. Professor Mulvey defends the Merchant Restraints on the grounds that "consumers will wrongly assume that VISA or MC is responsible for the surcharge" when one is assessed by a merchant. But the consumer will not be wrong. Merchants have little interest in surcharging Interac transactions or selectively accepting only certain Interac cards, because they are uniformly low cost to accept. If permitted to do so, some merchants undoubtedly will experiment with surcharging MasterCard and Visa credit card transactions, selectively accepting those cards, or entering into preferential arrangements with banks willing to reduce the merchants' fees. That is how competition works. When a merchant charges more for Coca Cola than for the store brand, a consumer generally would not be mistaken to attribute the higher price to the pricing by Coca Cola and its bottler, rather than the merchant. If MasterCard and Visa believe that their experts are correct about the serious consequences for those firms' brand equity in circumstances where merchants surcharge their Visa and MasterCard credit card transactions, then the networks will have a powerful incentive to reduce Interchange Fees (that is now lacking), particularly because the networks themselves do not directly profit from the interchange fee proceeds.

151. The Respondents' experts deny that MasterCard and Visa possess market power in a claimed relevant market. This has the implication that Visa, MasterCard, American Express and perhaps Interac could all be folded into a single entity with no adverse effects on the Canadian public or economy. This is simply not credible.

152. MasterCard has conceded in Australia that the ability for merchants to surcharge credit card transactions constrains the level of MasterCard's fees, yet now its experts attempt to deny this as the logical outcome of removing the Merchant Restraints. I have considered carefully the arguments and defences offered by Respondents' experts, and they have not caused me to alter any of the opinions that I offered in my initial report.

Date: April 23, 2012

ALAN S. FRANKEL

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CT-2010-010

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.

BETWEEN:

THE COMMISSIONER OF COMPETITION

Applicant

- and -

VISA CANADA CORPORATION and MASTERCARD INTERNATIONAL INCORPORATED

Respondents

- and -

THE TORONTO-DOMINION BANK
THE CANADIAN BANKERS ASSOCIATION

Intervenors

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