Submission to the Reserve Bank of Australia

Draft Standards for EFTPOS & Visa Debit

July 2005

Coles Myer Ltd

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1. Executive Summary

This submission is in response to the Reserve Bank of Australia's ("RBA") request for submissions following the publication of their Consultation Document[1] which sets out the RBA's draft standards for the EFTPOS and Visa Debit payment systems and the RBA's reasoning underlying these proposed standards.

In our July and October 2004 submissions[2], we stated that it would not be in the public interest for the RBA to designate the EFTPOS system. We still remain of this view and our comments on the proposed standard for EFTPOS are made without prejudice to CML's position in relation this issue.

The Federal Court is currently considering many of the issues on which the RBA has formed the opinions set out in the Consultation Document and which have led it to draft the standards on which submissions are sought. It is possible that the Federal Court may come to a view on these issues that is contrary to the views expressed by the RBA in the Consultation Document, irrespective of the outcome of the proceedings.

We therefore reserve the right to make further submissions following the decision in the Federal Court proceedings.

The Consultation Document released by the RBA outlines three draft standards for the EFTPOS and Visa Debit systems. The first two deal with the interchange fee arrangements for each of these systems, and the third deals with the issue of the "honour all cards rule" ("HACR") and the "no surcharge rule" as it applies to Visa Debit.

EFTPOS interchange fee standard

In our October 2004 submission[3] we argued that regulatory intervention should only be considered when there is clear evidence to show that there is a market failure and that the proposed intervention, by the adoption of standards for setting interchange fees, will adequately address that market failure.

There is no evidence there has been a market failure and even if such a failure had occurred, there is no evidence that the imposition of the proposed EFTPOS interchange standard would address such a failure.

CML does not accept that a proposal to regulate EFTPOS interchange fees is in the public interest. An examination of the RBA's reasoning does not support a conclusion that such regulation will increase competition and efficiency in the EFTPOS network. On the contrary, as we and others including the Australian Competition Tribunal have concluded, such a proposal is not in the public interest as it would increase costs to

[1] Reform of the EFTPOS and Visa Debit Systems in Australia, A Consultation Document, February 2005
[2] Submission to the Reserve Bank of Australia, Designation of Australia's EFTPOS and ATM Systems, July 2004 and Submission to the Reserve Bank of Australia, Designation of the Australian EFTPOS Payments System, October 2004
[3] See fn 1 above

consumers, reduce competition and efficiency, and threaten the ongoing viability of the EFTPOS system.

CML believes that in proposing a standard for EFTPOS interchange fees, costs will be transferred away from the users of the system and onto the general public, contrary to the user-pays principle. CML also believes, on the basis of its own experience, that the imposition of an EFTPOS interchange standard would reduce competition in the EFTPOS debit card market, by raising barriers to entry and making entry by new participants more difficult.

Set out below in sections 2 and 3 are our detailed submissions in relation to the proposed EFTPOS Interchange standard (Standard Number 3 in the Consultation Document).

Visa Debit interchange fee standard

On the question of the proposed Visa Debit standards, Coles Myer and the Australian Merchants Payments Forum ("AMPF") have made a number of submissions raising concerns about the Visa Debit payment system in Australia.

Fundamentally, Visa Debit is a **debit card** and there is no justification for the imposition of credit card interchange fees. We believe that the way in which Visa Debit operates in Australia is improper and contrived to earn credit card interchange fees on debit card transactions.

The current interchange arrangements that apply to Visa Debit significantly increase the costs of processing debit card transactions for merchants through higher merchant service fees and, as they are non PIN based, expose both merchants and cardholders to greater risks of fraud. We believe that Visa Debit issuers should not be rewarded for introducing greater costs and risks to merchants and cardholders, and reducing the efficiency of the Australian debit card market.

Set out below in section 4 is our detailed submission in relation to the Visa Debit Interchange standard (Standard Number 4 in the Consultation Document).

Visa Debit HACR and "no surcharge rule" standard

We also support the abolition of the HACR, in so far as it forces merchants to accept different products. We believe that an effect of this rule has been to unjustly and unreasonably force merchants to accept this expensive Visa Debit card product with the disadvantage of all its inherent risks.

We note that similar concerns regarding the HACR have been the subject of litigation in the United States, which resulted in a multi billion-dollar settlement for merchants.

Merchants ought to have the right to choose whether they wish to accept Visa Debit, regardless of whether they choose to accept other Visa products.

Set out below in section 5 is our detailed submission in relation to the HACR standard (Standard Number 5 in the Consultation Document).

2. Framework used to assess the efficiency of the EFTPOS Debit payment system

The RBA has decided that the best way to assess efficiency and competition is to apply a number of practical benchmarks. The Consultation Document concludes that an efficient and competitive payment system is one in which:

- the relative prices charged by financial institutions to consumers who use payment instruments reflect the relative costs of providing those instruments (except where the private benefits or costs do not match the society-wide benefits or costs) as well as demand conditions;

- merchants are free to set prices for customers that promote the competitiveness of their business;

- prices for payment services are transparent;

- any restrictions on entry of institutions to a payment system are the minimum necessary for the safe operation of the system; and

- competition within each payment system and between payment systems is open and effective.

In the RBA's opinion, the above benchmarks provide a sufficient basis for judging the efficiency and competitiveness of the current system.

2.1 Market Definition and Substitutability

However, in assessing a payment system against these benchmarks the RBA has determined that it is not necessary to strictly define the market in which particular payment systems including debit cards operate. Whilst noting that this type of analysis is customarily undertaken when assessing competition and efficiency issues under the *Trade Practices Act,* the RBA determined without a clear explanation that such analysis would not assist and was not necessary in order to form an opinion about competition and efficiency in Australia's debit card payment systems.

CML is of the view that identifying the market is critical to the analysis as to whether that market is efficient or effective. CML challenges the proposition that it is possible to reach the conclusion that a market has failed and hence warrants intervention if the market, which is said to have failed, has not been properly identified or defined.

The RBA also considered that it is not necessary to examine in detail the extent of substitutability between different payment instruments, preferring instead to rely on some observations about the features of credit and debit cards and concluding that obtaining reliable data to formally estimate elasticities would be too difficult.

Despite the difficulty in identifying the relevant market, the Australian Competition and Consumer Commission ("ACCC") has made efforts to identify the EFTPOS payments market and possible substitutes. Similarly the AMPF has conducted customer surveys that include data relevant to the question of market substitutes.

The issue of market definition and substitution in the context of the EFTPOS payment system was previously considered by the ACCC in 2003[4]. The ACCC noted that there was difficulty in accurately defining the relevant market for the EFTPOS payment system because of the extent to which financial services are bundled and the extent to which consumers did not pay fees for the use of their EFTPOS debit cards.

In its draft determination to deny the authorisation of a multi-lateral price fixing agreement for the EFTPOS payment system, the ACCC noted that:

> *"The Commission considers that it may be difficult to accurately define the relevant market(s) in this matter. For example, debit cards are often supplied as part of a bundle of financial services provided to customers. This bundle may include, among other things, loans and credit cards. In theory, customers pay a fee to their financial institution (issuer) for the use of debit cards. However, in practice a customer who acquires a debit card as part of a package of financial services may be exempted from paying all, or part, of the debit card fee. A notional rise in a supplier's debit card fees will not necessarily induce customers to switch to suppliers of close substitutes because: (a) they may not actually pay the fee; or (b) the fee is just one component of the entire cost of the financial package that is supplied. This means that even if a cardholder does observe an increase in fees, it will not necessarily be apparent that this is the result of a rise in debit card fees."*[5]

On the question of substitutability, the ACCC also made the point:

> *"The Commission accepts that each of the various payments instruments (for example debit cards, credit cards, cash and cheques) are substitutes to varying degrees in both demand and supply for consumers and merchants. However, the Commission considers that it is difficult without considerably more detailed information to determine whether the various payments instruments are sufficiently close substitutes to be considered in the same market. For instance, when determining the extent of substitutability it is also important to recognise that price is not always the main determinant. Both debit and credit cards are supplied with a range of additional features, such as loyalty programs, which offer benefits to users over and above the direct benefit associated with an ability to access the payments system. These additional benefits would need to be taken into account when considering substitutability. The value of benefits may also change over time, or particular instances. For example, a loyalty program attached to credit card usage may be less valuable when high fees or interest is payable compared with when they are not."*[6]

Contrary to the approach adopted by the ACCC, the RBA concluded that there is "strong evidence that credit and debit cards are highly substitutable for many

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[4] ACCC Draft Determination in relation to the collective setting of EFTPOS interchange fees, 8 August 2003, ACCC Determination in relation to the collective setting of EFTPOS interchange fees, 11 December 2003

[5] Draft Determination at 5.22

6 ACCC Determination at 6.24

people".[7] However, the Consultation Document fails to identify this evidence and relies heavily on price being a key determinant of substitutability, something that the ACCC had earlier cautioned.

Only one of the articles referred to by the RBA talks of this issue[8], the others don't discuss credit cards all.[9] In their article Lars Nyberg and Gabriela Guiborg observed that whilst there was a clear trend amongst Swedish card users to favour debit cards over credit cards this was not the case in Anglo-Saxon countries. They concluded that cultural differences might therefore account for the differential preferences between credit and debit card products.[10]

In its decision to reject a proposal for a multi-lateral price fixing agreement for EFTPOS, the Australian Competition Tribunal also expressed its surprise that no evidence had been provided to the Tribunal about the attitudes of consumers to the use of credit or debit cards, given the reliance the banks had placed on substitutability of credit cards and debit cards to seek to establish the net public benefit of their proposed agreement.[11]

The Australian Merchant Payments Forum did however commission a customer survey on the use by consumers of payment cards.[12] The survey demonstrated that there are a wide range of factors that influence customer choice of payment method. Consistent with the findings of the ACCC, it found that price ranked fairly low in the scale as a factor determining the use of credit or debit cards.[13] In fact, less than 20% of consumers using credit cards cited price as a reason.

CML submits that there is no "strong evidence" to support any degree of substitutability between credit and debit cards and there is no evidence at all to support a conclusion that they are "**highly** substitutable to **many** people**"**. Such a conclusion in our view is unreasaonable.

First, a change to substitution patterns will be dependent on the extent and form of pass through of changes in interchange fees. There is no basis for the RBA's view that pass through will be either significant or reflected in per transaction prices.

Second, substitution patterns are also dependent on the cardholders own financial circumstances ie availability of cash funds versus availability of credit.

Even if the reduction in interchange fees were passed on to cardholders in the form of lower transaction fees, this would affect less than 18% of EFTPOS transactions that attract fees. The limited effect that such a diluted reduction might have on those EFTPOS customers is dependent on:

(a) whether they have a credit card;

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[7] Consultation Document page 9
[8] L Nyberg and G Guiborg, 'Card Payments in Sweden' *Economic Review*, 2 Sveriges Riksbank, 2003
[9] Consultation Document footnote 2 and 15
[10] L Nyberg and G Guiborg, at page 31
[11] Re EFTPOS Interchange Fee Agreement [2004] ACompT 7 paragraph 121
[12] Consumer Behaviour – Use of Payments and Cards, October 2004
[13] Customer Survey at page 24

(b) whether and the extent to which they are incurring fees and charges in connection with the use of their credit card (for example, whether they are transactors or revolvers);
(c) whether they were previously incurring fees in connection with the use of their debit card; and
(d) their relative valuation of the different range of benefits they receive from their credit and debit cards in comparison with the prices of using them.

It seems therefore surprising that little regard is had to this issue in the Consultation Document given the reliance the RBA has placed on possible substitution effects as a consequence of their proposed EFTPOS interchange standard.

2.2 The Credit Card Reforms experience – application of the "user pays principle"

Before examining the proposed EFTPOS standard, it is worth considering the approach taken by the RBA with respect to the credit card reforms. In October 2000 the RBA and the ACCC jointly published a study on interchange fees and access. The object of the Joint Study was to assess whether interchange fees were encouraging efficient provision of debit and credit card services.

The RBA was concerned that the user-pays principle was not operative in the credit card system. The resource cost of using credit cards were not being borne by *transactors"* in the total prices they faced, because they paid no transaction fees or other charges such as interest. Instead the resource costs were being borne by *"revolvers"* and, more significantly, the general public. This was a result of a prima facie illegal collective setting of a uniform interchange fee[14], where the costs of the system were being pushed onto merchants who had no choice but to pass the costs onto the general public.

The irony of this is that the RBA is now proposing to impose a uniform interchange fee with respect to EFTPOS, the effect of which merchants will face higher costs and have little choice but to pass these higher costs on to the general public.

In its Regulation Impact Statement[15], the RBA identified the key problem was that price signals facing customers using credit cards were not established on the same basis as other payment instruments. It concluded:

> *"With the exception of credit cards, the prices charged by individual financial institutions to their customers for payment instruments, on a "user pays"*

[14] During the course of the Study, a separate investigation of interchange fees in credit card schemes was conducted by the Enforcement Division of the ACCC. Following that investigation, the ACCC wrote to various financial institutions and to the three credit card schemes in Australia informing them that, in its view, the joint setting of credit card interchange fees was a likely breach of section 45 of the Trade Practices Act. The ACCC later instituted proceedings under that Act against one major bank. The proceedings were later discontinued, without any finding by the court, when the RBA reached a decision to designate the credit card payment systems, and impose a standard regulating interchange fees.

[15] The Reserve Bank's Reform of Credit Card Schemes in Australia - IV Final Reforms and Regulation Impact Statement, 27 August 2002

basis, increasingly take account of the costs incurred in providing those instruments." [16]

In clear contrast to credit cards, the RBA found no imbalance in EFTPOS transaction prices and costs when it published its final consultation paper on credit card reforms in August 2002. The RBA observed:

> *"Consumers using a debit card typically face a transaction fee of around $0.50 per transaction (beyond a fee-free threshold) for accessing their own funds; this fee is broadly in line with the average cost of providing debit card services ($0.41)."* [17]

The position has only improved since then, in that per transaction fees (for those cardholders who face transactions fees above a fee free threshold) have fallen from 50 cents to 45 cents.[18]

The RBA made the point that reform of credit card interchange was needed as financial institutions actively promoted credit cards because it was the payment instrument for which they received the highest return. Despite it being a costly instrument for financial institutions to provide, the interchange pricing arrangements for credit cards, which were collectively set by the members of each scheme, encouraged the use of a relatively high-cost payment instrument over lower cost alternatives.

The credit card standard established a cost based benchmark based only on issuers' eligible costs. These included issuers processing, authorisation, fraud and interest free funding costs.

Whilst the new benchmark led to a significant reduction in average interchange fees, the standard still allows issuers to recover a significant part of their costs from acquirers and merchants rather than from their cardholder customers.

In other words, the distortion that the RBA was seeking to remove still remains. Credit card issuers have not altered their fee structures to impose transaction fees for credit card transactions, although they are free to do so. Credit card issuers benefit from greater use of credit cards and transaction fees would act as a disincentive to their use.

For many customers a credit card still remains a subsidised method of payment. If the balance is paid off by the due date, the cardholder receives a subsidy equal to the value of the interest free period. The issuers' costs of offering this subsidy are paid for by a combination of annual fees on cardholders, a typically high interest margin on those who do not pay their balance off by the due date, and **<u>interchange fees</u>.**

It also remains the case, based on data published in the Joint Study, that even with lower interchange fees, credit cards provide the highest return, and are more profitable, for issuing banks than debit cards. There is no reason to expect issuing

[16] Credit Card Schemes Regulation Impact Statement at page 2
[17] Credit Card Final Reforms page 3
[18] Reasons for the decision to designate the EFTPOS Payment System, 14 October 2004, paragraph 22

banks to suddenly commence promoting debit cards over credit card, and issuing banks have never suggested that this would occur. Designation of the EFTPOS payment system and regulation of interchange fees will not alter this.

The reality is that banks will continue to offer many cardholders a subsidy to use credit cards and banks will continue to promote their use ahead of debit cards.

Consistent with the approach taken with respect to the credit card reforms, and the conclusions it reached with respect to EFTPOS debit cards, there is simply no case for the introduction of any form of regulatory intervention. To the extent that there is concern that this subsidy leads to over-use of credit cards relative to the use of EFTPOS, the more appropriate approach would be to address this concern by further reforming credit cards. For example as originally proposed, the RBA could disallow the cost of providing the interest free period as an eligible cost in the credit card standard.

2.3. Relative Pricing of EFTPOS debit and credit cards

The RBA is now taking a different approach to justify the need for a standard for EFTPOS interchange fees than it did with respect to credit cards. In justifying its proposed EFTPOS interchange standards, it has not compared the average cost of providing debit card services with the fees typically faced by consumers, (which the RBA noted were broadly in line with respect to debit cards but not credit cards). Instead, the RBA justifies regulatory intervention to impose EFTPOS interchange standards by comparing relative fees for debit and credit cards.

In their media release the RBA make the claim that [19]

> *"An important effect of current interchange fees is that cardholders face higher effective prices for EFTPOS transactions than they do for Visa Debit or credit card transactions. This is despite the EFTPOS system having lower operating costs. The proposed standards seek to address this distortion in prices and costs."*

The RBA claim that users of the EFTPOS system face either a zero or positive price for each transaction, whereas users of credit cards typically face either a zero or negative price, and that a narrowing of this differential would promote the efficiency of the overall payments system.

CML submits that the RBA's proposed approach is inconsistent with the efficiency framework adopted with respect to the credit card interchange standard, where it sought to bring credit card prices in line with costs, which with respect to EFTPOS the RBA has conceded are already broadly in line. Further it does not have a sound economic basis and is unreasonable.

CML submits that this conclusion is not supported by the facts, and is based on a flawed analysis of cost and price.

[19] Payments System Reform, 25 February 2005

In its analysis in relation to credit cards, the RBA ignores annual fees, late payment fees, over limit fees, interest charges, merchant surcharges and the cost and value of benefits obtained through loyalty programs. It excludes the fact that consumers may regard interest as part of the price of using a credit card and that it is unavoidable for many people. With respect to debit cards, it dismisses the fact that the number of debit card transactions that attract a fee is now a minor and dwindling category and also ignores the fact that debit cards are often bundled with other products and no fees are charged for use of such debit cards.

Banks that issue credit cards have chosen, not to charge transaction fees and instead charge a range of other fees including annual fees and late payment fees. There is no suggestion that credit card issuing is other than a highly profitable business for banks, as shown in the Joint Study. The largest burden of credit card pricing falls on revolvers who must meet high interest charges and late payment fees. RBA data shows that about 70-75% of credit card balances accrue interest in any month.[20]

Accordingly, a large proportion of credit card users are paying a substantial price in connection with the use of their credit card. The terms and conditions generally offered by banks in connection with a credit card provide that for a cardholder to benefit from an interest free period, the cardholder must hold a particular type of card and must repay the whole of the balance of the credit card account within each statement period. If this condition is not satisfied, the cardholder must pay interest on the outstanding balance.

The RBA's concerns with respect to the relative pricing of credit cards and debit cards is also at odds with the RBA's own standard for credit card interchange, which allows the issuer to recover a range of eligible costs including interest costs and fraud costs from the acquirer/merchant rather than forcing them to recover these costs directly from the credit card holder.

Conversely, banks that issue debit cards have chosen, again for their own reasons, to charge fees on some debit transactions. However, since 1999, banks have been steadily reducing their reliance on debit transaction fees. The RBA's Bulletin dated May 2004 noted that fee income from account servicing charges grew more strongly than transaction fees in 2003; some banks had recently moved towards more simplified fee structures that offered unlimited free electronic transactions in exchange for a fixed monthly account-servicing fee.

The Bulletin also noted that most banks offered fee exemptions to various customer groups such as pensioners, social security recipients and under 18s and also typically offered fee discounts or waivers for customers who have multiple products with the bank eg a home loan, or who maintain a sufficiently high account balance.

This trend has continued as reported more recently. In May 2005, the RBA reported *"… most of the major banks now offer accounts with unlimited free electronic transactions and fixed monthly account servicing charges of around $5…"*[21]

[20] RBA Bulletin, The Changing Australian Retail Landscape, July 2003 pp4-5
[21] RBA Bulletin, Banking Fees in Australia, May 2005, p68

In summary, CML believes that the relative pricing analysis is inappropriate, is based on flawed analysis, does not recognise the deliberate pricing practices of the banks and is at odds with the RBA's own standard for credit card interchange.

2.4 Proposed EFTPOS interchange fee standard is contrary to the user-pays principle

It is CML's position that the user-pays principle is generally necessary and broadly sufficient for economic efficiency, and that any public policy decision that, unless evidence to the contrary demonstrated it, worked against the user-principle would prima facie be a departure from, not a move towards, economic efficiency. The RBA has not provided any evidence to suggest that departure from user-pays in this instance would increase economic efficiency.

In its decision to designate and impose a standard to reduce the credit card interchange fees, the RBA sought to advance the user-pays principle as a means of promoting efficiency. Similarly we would argue that the proposed standards with respect to Visa Debit cards seek to achieve similar goals.

However in proposing a standard for EFTPOS interchange with the express aim of reducing the EFTPOS interchange fee for the purpose of bringing about a reduction in the price paid by cardholders, the RBA is consciously transferring costs away from the users of the EFTPOS system and onto the general public, and thereby acting contrary to the user-pays principle.

2.5 Public Detriment

Reducing the EFTPOS interchange fee does not reduce costs. It simply transfers costs away from issuing banks and imposes those costs on merchants. As found by the Australian Competition Tribunal, to the extent possible, merchants can be expected to pass on the higher costs in a general increase in the price of goods and services.

Accordingly, the net effect of the RBA's proposed EFTPOS interchange standard will be to transfer costs associated with the use of a bank debit card away from debit cardholders and the issuing bank and impose those costs on all consumers in the form of a general increase in the price for goods and services.

The proposal would see more cross-subsidised transactions, paid for through a general rise in the price of goods and services, which is inimical to 'transparent' prices for payment services. Given that the RBA established transparency as one of the practical benchmarks to assess competition and efficiency, the RBA's position on EFTPOS is hard to fathom.

The RBA states that it is not concerned about transferring costs to the general public for two reasons. First, it states that if as a result of the change to interchange fees there is some substitution from credit cards to EFTPOS, merchant costs will be reduced[22] However the RBA is unable to provide any evidence to support that this will be the outcome of imposing an EFTPOS interchange standard.

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[22] Consultation Document p 20

In CML's view, this does not however justify acting contrary to the user-pays principle. As outlined above there is no evidence to support the likelihood of such substitution, indeed the AMPF Customer survey indicates such substitution is unlikely.

The RBA has not undertaken any modeling on the likely rate of substitution (particularly having regard to the low level of EFTPOS cardholders who currently pay transaction fees), and the rate that would be required in order for the switch to credit cards to outweigh the increased costs to merchants from the reduction in the interchange fee.

CML's own modeling shows that we would require a very significant shift in credit to debit card transactions, to offset the additional costs that would flow from the proposed debit card reforms (see Confidential Annexure A). There seems no likelihood that such a significant shift would occur.

The second reason given by the RBA for ignoring the principle of user-pays is that merchants have benefited from the change to the level of interchange fees in credit cards.[23] In other words the EFTPOS standard needs to be seen in the context of a package of reforms, where merchants benefit from credit card reforms but bear the burden of the debit reforms. This is an indefensible proposition.

If the credit card reforms were necessary to improve efficiency and competition in the credit card payment system (which CML accepts although much of the distortion identified by the RBA remains), then the merchants were entitled to any benefits that flowed through to them, particularly in light of the concerns regarding possible breaches of the *Trade Practices Act*. This does not justify the current proposed EFTPOS interchange standard. It has nothing to do with competition or efficiency in relation to the EFTPOS system, or the principle of user-pays. It also disregards the RBA's observation that those benefits have already been passed through to consumers[24].

The RBA has never suggested or argued that the lowering of the credit card interchange fees resulted in merchants increasing their profits. This is based upon the competitiveness of the retail sector where, fee reductions received by merchants have been passed onto the general public in the form of lower prices for goods and services. Indeed, the RBA undertook the regulation of the credit card interchange fees for that very reason.

There is no efficiency justification for the proposition that the benefit received by the general public from the credit card reforms, based on the user-pays principle, should be unwound or offset by the proposed regulation of the EFTPOS interchange fee. The effect of the reduction in the EFTPOS interchange fee will be precisely the opposite of the effect of the reduction in the credit card fee: it will increase costs to merchants and thereby increase costs to the general public.

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[23] Reasons at paragraph 81
[24] "Reform of the Payment System", address to Visa International, 2 March 2005

2.6. The Australian Competition Tribunal

The validity of the assumption that lowering EFTPOS interchange fees would increase competition and efficiency was directly challenged in the proceedings before the Australian Competition Tribunal ("Tribunal") in respect of which the RBA was granted leave to intervene.

The Tribunal handed down its decision on 25 May 2004 and dismissed a proposal to introduce a lowering of EFTPOS interchange fees to zero, stating that it did not agree with the ACCC that the public benefits and detriments of the proposed agreement were finely balanced. It concluded, *"any public benefits are clearly outweighed by the detriments" and that, "there is real public detriment in the likelihood of a flow on of costs to consumers generally."*[25]

The banks seeking to introduce zero EFTPOS interchange fees claimed that the lower fees would result in public benefits such as:

- Reducing the overall cost of the Australian payments system by decreasing the cost of EFTPOS, thereby encouraging its use in preference to credit cards and charge cards.

- Increasing the flexibility in setting future fees.

- Reducing barriers to entry for new market participants.

In responding to these claimed benefits CML presented evidence to show that zero EFTPOS interchange fees would not result in a public benefit but in fact would have the opposite effect**, a view adopted by the Tribunal,** for the following reasons:

- Reducing interchange fees does not reduce the overall cost of the Australian payment system, it simply shifts costs from issuers to merchants, increases general prices for goods and services and does not give rise to public benefits.

- There is no evidence that zero interchange fees would result in reduced cardholder fees.

- There is no evidence that zero interchange fees would lead to increased EFTPOS usage.

- Financial institutions will still have an incentive to promote credit cards as against debit cards.

- Lower returns on investment on EFTPOS infrastructure would impact on future innovation and network upgrades or enhancements.

The RBA dismisses the findings of the Tribunal, but provides little, by way of explanation as to how it has reached a different view to that of the Tribunal.

[25] Re EFTPOS Interchange Fee Agreement [2004] ACompT 7 paragraph 157

2.6.1 Tribunal's finding on pass-through

On the issue of pass through, the RBA expresses its confidence that the competitiveness of retail banking in Australia, in the event of lower EFTPOS interchange fees, would lead to more attractive EFTPOS pricing for cardholders or more favourable promotion of EFTPOS by financial institutions.

No evidence has been provided to support this opinion. Given the Tribunal's finding, and the evidence contradicting the RBA's view, CML finds the RBA's position unsustainable.

The likely response of the banks to a reduction in the EFTPOS interchange fee is evidenced by their public statements in connection with their application for authorisation of the Zero Interchange Fees Agreement advanced in 2003. The issuing banks advised the ACCC that the cost reduction resulting from the removal of interchange fees was likely to be passed on to cardholders in some form – such as lower retail banking fees and/or through enhanced services and/or higher transaction account deposit interest rates.

However, the banks acknowledged that **the change in interchange fees would not always necessarily be passed through to consumers in an easily observable manner** and it was unlikely that such a change would be in the form of a simple pass through of *"x"* cents per transaction.[26] It can be inferred that in these statements to the ACCC, the banks were putting the prospect of *"pass through"* as high as they possibly could.

The banks relied on these statements before the Tribunal, but did not introduce evidence as to what savings would be passed on, and in what form. The Tribunal observed that the banks who were parties to the Zero Interchange Fees Agreement had given only vague commitments to pass on the cost reduction.

2.6.1 Tribunal's finding on substitutability

The Tribunal also considered whether, assuming card issuers passed on the cost reduction to cardholders, this would be in the form of reduced transaction fees. The Tribunal concluded:

"Just as there was very little in the way of concrete evidence as to what savings might be passed through to cardholders, there was even less as to the nature of the signaling to cardholders.

Since such pass through as may occur is likely to be small in amount and in any event may take the form of other adjustments to the complex bundle of bank charges, ***any signaling of the change is not likely to be attention grabbing and conduct altering****.'(emphasis added)*[27]

[26] ACCC Final Determination at 4.10
[27] Tribunal Decision paragraphs 114-115

The Tribunal observed that even if the issuing banks raised the number of fee-free transactions, this may not have any effect on cardholder demand for EFTPOS. The Tribunal noted that there was a high level of EFTPOS users who pay no fees, as they are within the fee-free threshold. If a cardholder usually had five transactions a month with a fee-free level of seven, their decision whether to go to a sixth or seventh transaction, or substitute use of debit over use of their credit card, was not likely to be affected by a lift in the fee-free level from seven to fourteen.[28]
The Tribunal also observed that no evidence had been provided about the attitudes of consumers to the use of credit or debit cards.[29]

Another important factor that the Tribunal relied on was the fact that the major banks make far more substantial profits from credit cards than debit cards even following the RBA's credit card interchange reforms. The Tribunal concluded

> *"…it is a fact of commercial life that the Banks will continue to have an incentive to encourage credit card use as against debit card use...it would be contrary to the Banks' shareholders' interests to do otherwise."*[30]

This view was later supported in an article published in the Australian Financial Review, which reported that internal National Australia Bank analysis of the RBA reforms had identified the threat to the banks as not just being credit card interchange fee reductions and more expensive loyalty programs but also the impact of increased customer usage of EFTPOS.[31]

In final submissions before the Tribunal, CML summarised the position as follows:

> *"…There is an absence of firm evidence that issuing banks intend to introduce positive price signals to encourage the use of debit. Of equal importance is the fact that there is a total absence of evidence before the Tribunal that the issuing banks would seek to encourage the use of EFTPOS in preference to the use of credit. Finally, even if (contrary to their own commercial interests) banks did so, there is no evidence to support the view that consumers would change their behaviour. Many consumers would notice no difference, and even if they did, a significant proportion would maintain current habits for non-price reasons."* [32]

The banks acknowledged that they would seek to impose new charges on merchants to replace lost interchange revenue as a result of the introduction of zero EFTPOS interchange fees.

Whilst it was accepted that this increase in costs to merchants would likely discourage some merchants from accepting EFTPOS for low value transactions or to reduce the functionality of EFTPOS to cardholders in other ways, such as surcharging or minimum purchase requirements, the Tribunal found that the most likely consequence

[28] Tribunal Decision paragraph 118
[29] Tribunal Decision paragraph 121
[30] EFTPOS Tribunal Decision paragraph 94
[31] Australian Financial Review, 14 May 2004, page 1
[32] Tribunal Decision paragraph 121

(without excluding the possibility of other consequences) would be a general increase in prices.

The Tribunal concluded that the likelihood of **a flow on of costs to consumers** would result in real public detriment, and would likely have the effect of **passing on $170 million or a substantial part thereof** in increased costs to consumers.

Rather than sending more transparent price signals, this is in fact contrary to the principle of 'user-pays'. The effect of transferring this $170 million cost would be to "bury" the costs of EFTPOS transactions in higher retail prices charged by retailers to the detriment of **all consumers.**

2.7 Proposed EFTPOS Interchange Standard Effect on Investment

CML believes that there has been insufficient consideration of the effect of the proposed EFTPOS interchange standard on investment by merchants in the EFTPOS payment system, and CML believes that the conclusion it has reached is unreasonable in light of the evidence given on this issue.

In the Consultation Document, the RBA stated that it gave little weight to the argument that a reduction in EFTPOS interchange fees would result in reduced investment in the EFTPOS system. The reason given by the RBA for according the argument little weight was that internationally, EFTPOS debit card systems operate successfully without interchange fees.[33]

Further, the RBA's opinion is at odds with the conclusion of the Australian Competition Tribunal. On the evidence before it, the Tribunal concluded that the increased cost for merchants arising from the Zero Interchange Fees Agreement was likely to operate as a disincentive to undertaking future investment in upgrading the system.[34]

For example, Caltex gave evidence before the Tribunal that it had decided that it would not proceed with the introduction of EFTPOS readers at petrol pumps in a zero interchange fee environment.

CML also gave sworn evidence before the Tribunal, and more recently before the Federal Court, that the reduction or removal of interchange fees will have an adverse impact on CML's investment in EFTPOS infrastructure and technology improvements over time.

The RBA dismisses this evidence and instead relies on an assertion about investment incentives in other countries in circumstances where the validity of any such comparison is unknown and has not been investigated. The Australian Competition Tribunal cautioned that there was not a great deal of value in such generalised overseas comparisons, because the way a banking system operates in a given country is a result of a complex mix of historical, geographical, political, cultural and socio-economic factors,[35] making such comparisons tenuous at best.

[33] Consultation Document page 30
[34] Tribunal Decision paragraph 135
[35] Tribunal Decision paragraph 81

2.8 Why EFTPOS Interchange is justified

In the second half of the 1980's CML developed its EFTPOS strategy. This centered on our decision to invest directly in our own EFTPOS infrastructure. Our decision to invest in this infrastructure was predicated on reaching acceptable terms with card providers to reimburse CML for the cost of generating and delivering transactions to the providers. That is, it was dependent on the negotiation of acceptable interchange fees.

In the Joint Study, the RBA acknowledged that *"large merchants with their own acquiring infrastructure account for the majority of debit card payments accepted, in terms of both number and value."*[36] In its 2000 Annual Report, the Payments System Board stated that *"…most large merchants undertake many of the acquiring functions themselves, having invested heavily in processing infrastructure…"*.[37] Despite this awareness, the RBA has consistently disregarded the costs incurred by merchants in providing and operating infrastructure to facilitate the provision of EFTPOS services in its consideration of the resource costs of the EFTPOS payment system. It did so again in its Reasons for the designation decision.[38]

For the purposes of the Joint Study, the RBA did not seek or obtain any information concerning costs incurred by CML (which is also an acquirer) or any other merchants in facilitating the provision of the EFTPOS system. The information sought and obtained by the RBA was confined to costs incurred only by issuing and acquiring banks.[39] This was the data presented in table 6.1 of the Joint Study.

It is CML's view that we have a commercial right to negotiate with card issuers to seek recovery of the costs we incur in processing their cardholder transactions. We have invested and established our own network and we seek an appropriate return on our investment in that network from those who wish to access it. Details of CML's EFTPOS operating costs are outlined in Confidential Annexure B, together with details of our EFTPOS fee income which is considerably less than our total costs.

Put simply, third parties who benefit from the EFTPOS system should not be entitled to get a free ride. CML is not aware of any other industry where a participant is required to provide its own network for use by others and be denied the opportunity to charge a fee to recover the cost of its use.

It is not reasonable for the banks to be given the opportunity to recover costs and profit from cardholders and merchants, but CML, as a merchant principal, is denied the opportunity to charge banks for use of its network, particularly in light of the substantial investment and ongoing operating costs CML has committed to incur.

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[36] Joint Study page 63
[37] PSB Annual Report 2000 at page 19
[38] Reasons at paragraph 35 and 36
[39] Joint Study page 64

2.9 Anti-competitive effects of proposed EFTPOS debit Standard

CML's participation in the EFTPOS payment system has resulted in competitive pressure being imposed on the level of interchange fees being paid. The fees payable by issuing banks to CML are generally lower than the level of fees payable by issuing banks to acquiring banks. This is significant given that we account for approximately 16% of all EFTPOS debit transactions. By cutting out the intermediary (the acquiring bank), CML has been able to share the cost saving between the issuing bank and itself. The ability to negotiate these fees with issuing banks has been key to our entry to the market.

In CML's view, the variations in the fees negotiated between issuers, acquirers and merchants can only be explained as the product of competitive negotiations, where different parties place different valuations on the costs and benefits to themselves of participating in the EFTPOS payment system. The Joint Study acknowledged that this was the case. It concluded its discussion of debit card fees with the following observation:

> *"Notwithstanding what the formal interchange methodologies might suggest, debit card issuers in Australia have been prepared to pay as much as $0.35 per transaction (if they used gateways) to participate in the debit card network. This is because issuing of debit cards is regarded as an integral part of the provision of a transaction account, the costs of which can be recovered in various ways."*[40]

The Joint Study also found that the ability of merchants to negotiate fees with banks already exerted substantial competitive pressure on inter-bank fees in the EFTPOS payment system. In relation to debit card payment networks, the Joint Study noted that the difference between average interchange fees per transaction and average revenues per transaction were much closer in the case of the debit card payment network than in the case of the credit card payment network. The Joint Study attributed this feature of debit cards to the competitive discipline imposed by merchants:

> *"This mark-up is much lower than in credit card acquiring although infrastructure and procedures are very similar. The major reason is that large merchants have invested in their own acquiring infrastructure and have* ***negotiated arrangements to share interchange fees*** *with their financial institution."(emphasis added)."*[41]

A little later the Joint Study stated that in the debit card payment network "*large merchants with their own acquiring infrastructure have provided a countervailing force to traditional acquirers."*[42]

The effect of the RBA's decision will be to remove, or fundamentally reduce, competition between issuers and acquirers in the negotiation of the interchange fee.

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[40] Joint Study page 68
[41] Joint Study, Executive Summary
[42] Joint Study Executive Summary

The fee to be agreed between the counter parties would no longer be based on their individual costs, their individual assessment of benefits or the volume of transactions the subject of the agreement, all of which would have been relevant considerations in a competitive market environment. Instead, the negotiations would be subject to a regulatory cap, which does not properly reflect the true costs of operating and maintaining the EFTPOS network.

The RBA's decision will also have a number of consequential anti-competitive effects, in addition to the direct effect of removing or fundamentally reducing competition between issuers, acquirers and merchants in the negotiation of the interchange fee.
Removal or fixing of interchange fees will reduce the likelihood of new competitors entering the market and will reduce the likelihood of increased competition in the EFTPOS debit market.

Fundamentally, the decision is likely to raise barriers to entry to the EFTPOS payment system. As noted above, CML was able to act as an acquirer of EFTPOS payment services, and deal directly with issuers, by discounting the interchange fee that would otherwise have been payable by the issuer to an acquiring bank. Absent this ability to negotiate the fee, it would have been much more difficult for CML to negotiate direct access agreements. As a consequence, CML believes that new entry would be more difficult for any potential participant if there is no ability to negotiate the level of interchange fees. Consequently competition would be further reduced. CML also believes that this will not be mitigated by APCA's proposed access regime.

2.10 Competition in the EFTPOS Debit Market

The sole reason given by the RBA for its conclusion that fees are subject to little competitive pressure is a theoretical analysis, which does not bear out practical experience. The RBA posits that neither issuers nor acquirers are willing, or able, to initiate a process of competition over interchange fees; and this is because an issuer cannot credibly threaten to terminate an arrangement, and an acquirer cannot agree to a lower fee because if it receives lower revenues from issuers it would be unable to offer merchants a competitive price.[43]

In the Consultation Document, the RBA refers to the "hurt" that an issuer or acquirer might suffer if it were the first to move:

> *"The main reason for little competition emanating from the issuing side is that in any negotiation with an acquirer, an issuer cannot credibly threaten to end the current agreement if a lower interchange fee is not agreed to. Ending the agreement would mean that the issuer's cardholders were not able to use their cards at merchants serviced by the acquirer. For even the largest issuers, this would be seen as unacceptable as it would effectively mean that they could not offer a full-service transaction account. Indeed, during the genesis of the EFTPOS system, issuers did not offer universal merchant acceptance but were quickly driven to make arrangements with other banks to offer that service. Similarly, an acquirer attempting to expand its business would have difficulty*

[43] Consultation Document page 19-20

doing so if it were to offer, or agree to, a lower interchange fee. If the acquirer were receiving less revenue from interchange payments than its competitors, it would be unlikely to be able to offer merchants as competitive pricing as other acquirers. It would certainly not be able to do so profitably. Accepting a lower fee can hurt, not improve, the competitive position of acquirers."[44]

Promoting competition means promoting a situation in which individual issuers or acquirers take risks that they will win or lose business when they negotiate different fee levels. Competition is the antithesis of the comfortable situation where the banks know that they will only adjust prices in unison. We believe there appears to be a misconception between damage to particular competitors and the promotion of competition.

Far from not reflecting normal competitive pressures, as the RBA suggests at pages 19 and 20 of the Consultation Document, the risk that an acquirer or issuer may hurt its competitive position if it breaks ranks with the other banks and negotiates a more competitive interchange fee is the very stuff of competition. CML contends that the fear of breaking ranks shows that the operations of major acquiring and issuing banks are highly concentrated and oligopolistic in nature, and ought not to be shielded from the competitive pressure which merchants exert.[45]

The Australian Competition Tribunal rejected the RBA's line of reasoning. It concluded that merely because fees were paid upstream in a two-sided market did not mean that the fees were exempt from competitive pressure. It pointed to the concern exhibited by all issuing and acquiring banks about protecting the confidentiality of their bilateral agreements as evidence the very real competition to which they are subject in the negotiation of interchange fees. Knowledge of the fees payable by other banks would give a very real competitive advantage.

For example in defending the confidentiality of the Bank of Queensland's bilateral agreements with the ANZ and NAB, senior counsel for the banks said:

*"**One knows from the evidence that the acquiring market is highly competitive**, and it may be that an acquirer, for example – just to take the example we've been talking about – would seek to get the Bank of Queensland business and, knowing a bit more about their current arrangements, could reconfigure an offer that it would otherwise make to have a better chance of getting somewhere."*[46] *(emphasis added)*

Further, because all acquiring banks are issuing banks (ie they perform both functions), they have the potential to trade off any reduction in fees. For example, the acquiring division may have reduced its costs by reason of technological advances, or economies of scale and may be willing to negotiate the receipt of lower fees so that the issuing side of its business will pay lower fees. The issuing side may then be in a position to invest the savings in improved services to its customers.

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[44] Consultation Document pages 19 and 20

[45] The Joint Study reported that the acquiring market was very concentrated with the 4 largest acquirers accounting for over 90% of debit card transactions

[46] Tribunal Decision paragraph 89

Competition is based on the concept that individual traders are free to make decisions about prices, services offered and investments and take risks. In a free market environment, competition will produce winners and losers. Risk takers may be rewarded by competitive advantage, or may be hurt or may fail.

Protecting market participants from the forces of competition by regulation is the antithesis of competition,. There is simply no sound reason why as a matter of public policy why banks should be protected from the pressures of competition.

3. A Standard for the Setting of Interchange Fess in the EFTPOS Debit Payment System

For the reasoning we have outlined above, CML and others do not accept that a standard for EFTPOS interchange is necessary, desirable, defensible or in the public interest. Notwithstanding should the RBA decide to impose a standard, we believe a standard ought to be based on the following principles.

Observing the flow of money to determine who provides services to whom is a standard part of business theory. In the case of retail banking, customers provide both an input to banks (deposits), as well as pay fees to purchase services.[47] As a general rule, Barry Nalebuff and Adam Brandenburger urge readers to 'follow the dollar' to determine who are suppliers and who are customers, and state:

> *"Resources such as raw materials and labour flow from the suppliers to the company, and products and services flow from the company to its suppliers. Money flows in the reverse direction, from customers to the company and from the company to suppliers."*[48]

Applying this principle in the case of EFTPOS interchange fees, it is clear that services are being provided by acquirers to issuers. It is clear from the terms of our own agreements with issuers and is also clear from the terms of the interchange agreements between issuers and acquirers, as described by Counsel for the AMPF in the Federal Court in the cross-examination of witnesses and submissions. Moreover, the flow of fees also shows that some large merchants provide services to acquirers and/or issuers, since a payment is made reflecting the provision of services by the merchant that would otherwise be required to have been provided by the acquirer.

Consistency with the RBA's standards on credit card interchange fees would require an interchange fee that was based on costs incurred by acquirers, rather than issuers. This is because:

- it is consistent with the concept of redressing imbalances between the cost and revenues incurred by issuers and acquirers in providing debit card services, which is a concept the RBA has previously accepted;

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47 Lawrence, C. and Shay, R. 1986, Technology and Financial Intermediation in Multi product Banking Firms, in C. Lawrence and R. Shay (eds.), *Technological Innovation, Regulation and the Monetary Economy*, Ballinger, Cambridge, Mass., 53-107.

48 Nalebuff, B.J. and Brandenburger, A.M. 1997, *Co-opetition*, HarperCollinsBusiness, London, pp. 15-16.

- it reflects the historical direction of interchange fees, which the RBA did not challenge in its standards on credit card interchange fees; and
- it recognises the services that acquirers provide to cardholders in providing the debit card payment mechanism

The principles that the RBA used in determining which costs would be included in credit card interchange fees, and which costs would be excluded was to:

- include in its calculations costs of the payment services which are provided and for which costs are recovered through interchange fees; and

- exclude from its calculations costs that are not related to payment network considerations, and are therefore not relevant to interchange fee calculations.

Applying these principles to a possible EFTPOS interchange standard requires that the following costs be included:

(i) acquirers' and merchants' costs incurred in processing debit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions, the cost of installing and maintaining PINpad terminals, line encryptors and host security modules which are necessary to ensure the security and integrity of cardholders PIN data, APCA fees; and

(ii) acquirers' and merchants' costs incurred providing authorisation of debit card transactions; including network communication costs required to support online real time authorisations.

It is proposed that data be collected from institutions who account for at least 90% of the EFTPOS debit transaction acquired in the EFTPOS system. The RBA anticipates that data will be collected from around 5 institutions. The proposed standard however proposes only to use the eligible costs of the three ‘nominated EFTPOS acquirers’ with the lowest costs, to provide “efficiency incentives”.

In our view all acquirers/merchant principal costs (including those acquiring costs borne by merchants) should be included not just those of the three lowest. Efficiency incentives are still achieved by using an average of all participants’ surveyed costs. Further it would be inconsistent with the current credit card interchange standard and the proposed Visa Debit standard where all issuers’ costs are included and averaged.

The RBA has recently announced a possible change to the current credit card interchange standard.[49] One option proposed is to simply average the three credit card schemes eligible costs in order to establish one credit card benchmark. An alternative proposal which the RBA does not support, is to adopt the lowest cost schemes costs.

If the RBA does not adopt the proposal to use the lowest cost of the three credit card schemes, in line with its own recommendation, then consistency with the proposed EFTPOS interchange standard should demand that all nominated acquirers costs be considered and averaged not just the three lowest cost acquirers.

[49] Media Release, Payments System Reform, 20 July 2005

4. A Standard for the Setting of Interchange Fess in the Visa Debit Payment System

The Joint Study highlighted concerns with respect to Visa Debit cards, stating:

"…there is no case for simply extending credit card interchange fees to debit card transactions…issuing institutions are being over-compensated for what is, to all intents, a debit card transaction."[50]

These concerns have also been highlighted in a number of submissions made by the AMPF, and CML supports the arguments presented in these submissions.

Fundamentally, **Visa Debit is a debit card** and there is no justification for the imposition of credit card interchange fees. The current interchange arrangements that apply to Visa Debit significantly increase the costs of processing debit card transactions for merchants through higher merchant service fees, and as they are non-PIN based, expose both merchants and cardholders to greater risks of fraud.
There is no justification for applying the credit card interchange standard to a debit card. Debit card interchange standards should be based on a consistent basis. Of course making this task difficult is the fact that Visa Debit interchange currently flows in the opposite direction to EFTPOS debit.

We also note the same user-pays principle concerns in relation to Visa Debit as there are with credit cards. Unlike the position with EFTPOS debit, the costs of providing Visa Debit services are not broadly in line with the fees faced by cardholders.

In CML's view as a debit card, Visa Debit should have interchange arrangements consistent with EFTPOS Debit.

If the scheme and its members are unwilling to adopt interchange arrangements consistent the arrangements for EFTPOS Debit, then a standard should be adopted that brings interchange fees on Visa Debit into line with EFTPOS interchange fees. This standard should incorporate the cost components inherent in the current EFTPOS interchange fees namely those as described under sub points (i) and (ii) on page 23 of this submission.

Should the RBA decide that as an "evolutionary" step it is necessary to apply the credit card interchange standard to Visa Debit then only those relevant eligible costs should be included, ie the eligible costs referred to in paragraphs 11(i) and 11(iii).

Further there should not be any consideration given to including fraud costs. As it would be unconscionable to compensate issuers for the costs associated with adopting fraud prone signature based authorisations as against the secure PIN based authorisations offered by EFTPOS debit.

[50] Joint Study, page 70

5. A Standard for the HACR in the Visa Debit and Visa Credit Card Systems and the "No Surcharge Rule" in the Visa Debit System

As previously argued we support the abolition of the HACR as proposed in Standard 5, paragraph 10. Visa Debit ought to compete with other payment systems on its own merits, and its acceptance should not be tied to Visa credit acceptance.

We believe that the effect of this rule has been to unjustly force merchants to accept this expensive debit card product.

Similar concerns have been addressed in other markets notably in the US and in the UK. We also support the separate identification of Visa Debit cards proposed in paragraph 11, which will be necessary to give merchants that choice in practice as well as in theory.

Finally in relation to the proposed “no surcharge rule” there is simply no logical reason for this rule to continue to apply to Visa Debit cards given that the rule was abolished for credit cards nearly three years ago. We have no objections to the proposed wording of paragraphs 8 and 9.