

Review of Card Surcharging: A Consultation Document

JUNE 2011

Contents

1. Introduction	1
2. Background	2
3. Concerns about Surcharging Practices	5
4. Policy Options and Discussion	7
5. Summary of Issues for Consultation	10
6. Next Steps	11

Reserve Bank

Reserve Bank of Australia 2011. All rights reserved.

The contents of this publication shall not be reproduced, sold or distributed without the prior consent of the Reserve Bank of Australia.

ISBN 978-0-9871488-0-3 (Online)

1. Introduction

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

As part of the 2007/08 Review, the Board considered whether a modification to the Standards to allow schemes to limit the size of any surcharges imposed by merchants was necessary. This reflected concerns expressed through consultation that surcharging was being exploited by firms with market power. The Board decided, however, that the isolated cases of high surcharges, at that time, did not provide sufficient grounds to allow the schemes to impose restrictions on all merchants and hence limit their

negotiating flexibility. In fact, given that the high surcharges were likely to be a reflection of the market power of the merchants concerned, a cap on surcharges would not necessarily prevent higher prices being passed on in some other way. Survey data also suggested that, on average, surcharges were being set with reference to merchant service fees.

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

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

2. Background

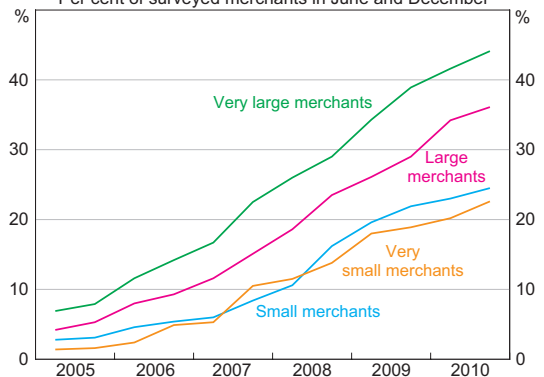
The Removal of No-surcharge Rules and Merchant Surcharging Behaviour

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

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

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

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



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

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

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

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

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

Consumer Responses to Surcharging

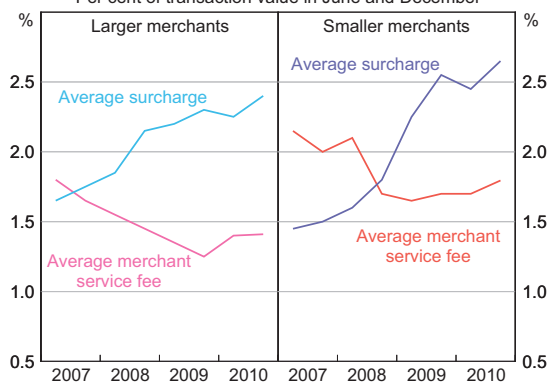
In the Board's view, the benefits from the removal of no-surcharge rules have been substantial, particularly in improving the price signals cardholders face when making payments. While merchants that apply surcharges are becoming increasingly commonplace, consumers appear to respond to price signals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

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

Graph 2.2

Surcharges and Merchant Fees by Merchant

Per cent of transaction value in June and December



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

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

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

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

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

Past Consideration of Surcharging

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

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

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

3. Concerns about Surcharging Practices

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

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

Excessive Surcharging

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

While there is potentially a large variation in the card acceptance costs faced by merchants, justifying significant variation in surcharges, concern has been expressed to the Bank that some merchants may be using surcharging as an additional means of generating revenue, rather than simply covering the costs of card acceptance. A similar conclusion

was reached in a report published by CHOICE in November 2010, commissioned by the New South Wales Department of Fair Trading.⁶

Blended Surcharging

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

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

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

4. Policy Options and Discussion

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

Capping of Surcharges

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

Under the first option, the Board could determine a specific permissible cap, possibly expressed as a percentage of the transaction value, for the designated MasterCard and Visa credit card systems, and the Visa Debit system.⁷ This would be the

lowest cap that schemes rules could choose to impose. That is, scheme rules may choose to impose a cap at a higher level than that specified in the Standards, or to not impose caps at all, but any cap below the level specified would not be permitted.

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

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

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

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

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

Another consideration under this more flexible option is whether surcharges should be capped at a level equal to the defined cost of acceptance, or whether they need only be 'reasonably related'

to that cost. Allowing for a reasonable relationship between surcharges and the cost of acceptance implies some level of tolerance around any surcharging cap. What constitutes 'reasonable' in this case could be left unspecified. Alternatively, a level of tolerance could be defined more precisely, for instance in terms of basis points for credit cards.

Clarification on Differential Surcharging

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

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

By contrast, some larger merchants receive 'interchange-plus' merchant pricing, where for each transaction the merchant is charged the interchange fee applying to that card or transaction type plus the acquirer's margin. A transaction made with a premium/platinum card will, therefore, at many merchants incur a higher merchant service fee than a transaction on a standard card because premium/platinum cards attract a higher interchange fee. Reflecting this, the merchant may choose to signal the different costs of acceptance for different

card types by imposing card-specific surcharges. Alternatively, they may choose to surcharge one rate across all cards of a particular scheme. If surcharging were tied to acceptance costs, such merchants would need to calculate (or be provided with) their own weighted-average (blended) merchant service fee for each card scheme they accept.

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

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

In order to enable merchants to differentially surcharge, revisions to the Standards could also require acquirers to pass on information about the

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

Disclosure

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

⁸ [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/news_for_business.pdf/\\$file/news_for_business.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/news_for_business.pdf/$file/news_for_business.pdf).

5. Summary of Issues for Consultation

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

- i. Is there a case for modifying the Standards to allow schemes to limit surcharges?
- ii. Is a surcharge cap best implemented by the Board setting a transparent and specific permissible cap that is specified in the Standards, and may then be imposed in scheme rules? Or, should the Standards allow scheme rules to limit surcharges to an amount that is either reasonably related, or equal, to each particular merchant's cost of card acceptance?
- iii. Should there be some level of tolerance allowed around any surcharge cap?
- iv. Is the merchant service fee an appropriate measure of the cost of card acceptance (that can be applied consistently across all merchants)?
- v. Should the no-surcharge Standards clarify that, notwithstanding any surcharging cap, scheme rules cannot prohibit merchants from applying a surcharge that is either a blended rate for each card scheme or the cost of accepting each card *within* a card scheme? Are there alternative ways to allow for differential surcharging?
- vi. Should the no-surcharge Standards require acquirers to pass on information about the merchant's cost of acceptance for each different card type if it is requested by the merchant? And, for those on 'interchange-plus' pricing, should the no-surcharge Standards require acquirers to pass on information about the weighted-average merchant service fee if it is requested by the merchant?
- vii. Is there a case for disclosure of the cost of card acceptance by merchants? Or, would it be sufficient for the Bank to collect and publish more detailed data on merchant service fees, such as the range and average of merchant service fees across merchant categories for each card scheme?

6. Next Steps

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

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

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

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