



**A U S T R A L I A N
R E T A I L E R S
A S S O C I A T I O N**

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28/3/03

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28 March 2003

The General Manager
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Dear General Manager

**Australian Retailers Association Submission on
Applications for Authorisation Nos A30224 and A30225 in relation to EFTPOS
interchange fees**

Please find attached a copy of the Australian Retailers Association (ARA) submission.

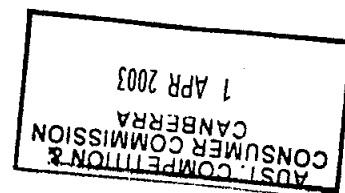
The ARA is happy for this submission to be placed on the public register or website.

Should you have any questions regarding the ARA submission, do not hesitate to contact either Melanie Hubbard or myself on 02 9299 6245. We would also be happy to meet with the Commission should you require clarification regarding our submission.

Yours sincerely,

Stan Moore
Chief Executive Officer

Encl.





**A U S T R A L I A N
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**Submission to
Australian Competition & Consumer Commission**

**Comment on Applicants Submission for Authorisation of
EFTPOS Reforms**

March 2003

Prepared with the assistance of
TransAction Resources Pty Ltd

Contents

1. Executive Summary	4
2. Introduction	5
2.1 The Australian Retailers Association	5
2.2 Objectives	5
2.3 Background.....	5
3. Key Issues.....	8
3.1 Network Access	8
3.2 Network Investment	9
3.3 Consumer Outcomes	11
3.4 Pricing Signals and Transparency.....	12
4. Net Public Benefit.....	13
4.1 Assertion 1 – Reduced Payments System Costs.....	14
4.2 Assertion 2 – Flexibility in Interchange Fees	15
4.3 Assertion 3 – Easier Access for Issuers and Acquirers.....	16
4.3.1 Effects Of Multilateral Interchange	16
4.3.2 Effects Of Zero Interchange.....	17
5. Conclusion And Recommendations.....	18

1. Executive Summary

The Applicants have requested the Commission to authorise, for a period of three years, a contractual arrangement that multilaterally sets EFTPOS interchange fees to zero.

The Applicants have asserted that the proposed reforms will not result in a lessening of competition and will deliver a net public benefit.

There has been no provision of data or empirical evidence and analysis to support the applicants' assertions, or to quantify the 'pre' and 'post' positions of the four parties affected by the proposed authorisation (merchants, consumers, acquirers and issuers). Despite the Applicants' assertions to the contrary, the ARA believes they have not properly considered the positions of all parties to Australia's EFTPOS system.

The ARA as shown in this paper, believes that the proposed conduct would be detrimental to competition in the EFTPOS market and would present a negative public benefit.

Consequently, we request that the Commission reject the authorisation request on the grounds that it reduces the level of competition and also fails to deliver a net public benefit.

2. Introduction

2.1 The Australian Retailers Association

The ARA is the nationwide voice of the Australian retail industry.

The ARA's membership comprises approximately 11,000 retail businesses, which transact an estimated 75% of the nation's retail sales and employ around three quarters of the retail workforce.

ARA members operate around 40,000 retail outlets across the nation. Approximately 10,000 or 95% of the Association's members are small businesses (i.e. employing less than 20 staff) operating in only one state.

Larger ARA members are responsible for significant investments in Australian payments infrastructure. Such retailers have invested tens of millions of dollars in providing consumers with the ability to reliably and securely utilise multiple payment methods.

2.2 Objectives

In this paper the ARA will address its serious concerns with the Applicants' submission¹. The objective of this paper is to demonstrate that the submission, if authorised, will:

1. reduce competition in the EFTPOS market; and
2. be to the detriment of the public interest.

Further, the ARA will demonstrate that the Applicants are not the sole parties with a core interest in the Australian EFTPOS system. Merchants and consumers are key stakeholders in the EFTPOS system and must be an integral part of any reform process.

2.3 Background

EFTPOS was introduced into Australia in 1984. The four major banks initiated its release (in conjunction with increasing customer acceptance of ATM's) as a long-term branch replacement strategy and to re-engineer their channel distribution strategy. The aim was to ultimately reduce bank costs by moving customers out of branches and reducing the number of over-the-counter transactions processed.

In order for the banks to effect this strategy, it was necessary for them to entice their customers to adopt electronic banking as the preferred method of accessing bank accounts instead of over-the-counter transactions. To achieve universal acceptance, banks needed to add value to debit cards beyond their use in ATM's – hence the significant push to EFTPOS in the late 1980's.

Typically an over-the-counter transaction has a significantly higher cost,² than an EFTPOS transaction, which has a bank cost of \$0.26.³

¹ "Submission by the Applicants to the Australian Competition and Consumer Commission in support of Applications for Authorisation of EFTPOS Reforms", February 2003"

Although cost reduction through branch replacement and transaction migration was the primary motive for banks to introduce EFTPOS, there were also a number of other considerations that influenced this decision. These included:

- banks were keen to pro-actively encourage companies to directly credit wages and salaries into employee's bank accounts (through lower transaction costs and savings in Bank Account Debits taxes)⁴. This would replace the traditional and costly method of paying employees by cash or cheques. In addition, this would increase customer use and dependency on debit cards in order to access funds and provide the banks with access to low cost funds in employee's current accounts;
- the introduction of debit cards saw the subsequent increase in the number of card terminals being used by retailers⁵. This in turn meant that credit card transactions at these retailer outlets were also being processed electronically, which improved transaction security (thereby reducing fraud) and achieved a major reduction in the number of paper-based credit card vouchers processed. These developments delivered further cost reductions for financial institutions; and
- EFTPOS was also identified as a business opportunity to derive new income streams from retailers, through the introduction of monthly terminal rental and debit transaction fees.

This strategy has been highly successful. Over the decade 1990 to 2000 there was a reduction in bank branches from 6,921 to 5,003 while at the same time EFTPOS terminals increased from 15,000 to 320,000.⁶ As the Australian Bankers' Association says: *"More than 90 percent of transactions are now conducted outside bank branches"*⁷

Australian banks have derived substantial on-going savings, with much of the investment in the EFTPOS system that has allowed this to happen having been provided by retailers.

In the early days of development, the Australian banks decided that all debit card transactions would be on-line authorised and PIN-validated to ensure a zero-risk (or close to zero-risk) position for the issuer. This approach was designed to keep fraud costs to the absolute minimum and would allow the debit-issuing financial institutions to issue debit cards to any account holder regardless of their account balance or credit history.

It was also decided at the time, that all debit cards would operate as domestic bank-branded cards (EFTPOS) and would NOT be products issued by the international schemes, Visa or MasterCard. This allowed debit transactions to be conducted in the domestic market without payments to the international card schemes and with processing rules set independently of these schemes by Australian issuers and acquirers.

² ABA Submission to the Wallis Report p. 606.

³ "Debit and Credit Card Schemes in Australia, A Study of Interchange Fees and Access", Reserve Bank of Australia and Australian Competition & Consumer Commission, October 2000. p. 65.

⁴ The Bulk Electronic Clearing System (BECS) only allows direct entry users to electronically credit nominated financial institution cheque and savings bank accounts. It does not permit the crediting of funds electronically to over-the-counter passbooks accounts.

⁵ In Australia, all debit (EFTPOS) card transactions are on-line authorised and PIN validated and may only be processed on paper in the event of a card terminal failure, and even then only under strict conditions. Australian retailers have made a significant investment in the acquisition or rental of card terminal equipment to comply with these security requirements.

⁶ Source: RBA statistical tables.

⁷ "New Ways of Banking", Australian Bankers' Association Fact Sheet, February 2003.

Negative interchange on domestic debit cards was put in place by the banks to generate income to acquirers from all debit card issuers. The aim was to see acquirers charging debit card issuers for use of secure, online acquiring infrastructure put in place and maintained at considerable cost. This was, and is, a sensible commercial decision based on the same interchange methodology used for ATMs, not only in Australia but throughout the world.

Initially, EFTPOS was slow to take off in the Australian market. By the late 1980's EFTPOS was still not meeting the banks' expectations and they were concerned about its success. Although EFTPOS transaction levels were slowly increasing, such increases were incremental and had little impact on reducing branch transaction levels.

It was not until the early 1990's that EFTPOS gained momentum, and this was due to strong marketing programs by a number of major retailers and oil companies rather than any initiatives by the banks. This view is supported by the Applicants themselves. The EFTPOS Industry Working Group's (EIWG)⁸ discussion paper states:

*"Usage of EFTPOS in Australia initially was moderate but was spurred by acceptance at petrol retailers. In 1991, several major retailers joined the network, after which fairly rapid transaction growth ensued."*⁹

It also was not until the major retailers installed their own card terminal networks that they were able to negotiate any income from acquirers. These negotiations were based on retailers receiving compensation for the considerable investment they had made in EFTPOS infrastructure and the costs of on-going operation and maintenance of the services provided.

Currently, over half of all EFTPOS transactions are processed via equipment owned and operated by Australian retailers, particularly in the supermarket and service station sectors.

The introduction of ATMs, EFTPOS and secure debit cards has moved the Australian bank customer towards electronic banking and has increased the profitability of Australian banks dramatically over the last 20 years by substantially lowering operating costs. It has also facilitated the implementation of "branch replacement strategies", further lowering overheads.

Interestingly, these cost savings are generally not included in any study of debit card economics conducted by the banks.

Australian retailers have been and continue to be fully supportive of efficient card payments systems. They continue to be an integral part of the Australian EFTPOS system and are continuing to make substantial investments in the ubiquity, reliability and security of the service. It is however apparent, that the Australian banking industry is not willing to share in the cost efficiencies achieved in an equitable manner.

Further background and other relevant information on the Australian EFTPOS system is contained in detailed submissions made to EIWG by both the ARA¹⁰ and the Australian Institute of Petroleum¹¹. Both documents are available on the RBA web site¹². These documents also provide an overview and commentary on examples of selected overseas debit networks.

⁸ All applicants were members of the EFTPOS Industry Working Group.

⁹ "Discussion Paper: Options for EFTPOS Interchange Fee Reform", EFTPOS Industry Working Group, July 2002, p.2.

¹⁰ "Response To EFTPOS Industry Working Group", Australian Retailers Association, 13 September 2002.

¹¹ "Response to Discussion Paper by EFTPOS Industry Working Group", Australian Institute of Petroleum, 12 September 2002

¹² <http://www.rba.gov.au/PaymentsSystem/PaymentsPolicy/EftposInterchangeFeeReform/ResponsesToDiscussionPaper/index.html>

3. Key Issues

The ARA understands that the ACCC will use as one of the measures for authorisation of the Applicants request, the effect of that request on competition in the EFTPOS market. Each of the points below will demonstrate negative competition effects, were the request to be authorised.

3.1 Network Access

The Applicants state in their submission that the need for access reform can be best addressed as part of the application for renewal of the current authorisation of the CECS regulations, due before September 7 2003, and not as part of the Applicants' current submission before the Commission. **The Applicants therefore acknowledge that their proposed reforms will not address the issue of network access, a critical part of delivering increased competition to the EFTPOS market.**

Access is a critical tool in driving down the costs of the EFTPOS system. Canada's Interac debit card system provides a good example. When access was opened to new members in 1996, a typical merchant service fee for debit cards for a large retailer was C\$0.15 cents per transaction. This fee is now typically around C\$0.05 cents¹³. During this period there has been no change in the interchange fee – it is the impact of opening access to the system which has resulted in such a significant reduction in costs through increasing competition.

The Applicants assert that currently, the commercial steps necessary for an organisation wishing to enter the EFTPOS acquiring market involve¹⁴:

- *"negotiation of technical and commercial bilateral agreements with incumbent network principals; and*
- *"reaching agreement with them about the timetable and allocation of costs for building the necessary physical interfaces between incumbent entrant networks."*

The Applicants go on to assert that moving to a multilateral interchange fee will remove a "significant" part of the access issues now faced by potential entrants. This is quite misleading, in that potential entrants to the EFTPOS acquiring network have a wide range of barriers to contend with, including:

- disparate technical interfaces and protocols between existing network participants. While the Applicants argue that technical standards in themselves are not a barrier to entry, having to contend with approximately as many interfaces and protocols as there are currently network participants presents major time and cost barriers. In fact, the cost barriers presented by this total lack of technical coherence results in potential participants not progressing past an initial analysis phase.

¹³ Information supplied by TransAction Resources

¹⁴ Submission by the Applicants to the Australian Competition and Consumer Commission. P. 18.

The Applicants state:

"The market for EFTPOS equipment is international and there are no obstacles to financial institutions or large merchant retailers purchasing all of the facilities needed to physically establish a proprietary EFTPOS network and to issue cards for use on that network."

This misses the key point – it is the software development needed to connect to each of the various network participants that is the issue. Each of these links is proprietary and there is no "off-the-shelf" software which can simply be plugged in to address the myriad of differing interfaces.

- timeframes to implement EFTPOS links. This aspect is an equally significant barrier to entry as the lack of technical standards. Currently 'gateway' providers and other organisations wishing to establish EFTPOS links with existing participants, usually canvass such entry on the basis of a major prospective customer or opportunity. The prospective customer organisation obviously has the option of purchasing services from an existing participant, therefore the timeframe within which a potential entrant can offer services is very important; and

The prioritisation of new link development by existing acquirers is undoubtedly based on economic returns, therefore a further effect of the Applicants proposal is the removal of a major incentive (interchange), to implement such new links on behalf of potential new issuers.

The important point here is that even if the application were authorised, the barriers would still exist as the current bilateral arrangements (other than the pricing element) and technical arrangements would remain.

Network access and competition will not be enhanced by the Applicants' submission, rather it will be made less accessible.

3.2 Network Investment

The Applicants agree that EFTPOS interchange fees "*played some part*" in the growth of EFTPOS in the Australian market¹⁵. They further acknowledge that setting interchange to zero will "*reduce the immediate returns on these investments and the incentives to undertake the expenditure needed to maintain or improve the present quality and penetration of the network*".¹⁶ They then go on to argue that this will not be a problem as acquiring institutions will simply raise merchant service charges to compensate for this revenue loss.

This assertion fails to acknowledge one key fact; **that acquiring institutions were not and are not, the only parties with major investments in EFTPOS infrastructure**. We would again point out the following in relation to network investment:

- retailer investments in EFTPOS infrastructure have been, and continue to be, key to the growth, ubiquity and security of the network; and
- investments by major supermarket and fuel retailers in the late 1980's and early 1990's were the key drivers of EFTPOS network growth. **In fact, the majority of EFTPOS transactions in Australia are processed through card terminals owned and operated by retailers.**

¹⁵ Submission by the Applicants to the Australian Competition and Consumer Commission. P. 17.

¹⁶ Ibid.

Australia's EFTPOS system is world class. It is secure, technically advanced, reliable, highly efficient and well accepted by all participants. It has achieved this distinction because of the significant investment that has been made in the infrastructure. This investment has been made because the current interchange arrangements have allowed those who have made the investment to earn a return on that investment and on the services they provide.

Acquirers and merchants have shared this investment. The current interchange arrangements have allowed acquirers to reimburse those merchants who have made such an investment. It must also be noted that beyond the initial capital investment in equipment, there are substantial on-going operational and maintenance costs.

The applicants' position leaves a major question unanswered: How and by whom will retailer investments be funded going forward, if the Applicants submission is authorised? The only course of action open to retailers is to:

- reduce expenditure on EFTPOS networks as far as possible (i.e. extend equipment life, minimise development and curtail the introduction of new features and functionality); and
- pass on both their own network costs and the higher acquiring institution costs (as agreed by the Applicants), to consumers. The most likely outcome is an increase in the general prices of goods and services.

The level of network investment is likely to decrease with current levels becoming unsustainable should interchange levels be set to zero. Both existing acquirers and retailers, who have made investments in EFTPOS infrastructure, are likely to curtail network expenditures in the future.

The Applicants imply that the major investment has now been made and that there is no longer a need for an interchange fee to be paid to the acquirers. This is not true. For example, APCA has mandated that all card terminals must be updated to be compatible with triple DES by the end of 2005. This will require a substantial investment, much of it to be made by retailers.

Discussions are also currently underway between the banks with a view to other upgrades to the infrastructure to reduce fraud. Visa has estimated this expenditure to be of the order of \$1 billion over the next few years¹⁷.

Clearly there is a need to continue to finance significant investment in the infrastructure for many years to come. **The current arrangements will allow that investment to continue, whereas a move to zero interchange will delay or put at risk these improvements.**

The Applicants also propose that a review be conducted at some point between the date of authorisation and three years, *"if there is a material change in circumstances which would include any significant drop in investment in EFTPOS"*¹⁸. The ARA sees this as an unreasonable proposition, because in effect what the Applicants are requesting is that the ACCC:

- authorise a reduction in interchange to zero, with no detailed, empirical analysis of the true effects on all parties to the system; and

¹⁷ "Card Fund Seems A Smart Move" Ben Woodhead, Australian Financial Review 26 November 2002.

¹⁸ Submission by the Applicants to the Australian Competition and Consumer Commission. p.18.

- then leave the Applicants to determine appropriate levels of investment, review periods and a future fee quantum, as they see fit.

Not only have the Applicants not provided any supporting data on the effects of zero interchange, they actually agree that “... *the investment effects of lowering interchange fees remain unclear* ...”¹⁹. To authorise their request for zero interchange on the basis of no supporting data and on the basis that, at best, the “*investment effects of lowering interchange fees remain unclear*”, would not be sensible.

The Applicants are required to demonstrate that there is a net public benefit resulting from their proposal. By their own words they have not done that. The on-going health of Australia’s EFTPOS system is the most critical factor to be considered in any review. To put at risk this world class system on the basis of an “unclear” outcome would be negligent.

3.3 Consumer Outcomes

The Applicants state that “*effective competition in retailing is likely to see merchants recover their higher costs through a general (although inconsequential) rise in the price of goods and services...*”²⁰ They go on to assert that consumers, as a result of a “fall” in the cost of EFTPOS transactions, will on balance be better off than if they used other forms of payment, and further, that “*this is likely to lead to substitution by consumers towards debit cards and away from credit cards...*”²¹ We reject these assertions and point out the following, in relation to consumer effects of the Applicants’ submission:

- retailers will most likely opt for a general increase in prices, to recover additional EFTPOS costs. Surcharging would be complex to implement and administer and competitive pressures are likely to ensure this does not happen. Further, we know of no instances anywhere in the world where surcharging occurs for debit cards in the retail environment.

Thus, all consumers are likely to subsidise users of EFTPOS. This is exactly the position that the RBA and ACCC were seeking to rectify in relation to credit cards. As is stated in the Applicants’ submission:

*“The credit card network has consequently grown at the expense of debit card transactions, which consume fewer resources. As a result, the Joint Study concluded that Australia has a higher cost retail payments system than is necessary and much of this higher cost is borne by consumers who do not use credit cards.”*²²

The joint study itself, demonstrating its concern with this issue, said:

*“... cardholders face price signals which do not reflect the costs of providing credit card services. That is, these costs are incorporated into the selling price of goods and services, and all purchasers pay the same price regardless of whether they used a high or low cost payment instrument.”*²³

¹⁹ Ibid p.17.

²⁰ Ibid p.21.

²¹ Ibid p.21.

²² Ibid p.10

²³ “Debit and Credit Card Schemes in Australia, A Study of Interchange Fees and Access”, Reserve Bank of Australia and Australian Competition & Consumer Commission, October 2000. p. 75.

Why would we want to replicate exactly the same situation with debit cards that the RBA and ACCC have found so unsuitable for credit cards?

- consumers are currently given an average of 96 fee free debit transactions per annum (eight per month), with many totally exempted from any fees at all. It is likely that the “fall” in the cost of EFTPOS transactions proposed by the Applicants will translate into “savings” for consumers via a rise in the quantity of fee free transactions. In 2002, there was an average of 38 EFTPOS transactions and 30 cash withdrawals per account²⁴. This is substantially lower than the currently available 96 fee free transactions per annum. Therefore, debit card issuers, by passing on EFTPOS savings as an increase in fee free transactions, will in fact not be passing any real benefit to the greater majority of debit card users.

The benefits asserted by the Applicants as accruing to consumers are highly unlikely to materialise.

3.4 Pricing Signals and Transparency

The previous issue of Consumer Outcomes leads to the issues of sending the correct pricing signals and transparency. These are both highly important issues and both the RBA and the ACCC consider these issues crucial in the reform of the payments system.

As discussed in the previous section, the RBA/ACCC joint study stressed the importance of consumers being sent the correct price signals when making a choice of payment systems. However, this can only happen when the cost of the payment method is clearly identified and is not built in to the merchant's overall price structure. **If consumers are to receive the correct price signals, they must see charges which specifically relate to the cost of their debit card purchases.**

If the request for zero interchange is authorised, acquirers will need to recover their lost income from merchants. The Applicants state:

“Following the loss of interchange fee revenue caused by the adoption of zero interchange fees, it is likely that acquirers will seek to recover the cost of providing merchant acquiring services from other revenue sources. Effective competition in commercial banking suggests there will be changes in merchant service charges to reflect these increased costs.”²⁵

As demonstrated earlier, surcharging for EFTPOS is unlikely to happen and the only viable option for retailers in general would be to build their increased costs into the price of their goods. This means that all consumers will pay for the cost of EFTPOS, thereby ensuring there is no transparency in the pricing and also ensuring that no price signals at all are sent. All consumers will see the same price irrespective of their payment method. In other words, the very outcome the RBA and ACCC has sought to avoid will be achieved, ie *“... all purchasers pay the same price regardless of whether they used a high or low cost payment instrument”*.²³

Another outcome the Applicants seem to have disregarded, is that under their proposed scenario, it may actually cost more to accept debit cards than credit cards for small value purchases. The Applicants believe that merchants will *“continue to accept credit cards,*

²⁴ RBA payment system statistics - <http://www.rba.gov.au/Statistics/Bulletin/C02hist.xls>

²⁵ Ibid, pp.15-16

which involve (and are likely to continue to involve) higher merchant service charges and merchant risks than EFTPOS transactions.”

Despite their assertion that “it is unlikely that merchants would discriminate against EFTPOS transactions just because merchant service charges were increased”²⁶, there is no supporting evidence for this stand.

For example, if credit card interchange was to reduce by 40 basis points, as seems likely due to the RBA’s reforms, and these savings were passed on to retailers via correspondingly lower MSF charges, the following table illustrates the result for a retailer with an average sale value of say \$20 (a not unusual ticket size for smaller retailers processing medium volume levels):

Original credit card cost ²⁷	Original debit card cost	New credit card cost ²⁸	New debit card cost ²⁹
\$0.28	\$0.15	\$0.20	\$0.35

Table 1: Relative Costs to Merchants – Debit vs Credit for \$20 purchase

In the above example, the retailer would be likely to encourage use of credit cards rather than debit cards, again contrary to outcomes considered desirable by the RBA. The additional cost to the retailer in the above example for debit above credit is 15 cents or 0.75% of the purchase value. This 0.75% would come straight off the merchant’s bottom line.

Finally, the RBA’s findings for credit cards have recommended that a limited number of “eligible costs” be allowed when calculating the interchange fee. The cost of loyalty programs will not be allowed as an “eligible cost”, thereby removing one of the key factors that has been distorting pricing signals. Now that the cost of loyalty will not be funded by the interchange fee for credit cards, then the price signals should return to normal. In other words, the cause of the wrong pricing signals (i.e. credit card interchange at levels which were too high) will be removed, correct pricing signals will be sent and efficiency in the card payment system will be restored.

Credit card issuers have already commenced the process of reducing loyalty program costs and increasing card fees, to cardholders.

4. Net Public Benefit

It is a requirement that the proposal put forward by the Applicants will generate a net public benefit. We will show below, how each of the assertions made by the Applicants as being net public benefits, are not in fact so and are in some cases to the detriment of the public benefit.

²⁶ Ibid, p.16

²⁷ Assuming a current MSF of 1.4% plus GST

²⁸ Assuming a 40 basis point fall in interchange i.e. MSF falls from 1.4% to 1.0% plus GST

²⁹ The new debit card cost, as per the Applicants submission, assumes that acquirers will seek to recover all revenues previously obtained from issuers, from retailers. This is based on the average interchange fee currently paid being 21 cents as per the RBA/ACCC joint study, p.65.

The Applicants assert there will be three major public benefits were their submission to be authorised:³⁰

- i. *“making EFTPOS more attractive to consumers relative to less efficient means of payment, particularly credit cards, thereby inducing a shift towards the use of EFTPOS and reducing the overall cost of the Australian payments system;*
- ii. *“introducing greater flexibility into the setting of EFTPOS interchange fees, reducing the inertia that has made them unresponsive to changes in market circumstances, and providing an explicit mechanism for reviewing interchange fees; and*
- iii. *“making entry as a new issuer or acquirer of EFTPOS transactions easier by simplifying the negotiation of bilateral interchange agreements.”*

Prior to addressing each of these points, we would highlight the fact that the Applicants have not provided any empirical support for their assertions on net public benefits (in fact, **there is no empirical support provided at all, throughout the submission**). Specifically, there is no analysis of:

- the economic position of retailers, consumers, acquirers and issuers under the current environment;
- the economic position of each of these groups under the environment proposed by the Applicants; and
- thereby via a comparison of the two positions, proving or disproving the existence, of a net public benefit as a result of the Applicants submission.

In addition, there is a strong reliance on the joint study by the RBA and ACCC and the figures contained in that study. However, not only does that study not take into account the costs of merchants or consumers, the environment has changed and is continuing to change since then. For example, the proposed credit card reforms that will lower interchange on credit cards and also allow surcharging, will impact the relativity between credit cards and EFTPOS.

A number of public benefit assertions are made, with outcomes not in any way analysed or proven.

4.1 Assertion 1 – Reduced Payments System Costs

The Applicants, while on one hand making the assertion that costs in the payments system would fall, state that *“the total cost to consumers and merchants of using EFTPOS will be unchanged...”*³¹

It is therefore clear from:

- our analysis in 3.3; and
- from the Applications own admission,

that **there will not be an overall reduction in payments system costs**. The Applicants submission would simply result in a shift of costs, away from issuers, to both consumers and retailers. As argued in 2.3 this is an inequitable position, as it is issuers who have derived

³⁰ Submission by the Applicants to the Australian Competition and Consumer Commission. P. 21.

³¹ *ibid* p. 17.

the major benefit from the widespread adoption and use of EFTPOS. **A simple shift of costs does not generate a net public benefit, nor does it constitute effective and efficient reform.**

If zero interchange is approved, the result will be a shift of costs and a resultant inequitable distribution of these costs. For example, a small issuer would have access to the EFTPOS acquiring infrastructure at no cost. On the other hand, those large retailers who have made a significant investment in EFTPOS infrastructure would have to pay a fee for processing transactions through their own equipment. **This clearly does not make economic or commercial sense.**

4.2 Assertion 2 – Flexibility in Interchange Fees

Setting of interchange fees to zero, as proposed by the Applicants, does not present any greater level of flexibility than that which currently exists. In fact, the Applicants are seeking to replace bilaterally negotiated arrangements with a multilateral price-fixing arrangement subject to annual monitoring and a three year review process, with interchange levels at the total discretion of the Applicants.³²

It is hard to see how a move from bilateral arrangements to a multilateral arrangement, whatever other benefits there may be, could possibly be considered an improvement in flexibility. Under the current bilateral system, changes can be made to interchange fees with only two parties wanting that change. Under the proposed multilateral arrangement, 75% parties would need to be involved in any changes. This is, by its very nature, more unwieldy, more time consuming and less flexible.

The proposed arrangement clearly presents a reduced level of flexibility and competition, and a detrimental outcome for retailers, as their ability to negotiate individual arrangements with acquirers will be impaired.

The Applicants assert that their proposed changes will result in a more responsive situation for EFTPOS interchange fees vis-à-vis market circumstances via the “*provision of an explicit mechanism for reviewing interchange fees*”³³ in the event that they are causing “*unforeseen effects or inequalities*”³⁴

There is no explanation of what constitutes an “*explicit mechanism*” and the Applicants do not propose any independent review process to:

- establish what emerging outcomes would be deemed as “*unforeseen effects or inequalities*”;
- establish what specific actions would be taken were there to be any such ‘*unforeseen effects or inequalities*’; and
- provide an avenue of appeal should retailers, consumers or others believe they may have cause for complaint.

³² ibid p 17~18.

³³ ibid p.21.

³⁴ Ibid p. 17

Setting of interchange fees to zero and placing all review processes in the hands of the Applicants (who are not independent and do not represent all EFTPOS stakeholders), will therefore not enhance flexibility and most certainly will not result in a net public benefit.

4.3 Assertion 3 – Easier Access for Issuers and Acquirers

Further to the discussion in 3.1, the Applicants' proposed reforms would not make access to the EFTPOS system easier for all. The Applicants state that a multilateral interchange fee would make entry to the EFTPOS system easier for new issuers and acquirers.³⁵ Further, they assert that the optimum level for such a fee is zero. This latter point holds true for new issuers as such entrants would not have to compensate either retailers or acquirers for the investments made and ongoing costs incurred, in processing the new issuer's card base. A new issuer would be able to enter the market without any upfront or ongoing payment for use of the infrastructure, which they would be leveraging. The assertion does not however hold true in the case of new acquirers.

A new acquirer wishing to enter the market, or a retailer contemplating self acquiring activities, would as a result of a zero interchange position, find it more difficult to do so. A new acquirer (self acquirer or otherwise) would be faced with a number of costs in entering the market:

- initial technology development costs;
- terminal purchase and deployment costs (where required);
- recurring telecommunications costs and terminal operating costs; and
- prudential requirements.

Analysis of the above costs, carried out by TransAction Resources, shows overall acquiring costs (whether incurred by the acquirer or the merchant) to be in the order of \$0.21 per transaction.

4.3.1 Effects Of Multilateral Interchange

An interesting element of the Applicants claim is that a multilateral interchange fee would make access easier for new entrants. The Applicants however fail to mention their aim for zero interchange in this context, even though this is the key plank of their request.

A multilateral fee regime would not on its own, serve to enhance access. A prospective entrant, in a multilateral fee environment would as advised above, still be faced with bi lateral negotiations on technical and other commercial issues. Such requirements present the same barriers to prospective entrants under multilateral or bilateral fee arrangements.

No empirical evidence has been presented to support the assertion that adoption of multilateral interchange would enhance access.

The fee setting process should not be the exclusive domain of a sub-set of EFTPOS stakeholders, who may then manipulate that fee for their own benefit. All stakeholders should be involved in interchange fee setting, in order to ensure fair, equitable and cost based outcomes.

³⁵ Ibid p.23

4.3.2 Effects Of Zero Interchange

The Applicants are seeking authorisation for both a multilateral fee regime as well as an initial interchange level of zero. From an access perspective we believe that an interchange fee of zero would be detrimental to enhanced access, as shown below.

Interchange is a key component of acquirers' current revenue sources and profitability. The relative importance of interchange as an acquirers revenue source is illustrated below, in the case of small to average retailer:³⁶

Item	Trans. Vol. PA	\$ Value Per Annum	Percentage Of Total
Interchange Fees	2,400	\$480	36%
Transaction Fees		\$480	36%
Terminal Rental		\$360	28%

Table 3: Acquirer Revenues – Small / Average Retailer

In the case of a small to average retailer, acquirers currently derive 36% of their revenues from interchange fees paid by issuers, with retailers contributing the remaining 64%. In the case of a large retailer, this percentage is even more pronounced, as shown in the table below:³⁷

Item	Trans. Vol. PA	\$ Value Per Annum	Percentage Of Total
Interchange Fees ³⁸	20,000,000	\$4,000,000	100%
Transaction Fees		\$0	0%
Terminal Rental		\$0	0%

Table 4: Acquirer Revenues – Large Retailer

Acquirers in the case of large retailers, currently rely totally on interchange fees for their revenues. Under the Applicants proposal for interchange fees to move to zero, acquirers would be obliged to recover this lost revenue from retailers. In the case of small retailers (as per Table 3 above), costs would increase from \$840 per annum, made up of:

- transaction fees of \$480 per annum plus;
- terminal rental charges \$360 per annum;

to \$1,320 per annum, which would comprise;

- transaction fees of \$480 per annum;
- lost interchange revenues of \$480, plus;
- terminal rental charges \$360 per annum.

³⁶ Assuming an average retailer, renting terminal equipment from their acquirer and processing 200 debit transactions per month or 2,400 per annum. Terminal / transaction fees an average of \$360 pa (terminal) and \$0.20 per transaction. Also assuming average interchange levels of \$0.20.

³⁷ Assuming a large retailer, conducting 20 million transactions per annum, having invested in their own equipment, paying all ongoing costs including data communications charges, and receiving a network access fee from the acquirer of \$0.10 per transaction. Also assuming average interchange levels of \$0.20.

³⁸ Net interchange fees calculated, after payment to the retailer of a \$0.10 network access fee.

Setting of interchange levels to zero would therefore necessitate new specialist acquirers seeking to recover virtually all of their income from retailers, thereby significantly reducing their competitive position.

Potential specialist acquirers would be required to compete with existing acquirers, all of which have been in the market for many years, while at the same time seeking to derive 100% of revenues from provision of EFTPOS services to retailers. Existing acquirers do not have to contend with such a single source of income.

The propensity therefore, for a new specialist acquirer to enter the market in an environment where they would both have to compete with existing major participants and charge higher fees to retailers, would be very low. Existing participants, all being financial institutions, would have an entrenched relationship with a given retailer, with multiple revenue streams (e.g. debt funding, transactional services and card services). This presents such organisations with the ability to subsidise as required, various services provided to retailers.

The most likely outcome of setting interchange to zero is that even if new specialist acquirers were to enter the market, they would quickly find that as all their revenues were to be derived from the provision of EFTPOS services to retailers, existing participants would aggressively defend their positions via subsidised pricing. **New specialist entrants would not have the ability to compete with such subsidised pricing.**

Specialist acquirers would therefore be discouraged from entering the market given the hurdles presented.

The Applicants assertion that their submission if authorised, would make access easier for all, is therefore patently false.

5. Conclusion And Recommendations

The ARA recommends that the Commission reject the authorisation request submitted by the Applicants. The request clearly does not meet the criteria against which the Commission is required to evaluate. Specifically, the request will result in a lessening of competition in at least the EFTPOS acquiring market and as we have demonstrated the proposed actions would be detrimental to the public benefit.