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28 March 2003

Mr Paul Palisi
General Manager, Adjudication Branch
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Dear Mr Palisi

Re: Application for Authorisation re EFTPOS Interchange Fees Nos A 30224 and A 30225 Your Reference C2003/238 C2003/240

Please find attached Coles Myer's submission in response to the Application for Authorisation of zero interchange fees for EFTPOS transactions lodged by a group of banks, building societies and credit unions.

Coles Myer is a significant participant in the Australian payments system, owning and operating its own EFTPOS infrastructure. This involvement in the payments system has been recognised by the Australian Payments Clearing Association ("APCA") through the granting of membership to APCA's Consumer Electronic Clearing System. Coles Myer is therefore well positioned to provide informed comment in relation to the Authorisation Application.

In Coles Myer's opinion, the Application and the recommendations contained in it will not, as claimed by the Applicants, result in a net public benefit. Nor will it improve efficiency or competition within the EFTPOS payments system.

We would welcome the opportunity to discuss with you our concerns at your earliest convenience.

Yours faithfully

David Howell
General Manager, Electronic Payment Services
Coles Myer Ltd.

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1 Executive Summary

This submission responds to the assertions made in support of the Applicants' proposal for Australian Competition and Consumer Commission ("ACCC") authorisation of its zero interchange fee proposal.

Contrary to the Applicants' claims, Coles Myer ("CML") does not believe that the proposed conduct will result in a net public benefit. Our reasons for reaching this conclusion are several:

- the Applicants propose to shift the costs from the Issuer to the Merchant, which will lead to increased prices for all consumers and does not represent effective reform or public benefit
- the Applicants have not provided evidence to suggest that the reduction in costs experienced as a result of a zero interchange fee will be passed onto cardholders
- the Applicants have not provided any evidence to support their claim that the proposed conduct will have any effect on EFTPOS usage
- the Applicants have failed to address the impact this reform will have on the continued investment required to ensure its ongoing security and reliability
- the Applicants have failed to address the implications of the proposal for access and effect on competition, and have not addressed the market power they exert over the payments system

The EFTPOS network is an essential element to the products and services that Issuers provide to their customers. The Applicants' proposal will result in Issuers accessing, free of charge, the networks and infrastructure that others have invested in and supported. Therefore future entrants will be discouraged due to the inability to recover their investment costs.

In their supporting material, the Applicants suggest that their Application for Authorisation was a result of discussions, debate and consideration of issues raised by a number of EFTPOS industry stakeholders. However as a member of the EFTPOS Industry Working Group ("EIWG"), CML believes that there was neither proper investigation, debate, nor serious consideration of views or options other than those of the Applicants.

- The parties that stand to benefit most from the proposal are the Applicants themselves. Ultimately consumers will pay more for goods and services as the Applicants acknowledge. Therefore we oppose the Application on the basis of the diminished benefit to consumers.

2 Introduction

This submission has been prepared in response to an Application for Authorisation submitted by a number of banks and non bank financial institutions for a proposal to collectively set a zero interchange fee in the EFTPOS debit payment network. It outlines a number of concerns CML has in relation to the proposal and the assertions made by the Applicants.

The first part of the submission provides details of the reform process that was initiated by the RBA that has ultimately led to this Authorisation Application. It details CML's concerns with respect to the lack of consultation and consideration given to the issues and concerns of all stakeholders in the EFTPOS network, which CML believes is reflected in the Applicant's submission.

The following section provides history of the development of the EFTPOS network from a retailer's perspective, and emphasises the key role retailers have played in establishing and maintaining the network we have today. It also outlines the role of interchange in the EFTPOS network environment and its importance to the network, both in its development and in its ongoing maintenance.

The next section provides some further background on overseas debit card arrangements. There is a common misconception that the directional flow of fees in the Australian EFTPOS system is unique to Australia, and that examples of markets operating without interchange are evidence that the Australian system is inefficient. A closer examination of overseas markets shows this not to be the case and reveals a number of important lessons that ought to be avoided in Australia.

The following section of our submission details our key concerns with the Application and the assertions made in support of the proposal, which we believe, contrary to the applicant's claims, will not result in a net public benefit.

The final section outlines CML's thinking on reform and improvements we believe that could be made to the current system. CML supports the need to address the issues with the current system, which we believe are more to do with a lack of competition in the market than with the level of interchange. We believe that an approach that seeks to reform the process of setting interchange and access conditions to the network will be far more effective than to simply impose mandatory constraints on the level of interchange.

3 The EFTPOS Review Process

Sixteen months after the publication of the *Joint Study* in October 2000, EIWG was convened by the Reserve Bank of Australia ("RBA") to develop and implement options for debit card reform. Those options were to address the concerns of the RBA relating to debit cards and the EFTPOS network that were identified in the *Joint Study*.

In their supporting material, the Applicants have made a number of suggestions that this Application for Authorisation is a result of discussions, debate and consideration of issues raised by a number of stakeholders. CML believes it is important to respond to these assertions and we state in the strongest terms that they are inaccurate and misleading. From our participation in EIWG we believe that, contrary to the position put by the Applicants there has been neither genuine investigation nor debate of EFTPOS reform.

CML believes that all other members of EIWG approached this committee having already resolved the only option for reform was that of zero interchange fees. There was no genuine consideration of the various options put by parties other than that position which now embodies the current application. Importantly, there has been no genuine opportunity for participants in the EFTPOS network other than the financial institutions to have their interests included in the debate. It is not sufficient, as EIWG did, to invite submissions from interested parties then fail to provide any further opportunity for the matters raised in such submissions to be debated. Nor is it appropriate, as EIWG did, to fail to produce any document that sets out how the various submissions were analysed and the ultimate position or conclusion reached.[1]

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[1] This approach is in stark contrast to the approach adopted by the ATM Industry Working who have recently published a paper outlining their final recommendations and have asked for public comment, ATM Industry Steering Group Discussion Paper: Direct Charging for 'Foreign' Automatic Teller Machine (ATM) Transactions in Australia, 4 March 2003

In this respect EIWG failed to meet the RBA's objectives for an industry forum and this Application misrepresents itself as a considered position taking into account the view of all participants in the network.

Before looking at some of the particular failings of the process adopted by EIWG in the last year, it is worthwhile to acknowledge the process adopted by the RBA in relation to credit card interchange reform. With respect to its investigation into reform of the credit card network, the RBA made the following statements in its publication headed "Final Reforms and Regulatory Impact" issued on 27 August 2002.

> **"6. CONSULTATION"**
>
> *Throughout the reform process, the Reserve Bank has attached high priority to consultations with interested parties.*
>
> *The Joint Study published in October 2000 generated considerable comment from all sections of the community, including the credit card schemes, financial institutions, merchants and consumer representatives. In the six-month period before the designation of the three credit card schemes in April 2001, the Reserve Bank received 22 written submissions containing a wide range of views on the findings of the Joint Study and recommendations both for and against regulatory action.*
>
> *Following the designation, the Reserve Bank received a further 45 written submissions over the remainder of 2001. It considered all of the material provided and held numerous meetings with organisations, which had made submissions to discuss their comments in detail. This consultation process culminated in the publication of the Consultation Document in December 2001. The Consultation Document reviewed the main regulations of the four party credit card schemes from the public interest viewpoint, taking into account the issues raised in the submissions. It provided extensive discussion of the purpose and effect*

of the Reserve Bank's proposed reform measures in promoting efficiency and competition in the Australian payments system. At the same time, the Reserve Bank published a commissioned report on the operations of credit card schemes from an international expert in network economics, as well as all of the prior public submissions it had received.

Much of the consultation afforded the credit card reform has been lacking in the consideration of debit card reform. EIWG was convened originally with only financial institutions as members. CML was finally permitted to join only after EIWG had commenced its process and started drafting the discussion paper on EFTPOS reform, despite the fact that CML is a member of the Consumer Electronic Clearing System ("CECS"). Even after CML was given permission to participate in EIWG, various other parties continued to raise numerous concerns as to the constitution of EIWG. The vested interests of financial institutions, which constituted all but one of the EIWG membership, has already been noted (page 6, ARA paper dated 13 September 2002). Requests were made in the written submissions filed by interested parties to "reconstitute the Working Group to make it representative of all stakeholders". (See page 5 of the AIP paper dated 12 September 2002 and page 3 of the paper filed by the National Association of Retail Grocers of Australia.) Similarly requests were made to open up the intended review process to make it more transparent (see page 6 of the ARA paper).

Such requests for a re-constitution of EIWG and a wider, more rigorous process of debate and investigation were also made regularly by CML. All requests were refused or ignored.

The opportunities that were provided for outside parties to participate were severely hampered by a very apparent failure to genuinely consider, debate and properly address the substance of the input that interested parties made. The details of the various failings by EIWG to ensure a fair and genuine process for reform was adopted are set out in Schedule 1. From the outset EIWG persistently adopted the position that there was only one option for reform and consequently there was no need to investigate or engage in debate of alternative options.

For example EIWG resolved to engage independent economists to provide assistance to the group, however once engaged their brief was simply one of preparing a report in support of zero interchange fees, being the position favoured by the Applicant financial institutions. At no time did EIWG ask for an economic opinion as to either the need for reform of debit card interchange fees, the scope of such reform, or indeed the relative merits of alternative reform options.

The failure to consider alternative options is significant in that when assessing the net public benefit of a proposed arrangement it is well known the test is one of benefit to the community generally not just those who have brought the Application before the Commission. For the Applicants to assert their proposal meets the public benefit test when they have systematically ignored contrary positions and disengaged other parties from any genuine debate is unsustainable. For the Applicants to suggest that this application forms the result of wide-ranging and rigorous debate of all options is simply misleading.

4 History of EFTPOS/Debit Cards and the role of retailers in the EFTPOS network

Technological advances facilitated the offering of financial services outside of normal banking hours through the introduction of the Automatic Teller Machine ("ATM"). The debit card was the means by which financial institutions enabled their customers to access and to utilise the service. The EFTPOS network followed making it possible for customers to have direct access to their cheque or savings account at the retail point of sale.

The ATM network was developed based on the payment of fees to the network owners. This fee, which is still charged today, is based on the economic principle of 'user-pays'. The current ATM model and the associated directional flow of fees have proven worldwide to be an efficient model to establish and maintain these types of networks. To some degree all participants in the network contribute to the costs of operating and maintaining the system.[2]

Similarly in the case of EFTPOS the banks recognised that to encourage acquirer and retailer participation in the system, the fee structure that best encouraged this was one where the costs of operating and maintaining the network are shared amongst the participants.

The Australian EFTPOS system has been acknowledged as being world class as it is a PIN based, secure and online system. The interchange arrangements entered into by each network participant provide incentives for acquirers and merchants to invest in infrastructure. This has resulted in Australia having the highest penetration of EFTPOS machines of the 12 major

[2] Whilst there has been a suggestion by the ATM Industry Steering Group that the ATM model in Australia change to a 'direct charging' model this does not fundamentally change the 'user pay' characteristic of the current model. It is also worth noting that such a proposal is unique to ATMs as there would be a number of practical limitations that would make a similar proposal unworkable in an EFTPOS environment.

untries studied by the Bank for International Settlements ("BIS"). The current interchange structure can be said to be the basis of the success of Australia's EFTPOS system in that it provides an incentive for acquirers and merchants to continue to invest in new technology needed to maintain the sustainability of the network.

The willingness of acquirers and some retailers to develop the EFTPOS system to meet the needs of customers, and the subsequent acceptance of debit cards by consumers as a payment instrument, led to the rapid growth in the use of debit cards. However credit cards have emerged as the favoured payment type due to the price distortion that exists in the credit card market. A majority of retailers now accept debit cards as a payment method, and virtually all financial institutions offer their customers access to their funds via the EFTPOS and ATM networks across Australia.

Sharing in the benefits of the debit card network has been critical to the success of the network. The banks also recognised that the development of a debit card network was a cost-effective way for them to reduce their channel costs. As retailers began to offer EFTPOS facilities, and began to offer the option of 'cash-out', banks were able to reduce their costly branch networks, and hence reduce their operating costs.

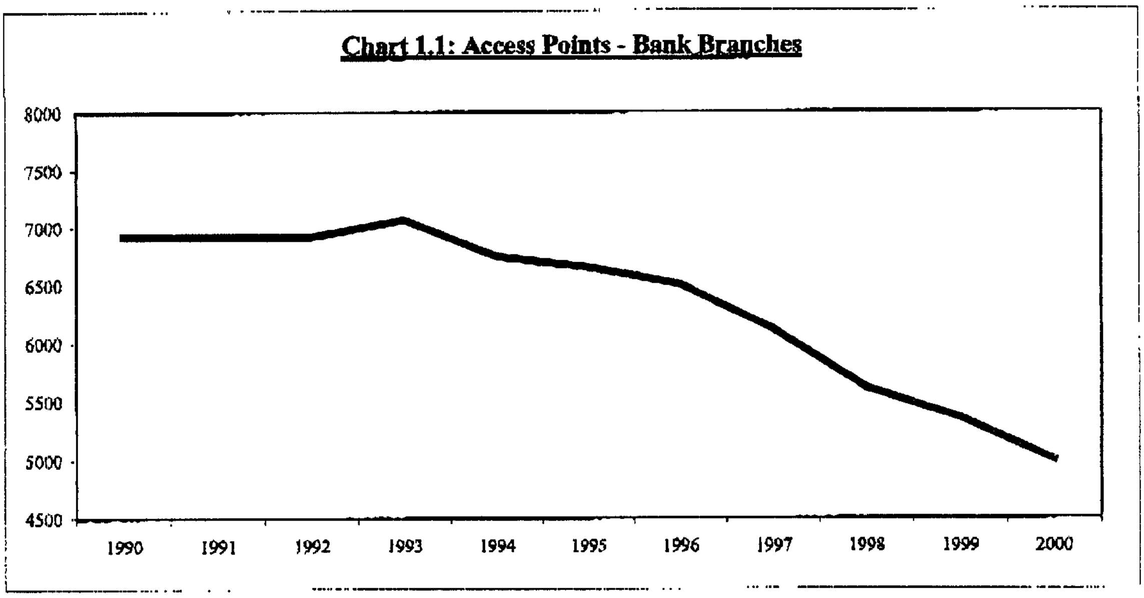
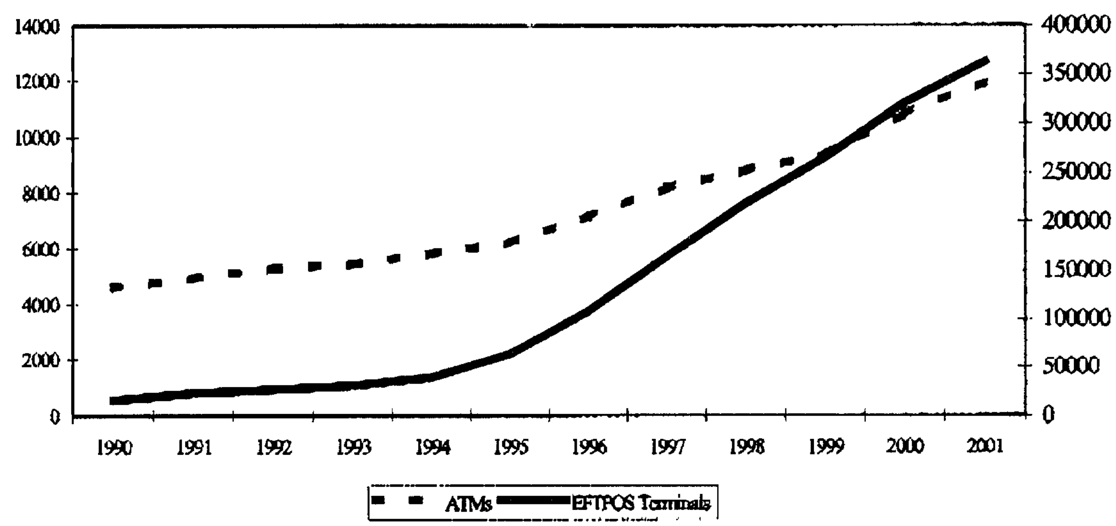


Chart 1.1 illustrates that the banks have been able to significantly reduce the number of physical branches that they operate, and hence have been able to significantly reduce their costs of operation. Contrasting these statistics is the number of ATMs and EFTPOS facilities available to consumers. Chart 1.2 shows that these alternative electronic networks have grown significantly at the same time that the banks have been reducing the number of branches.

The growth highlighted in Chart 1.2 for alternative payment methods and alternative points of access to cash would not have been possible if retailers and acquirers did not support and invest in the EFTPOS network. This investment was encouraged by a fee structure that ensured the network participants shared in the benefits of the system. A key element of encouraging new card acquirers to the network is the payment of fees to those acquirers recognising their investment in the network, and recognising the value of that network to third parties.

Chart 1.2: Access Points - ATMs & EFTPOS



The RBA recognised this in the Joint Study in relation to the ATM where it stated that, 'the interchange fee...is designed to reimburse the ATM owner for costs incurred in providing a service to the issuer's customers.'[3] CML would argue that the same argument applies to EFTPOS.

This is a basic and fundamental economic proposition. Where parties establish and provide a network, those parties that use it ought to pay a usage fee. A party cannot be expected to provide and maintain a network and not be compensated for it. Why, as it has been suggested, is it unreasonable to expect card issuers, particularly those that have not invested in the network, wanting access to the EFTPOS network for their own benefit, to contribute to the cost of developing and maintaining that network?

The involvement of other parties in the transaction process and a willingness by those parties to continually reinvest in the development and the maintenance of the network, has created the efficient, secure and reliable EFTPOS payments network that we have today. That network sees almost non-existent levels of fraud due to PIN based security measures, widespread acceptance of the payment type by retailers and consumers, and a system that is recognised as being world class.

It has been suggested that the network is mature and that the costs associated with developing and maintaining the network are minimal. This ignores the fact that this proposal comes at a time when the industry is currently involved in the most significant upgrade to the network since its inception. This initiative still has a number of years to run and will involve a substantial investment by all network owners to increase the current level of security to ensure the long term integrity of the network[4]. It also ignores the fact that new technologies such as chip cards will emerge and again further investments will be required in order for the network to develop.

A key concern of retailers is that their increased involvement and investment in the EFTPOS network, has been ignored in the current EFTPOS debate.

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[3] RBA/ACCC Joint Study page 33

[4] Further information on this initiative is publicly available on the Australian Payments Clearing Association website.

This is despite the fact that a key differentiating feature of the debit card network is the role of retailers in providing a countervailing force, which is lacking in the credit card network.

This is also a reflection of the process that was adopted to discuss and debate EFTPOS reform. All other participants of EIWG were either issuers or issuers and acquirers. Other than CML there were no representatives of network owners only, despite their importance to the network.

It is most unlikely that if the current fee structure were changed, retailers and other network owners would provide the same level of support and investment in the network. That is not to say that there will be no further investment, but that the level of investment is likely to reduce, lowering the standard of the network in terms of security, maintenance and development that we have today. A closer examination of other EFTPOS networks around the world, particularly in the UK further supports this conclusion.

5 Lessons from overseas

A common misconception held by many is that the directional flow of fees in the Australian EFTPOS system is unique to Australia. Further research however has highlighted a number of countries where issuers pay interchange fees to the acquirers on EFTPOS transactions.[5]

Furthermore markets operating elsewhere without an interchange fee arrangement, have been cited as evidence that the Australian system is inefficient and the current model is unjustified.

There is no indication that zero or interchange flowing to issuers rather than acquirers as is the case in Australia contributes towards a more efficient debit card payments system. Likewise there is no evidence that the Australian debit system is inherently less efficient. On the contrary it compares favourably to other systems. In general debit card systems with the lowest cost for the merchant seem to achieve wider acceptance and higher transaction volumes.

Nonetheless a review of overseas markets shows that there are clearly some important lessons to be learnt.

For example in the UK, the two major debit card schemes are Switch and Visa Debit. Transactions at the point-of-sale are authorised by signature verification, and are processed offline, although PINs are required to withdraw funds from ATMs. Interchange fees are fixed fees per transaction and are paid by the acquirer to the issuer.

It has been said that the UK system is old, outdated and incapable of meeting modern debit card processing requirements such as on–line and or PIN based processing of transactions. The interchange arrangements provide no

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[5] See Australian Institute of Petroleum (AIP) and Australian Retailers Association (ARA) submissions to EIWG

incentive for network owners be they merchants or acquirers to invest in card processing infrastructure and consequently the system has many shortfalls.

Being an offline system, fraud levels are high compared with the Australian experience. PIN on chip technology is in the process of being implemented to curb the high levels of fraud, however there is little incentive for retailers and acquirers to upgrade to the new technology.

The key learning from our perspective is that incentives to reinvest in the network are important and can't be ignored, without such there is nothing to ensure that the system remains up-to-date, secure and able to meet the demands placed on it.

By way of contrast the Canadian system is similar to the Australian system in that it is a PIN-based, online processing system with almost no fraud and little bad debt risk for card issuers. It has a zero interchange fee but members pay a processing fee to an industry association called Interac to cover its costs of operating and managing the network.

The key to the success of the Canadian system has been the increased competition that has resulted from the number of new entrants that have entered the market since the system was opened up as a result of action taken by the Canadian Competition Bureau in 1995.

According to the Australian Institute of Petroleum the number of Interac members has increased from 9 to more than 80. The membership now includes retailers, insurance companies and technology suppliers in addition to the traditional banks, and the average cost per debit card transactions for Canadian retailers has fallen.

The Canadian system therefore shows the importance of access and the effect this in turn has on competition. Increased competition has driven down the costs for merchants and the network has enjoyed strong transaction growth as merchant acceptance has increased.

These two examples illustrate how common issues have been addressed or resolved, what important lessons can be learnt and what best practice examples that we could adopt through a closer examination of overseas markets. Despite indicating in its initial discussion paper that "the structure and interchange fees of overseas debit card networks may provide a useful reference point for EFTPOS in Australia", it chose not to undertake any such research.

CML believes that there are clearly lessons to be learnt from overseas experience and we believe a more detailed examination of overseas markets is required to assess possible consequences the applicants' proposal, particularly to ensure that undesirable features of overseas networks are not introduced.

6 Response to Authorisation Application

The Trade Practices Act 1974 (Cth) (the "TPA") prohibits collusive conduct, that is, anti-competitive conduct engaged in by a group of competitors in a market for goods and services. The collusive conduct prohibited under the TPA includes the making or giving effect to a provision in a contract that has the likely effect of substantially lessening competition or of fixing, controlling or maintaining prices.

Under section 45A of the TPA, fixing the price of goods or services to be supplied by competitors who are party to the contract is deemed to have the likely effect of substantially lessening competition.

Pursuant to the requirements of the TPA the application is filed in two forms. One concerns authorisation of exclusionary provisions and the other concerns arrangements affecting competition.

The Applicants' proposal submitted to the ACCC for authorisation under section 90(6) is the making and giving effect *"to a contract by which they would multilaterally set EFTPOS interchange fees"*. The word "multilaterally" refers to the fact that the proposed contract to fix debit card interchange fees would be between the twelve financial institution Applicants, and new issuing or acquiring entrants that subsequently become parties to the contract.

Sub-section 90(6) of the TPA provides that the ACCC must not authorise a contract that contains a provision involving price fixing unless the provision would result or be likely to result in a benefit, and that benefit would outweigh the public detriment incurred as a result of any lessening of competition.

This submission responds to the assertions made in support of the Applicants' proposal for ACCC authorisation of its proposed EFTPOS reforms. The

Applicants claim that the proposed conduct will be likely to result in significant public benefits such as:

- Reducing the overall cost of the Australian payments system, by decreasing the cost of EFTPOS for consumers and thereby encouraging the use of EFTPOS;
- Introducing greater flexibility over time into setting of EFTPOS interchange fees, reducing the inertia that has made them unresponsive to changes in market circumstances; and
- Making entry as a new issuer or acquirer of EFTPOS transactions easier.

Contrary to the Applicants' claims, CML does not believe there is any evidence to support the proposition that the proposed conduct will result in a net public benefit. Our reasons for reaching this conclusion are several:

- simply shifting costs from the Issuer to the Merchant does not give rise to net public benefit
- there is no evidence to suggest that the reduction in costs experienced as a result of a zero interchange fee will be passed onto cardholders
- the Applicants have not provided any evidence to support their claim that the proposed conduct will have any effect on EFTPOS usage
- the Applicants have failed to address the implications of the proposal for access and effect on competition

Each of these points is explored in more detail in the following sections. In addition CML sought opinion from an independent expert on the question of whether the proposed conduct would result in a net public benefit. That opinion concluded that the analysis in the Joint Study does not provide a sound basis on which to base the Application, and contrary to the statements made by the Applicants, the imposition of a zero interchange fee on EFTPOS transactions would not result in a net public benefit because it would:

- entail a loss of net consumer benefit for all consumers;

- involve a loss of some of the network benefits that are associated with EFTPOS;
- impose additional transaction costs on network operators and network users;
- discourage investment in the EFTPOS network;
- discourage the emergence of new payment instruments; and
- not address the issue of market power in the payments system.

The details of this analysis are provided in Schedule 3 of this submission.

6.1 Assumption that zero interchange fees will result in reduced transaction fees

One of the key alleged *benefits* identified by the Applicants of reducing interchange fees to zero is that all issuing financial institutions will incur lower costs in processing EFTPOS transactions and hence this will lead to reduced transaction fees[6]. The accuracy of the statement that issuers will experience an immediate reduction of costs is not disputed. The validity of the assumption that these cost savings will be passed on as lower retail banking fees paid by cardholders and/or through improved services is not, however, accepted. Indeed, the Applicants put it no more highly than a "likely effect".

The Applicants have not presented evidence to show that *"effective competition in retail banking"* will mean that cost savings enjoyed by issuers will result in a concomitant reduction in fees charged to cardholders. Indeed it would appear that the evidence points to a lack of competition. For example, a report published by the RBA in 2000 noted, *"it is difficult to point to obvious areas of increased competition in deposit markets over the 1990's".*[7]

The Applicants' submission states that questions about what these changes will be or should be are questions that need not be addressed by the

[6] See for example at page 15, paragraph 5.2.2 of the Applicants' Submissions

[7] "The Australian Financial System in the 1990's", Marianne Gizycki and Philip Lowe, Reserve Bank of Australia, 2000, page 196.

proposed arrangements but that the parties should be left to develop these arrangements in a competitive market[8]. In other words, there is an implied recognition of the risk that there will be a disparity between what "*should*" occur in the banking market as a result of the reduction of the interchange fee to zero, and what will *actually* occur. While it is clear that the setting of interchange fees to zero will result in increased profits enjoyed by all issuers, there is no similar certainty that a public benefit in the form of reduced transaction fees will result.

In particular, whilst reflected in the material previously published by the RBA, it is conveniently passed over in the Applicant's paper that the costs of debit transactions to consumers by the way of transaction fees is a difficult matter to pin down. Card issuers currently charge account holders transaction fees, account fees, and earn revenue from the interest rate margins applicable to those deposit accounts. Cross-subsidisation exists between account holders. Some account holders do not pay transaction fees at all, others pay fees only when they exceed a given number of free transactions. Therefore, it will be difficult to establish that financial institutions even pass on the benefits to cardholders.

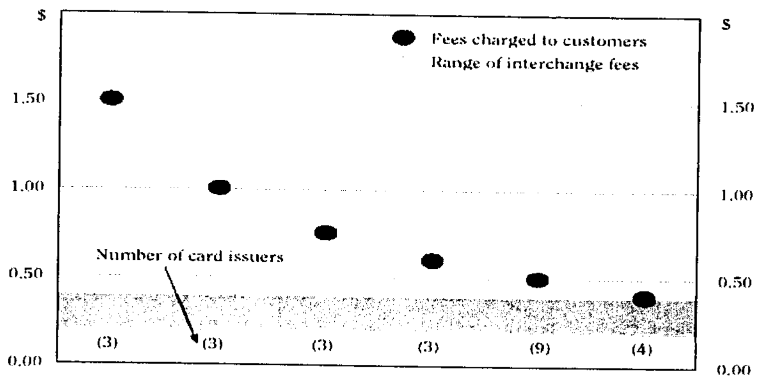
Past experience reveals that cost savings enjoyed by financial institutions are not necessarily reflected in reduced bank fees charged to customers or enhanced services. As stated in the Applicants' submissions, there has been a proliferation of EFTPOS terminal diffusion in recent years compared with Automatic Teller Machines since 1989.[9] Over this same period, there has been a significant reduction in bank branches. The resulting cost savings have not, on the whole, been converted into reduced fees imposed on or better services provided to bank customers. In fact, to the contrary, we would suggest that fees have risen steadily over the last five years.

The *Joint Study* made the point that since its inception EFTPOS interchange fees have changed little, although in real terms arguably they have fallen.

[8] Page 15, paragraph 5.2.2 of the Applicants' Submissions

Despite little or no movement in interchange fees, EFTPOS fees charged to consumers have increased significantly over this period. This suggests that there are a number of factors that determine card fees paid by consumers, and there is little evidence to suggest that any fee reduction made possible through lower interchange would not be offset by these other factors. Figure 6.3 reproduced from the RBA Study shows the wide range of fees paid by customers, with some issuers charging significantly more than the current range of interchange fees might otherwise indicate.

Figure 6.3: Customer fees for debit card transactions (after fee-free transactions)



Source: CANNEX Australia and information provided to the study

There is no evidence to suggest that the reduction in costs experienced as a result of a zero interchange fee will be passed onto cardholders. Indeed there is evidence that would suggest that there is no obvious pressure for issuers to reduce fees[10], and there is a common incentive for them all to resist this. Consequently it is more likely that issuers, not cardholders, would be beneficiaries of this proposal.

[9] Page 3, paragraph 2.1of the Applicants' Submissions

[10] For example a number of banks have significantly increased credit card fees well before anticipated changes to the credit card schemes. In another example despite supporting proposed abolition of ATM interchange fees Westpac has recently announced increases to the fees it charges customers for non-Westpac group ATMs effective 1 May 2003 see Schedule 2.

6.2 There is no certainty that zero interchange fees will increase usage of debit cards

The Applicants assert that the use of EFTPOS will increase, as a result of the likely decrease in the cost of EFTPOS[11]. This assertion is premised on the assumption that issuers will pass on their cost savings arising from the setting of a zero interchange fee to their cardholding customers.

Even if the assumption that issuer's cost savings will translate to reduced fees to their cardholders is accepted, the consequential impact on the number of EFTPOS transactions relative to credit card transactions may be insignificant for the following reasons:

a) Many debit cardholders are not charged directly for EFTPOS transactions, either due to bundled "packages" offered by issuers or by typically giving customers the first 8 transactions for free and working these costs into the pricing of the underlying financial product. For these cardholders it is difficult to see how they will benefit. It seems unlikely that they would be rebated 20 cents (approximate value of interchange fee savings) for these transactions. Consequently their decision to use EFTPOS in preference to a credit card would not be influenced by the setting of interchange fees to zero.

b) Other factors aside from transaction fees influence consumer decisions regarding payment options. Factors such as reward schemes available to participating credit card holders, the necessity of credit when there are insufficient available funds to cover the debt and the ease with which credit cards allow cardholders to manage their finances.

Even if price signals were to change, the fact will remain that credit cards will still be significantly more attractive than debit cards for issuers and ultimately their pricing to their customers will reflect this. There is simply no evidence to

[11] Page ii, Executive Summary of the Applicants' Submissions

support the Applicant's claim that the proposed conduct will have any effect on EFTPOS usage.

6.3 Shifting of costs from the Issuer to the Merchant does not give rise to Net Public Benefit

The Applicants' submission states that "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 banking services from other revenue sources"[12]. The Application admits that the likely effect will include higher average merchant service fees and increased marginal transaction charges for using EFTPOS. In other words, the merchant will be charged more for EFTPOS facilities. The Applicants note that the likely flow on effect will be increased average higher prices charged to consumers for retail goods and services.

An increase in the price paid for goods and services by all consumers regardless of whether they use debit or credit cards is inequitable and contrary to the principal of "*user pays*" let alone "net public benefit". Indeed ironically, this is precisely the issue that the credit card reform was trying to address. It is difficult to successfully argue that a net public benefit will result from the Interchange Fee Agreement when the result is that costs previously born directly by issuers, and arguably by debit card users in the form of transaction fees, are now to be absorbed by consumers at large. The Applicants' again dismiss this consequence as *"a market-driven outcome (that is not within the scope of the proposed arrangement)"*[13]

[12] page 15 of Applicants' Submissions
[13] page 16 of Applicants' Submissions

6.4 Theoretical Approach to problems with Access ignores reality of market

The Application asserts there are no real barriers to access to the EFTPOS network, whether such access is direct or indirect. It further asserts any current difficulty for new entrants would be overcome with this Application as it removes the need to negotiate one "significant" part of the terms of any bilateral agreement namely price.[14]

In CML's opinion a successful negotiation of an interchange agreement requires that the parties to that agreement reach agreement on price, however we would suggest that to implement a new interchange arrangement also requires agreement on a number of other matters other than price including:

- An agreement on the technical interfaces to be used - whilst Australian Standards set high level EFTPOS message standards there are still a number of detailed technical interface issues that interchange partners need to specify, develop, test and certify in order to successfully implement a new link.

- Implementation costs and resource allocations – a key issue for implementation is the willingness of interchange partners to commit resources necessary to build these interfaces. Whilst the costs to implement these links are generally modest, the biggest issue for implementation relates to the scheduling of resources. The delay in allocating resources could be used by existing network participants to frustrate the aspirations of organisations that they may perceive as potential new competitors.

- Commercial incentive – we would also make the point that our own partial success in entering into interchange arrangements has been largely due to the financial incentives we have offered prospective interchange partners.

[14] para 5.4 of Applicant's Submissions

Specifically, the existence of interchange fees and the ability to discount them allows a market price to be determined. This provides a financial incentive to drive a willingness to establish interchange links. Without these incentives we do not believe that these implementation issues would be overcome, and new entrants may be forced into more costly gateway arrangements with existing network participants.

Therefore whilst price is an important element of any contract, in our experience these other issues surrounding access to the debit card network are more likely to frustrate potential new entrants and would need to be resolved to properly address this issue.

Of concern to CML is the fact that the Applicants have failed to acknowledge the fact that the proposed conduct will in fact reduce the incentive for incumbents to engage in interchange activity with new entrants making access to the network more difficult. This is of particular concern to CML as we believe that access to the payments network is essential to encourage further needed competition in the industry, a key issue identified in the Joint Study.

We would also make the point that the ACCC has already considered in some detail these access issues in its determination of APCA's authorisation application of CECS.[15]

A key point in the ACCC's decision was the fact that APCA's application did not propose any self-regulation of ATM and EFTPOS interchange fees. The ACCC concluded that imposing a comprehensive access regime would not be justified in these circumstances.

In light of the ACCC's comments in paragraphs 7.77 and 7.78 of their determination, we would suggest that any proposal to self-regulate interchange fees would need to address these access issues.

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[15] Applications for Authorisation, Australian Payments Clearing Association, Draft Determination, ACCC, 5 July 2000

6.5 Concurrent Reform

A great deal of urgency is placed upon the need for the authorisation of this Application concurrent with the timetable for the RBA's implementation of reform of the credit card network. No real explanation is given for this urgency save for the suggestion that for consumers this saving in transaction fees will offset any increasing cost of credit card use after the reforms.

Given the lack of commitment by the Applicants to make clear and transparent the alleged saving in debit card transactions and the serious flaws in this assertion as outlined above, this suggested offset value of concurrent reform can not be accepted as the principal driver for timing of reform. Similarly, any argument that merchants will be aided in lessening the administrative burden of change can not be seriously maintained in the face of the Applicants' concession that merchants are likely to bear the cost of this reform through higher fees.

What is clear is that financial institutions will lose revenue in the reform of interchange fees on credit cards and in debit card reform have admitted the likelihood of creating new revenue streams by raising fees to merchants. The urgency for concurrent reform must be assessed in the face of this conceded reality and leads to the conclusion the urgency is purely a self-interested argument that severely limits this debate being properly conducted.

6.6 Segregation of credit card and EFTPOS reforms

The Applicants and others justify increasing the costs to merchants on the basis that a reduction in credit card interchange fees will offset any EFTPOS fee increase.

Credit card reforms are a separate matter currently being implemented by the RBA. Any reduction in fees to merchants resulting from these reforms we believe are long overdue. It is inappropriate for the Applicants to attempt to "claw back" some of losses from credit card reform using as their justification some hypothetical netting arrangement.

The key issue to be considered here is whether the proposed conduct of the Applicants will result in a net public benefit. It is inappropriate in making this assessment to reference other initiatives that are in no way connected to the proposed conduct of the Applicants.

We would also point out that we are still some months away from finding out what reductions, if any, retailers will receive following the credit card reforms. Even if the RBA's estimates were correct, there will still remain a significant cost for retailers if the Applicants' proposal is authorised.

6.7 Review of the zero interchange fee within the period of Authorisation

The Applicants' seek ACCC authorisation of the proposed Interchange Fee Agreement for a period of not less than four years in the first instance.[16] However, their Application proposes that the parties will monitor and can themselves amend the Interchange Fee Agreement every three years approximately from the date of commencement or earlier if there is a "*material change in circumstances*"[17].

This means that with a 75% member agreement, there is potential for the Applicants to amend the Agreement (ie to impose a fixed interchange fee of a different amount) after three years or even earlier if the parties perceive a material change in circumstances.

This suggestion for review is unworkable. There is no provision for any independent regulatory role in such review and/or amendment of the fee.

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[16] Page 1 of Applicants' Submissions
[17] Clause 3 of the proposed Interchange Fee Agreement

The phrase *"material change in circumstances"*, which is not defined in the Agreement, is vague and open to interpretation. Any alleged public benefit derived from zero interchange fees will be cancelled if the parties have the discretion to fix interchange fees at any rate they consider appropriate, under the protection of an authorised agreement. While the Interchange Fee Agreement provides a mechanism to review interchange fees if there is a "*material change in circumstances*" or otherwise approximately every three years, no evidence has been presented that amendments will be driven primarily by market forces rather than self-interest. An agreed process for change does not guarantee that considerations of net public benefit will be the driving force behind any amendment of the interchange fee agreement.

In the event that the parties to the Interchange Fee Agreement decide to exercise their discretion to increase the fixed interchange fee prior to the expiry of the authorisation period, any public benefit derived under the initial zero fee arrangements will be outweighed by the detriment arising from anti-competitive pricing arrangements. There is no guarantee that an amended interchange fee amount fixed under the Agreement will reflect the cost of provision of the service.

7 Alternative options for EFTPOS reform

The Joint Study believes that there is a risk to the economic welfare of the community as a whole from the current practice of allowing EFTPOS participants to determine voluntarily interchange fees and other access conditions for the EFTPOS network.

It is likely that differences of view will remain as to the nature and extent of the risks to economic welfare posed by the current access arrangements for the EFTPOS network.

CML believes however that the Applicants have failed to outline the case for proceeding down the path of either:

- multilateral determination of interchange fees or access conditions by the industry as a whole; or
- unilateral determination of interchange fees or access conditions by a single regulator, whether appointed by the government or the industry.

Each of these paths would run a far greater risk of regulatory failure and substantial adjustment costs.

Any increase in the risk of regulatory failure would be likely to have an adverse impact on the welfare of the community as a whole for little or no demonstrable economic benefit.

It would discourage the entry of prospective participants into the EFTPOS network and the emergence of new payment networks to compete with EFTPOS.

Moreover any increase in regulatory risk would discourage investment by the existing EFTPOS participants to upgrade and extend the network. This disincentive would be particularly pronounced for the non-financial institutions,