Submission to the ACCC

Response to an Application for Authorisation of EFTPOS Reforms

'The Fresh Food People'
WOOLWORTHS
Bringing food to life.

Woolworths Limited

31 March 2003

NON - CONFIDENTIAL VERSION

Contents

This document has been prepared with the assistance of TransAction Resources Pty Ltd

1. Confidentiality

This version of Woolworths' response to the Applicants' submission to the ACCC has had confidential commercial information removed so that the report can be released into the public domain. Where information has been deleted, it is marked by the statement:

[Confidential Information Deleted].

Confidential information has been deleted from the following Sections

Section 2	Executive Summary
Section 4.1	Woolworths' Role in EFTPOS
Section 6.1.5	Network Investment
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2. Executive Summary

Woolworths is a key stakeholder in the Australian EFTPOS system, *[Confidential Information Deleted].* Woolworths has also made a considerable investment in the purchase, development and on-going operation of a secure EFTPOS payments infrastructure in its retail outlets since 1993.

The majority of Australian EFTPOS transactions are processed through secure card terminals owned, maintained and operated by merchants.

The Applicants have failed to establish that there are any problems with the existing system. Australia's EFTPOS system is a world class facility which is secure, fast, reliable and efficient. It is well accepted by both merchants and consumers and the long term health of this system should not be jeopardised by unwarranted changes.

The Application makes a series of claims and assertions with no supporting data or evidence. It provides no detailed economic analysis of the affected markets either with or without the proposed reforms. No actual current cost data has been provided for acquirers, issuers, merchants or cardholders. It must therefore be concluded that the claimed likely outcomes of the proposed reforms have not been credibly substantiated.

The Application relies heavily upon the RBA/ACCC Joint Study of October 2000. This Joint Study was a high-level preliminary look at the costs of issuers and acquirers in relation to interchange fees. However, no data was gathered or analysed by the Joint Study in relation to the actual investments or operating costs of merchants. Neither was any data collected in regard to establishing the actual costs of cardholders. The Joint Study therefore did not provide a basis upon which the impacts of reform on merchants and cardholders could be reliably estimated. It was always intended that there would be detailed follow-up studies for credit cards, EFTPOS and ATMs. While this has happened for credit cards and ATMs, this has not been the case for EFTPOS.

The public benefits claimed as likely outcomes of the proposed reforms are unlikely to be realised in practice and are at best doubtful. For example, lower costs for cardholders are unlikely to be realised as most cardholders pay no EFTPOS fees today. A move from bilateral pricing agreements to a price-fixing agreement is most unlikely to result in more flexibility in price-setting as 75% of parties would have to agree a new price, and not just 2 of them. No process, or methodology of any sort, has been suggested for setting new prices in the future. Merchants and cardholders, both key stakeholders, will be excluded from the proposed price monitoring and review process.

A general increase in retail prices for all consumers, including those who do not pay by EFTPOS, is not in the public benefit and will reduce transparency and potentially remove some of the current price signals to consumers.

In response to the RBA review of credit cards, banks have already increased credit card fees and implemented higher interest margins to recover anticipated reduced revenue from interchange, ahead of the actual changes. It now appears that the banks are seeking to gain further income through likely increases in EFTPOS fees to merchants.

The introduction of a price-fixing agreement is likely to lead to a substantial lessening of competition, as defined by Section 45A of the *Trade Practices Act 1974*. The proposed reforms are also likely to lead to reduced price flexibility in the market between acquirers and merchants as one significant variable (interchange income) will be removed. It will also become more difficult for new specialist acquirers to enter the EFTPOS market as they will have fewer options to recover their necessary investment and they will compete against other acquirers who have already paid for their existing processing platforms under the existing arrangements.

A multilateral interchange fee will not make it easier for a new acquirer to enter the market. As the Application agrees, the main obstacles to entry are the bilateral commercial agreements and the various proprietary technical standards. The proposed reforms leave these barriers in place.

The Application implies that there is no longer any requirement for substantial investment in secure infrastructure, that these investments have been made in the past and there is no longer any need to provide incentives for further investment. As the Applicants are well aware, the Australian Payments Clearing Association (APCA) has determined that DES is no longer sufficiently secure to protect cardholder PINs and transaction messages. APCA has directed all Australian merchants to upgrade their card processing equipment to a new encryption algorithm called Triple DES by 31 December 2005. The cost to Australian merchants for either upgrading or replacing all current equipment has not yet been established, but it will cost several millions to achieve this. *[Confidential Information Deleted]*. In other words, merchants will continue to incur capital and maintenance costs associated with payments infrastructure.

A likely outcome of the proposed reforms is that merchant incentives to invest in secure payments infrastructure will be substantially reduced, and therefore it is likely that the EFTPOS infrastructure will begin to degrade over time. This threatens public confidence and may potentially lead to increased fraud costs. Either of these outcomes would lead to a less efficient EFTPOS payment system which will be to the disadvantage of customers.

As the Application agrees, acquirers provide a service to issuers. Issuers are able to offer a low cost EFTPOS card to their customers, which allows nationwide access to a network of secure payment equipment at tens of thousands of points of sale. Why should issuers be provided access to this high cost network infrastructure free? This proposition makes no commercial sense. Issuers have used EFTPOS cards to move their customers to electronic banking, reduce their investments in branch networks, and substantially lower their cost to income ratios. Issuers receive significant financial benefits from their cardholders having access to the Australian EFTPOS network, which acquirers and merchants have jointly provided, and continue to provide.

As the Application fails to credibly substantiate the claimed public benefits, and as the proposed reforms are likely to result in a substantial lessening of competition, it is Woolworths' view that the Application should not succeed.

3. Introduction

Following the deliberations of the EFTPOS Industry Working Group (EIWG) during 2002 and early 2003, this group decided to disband itself and abandon discussions with other stakeholders. All of the EIWG members, with the exception of Coles Myer Limited, have now submitted a document to the Australian Competition & Consumer Commission (ACCC) requesting authorisation for a multilateral EFTPOS fee, to be initially set to a level of zero.

This document, "The Application[1]" sets out the arguments of the Applicants as to why authorisation should be granted.

Woolworths Limited, as a major stakeholder in the Australian EFTPOS system, wishes to express its views on the Application. This document outlines those views. Woolworths has been involved in both the credit card and EFTPOS reviews, both in its own right and through its involvement with the Australian Retailers Association.

Woolworths supports the concept of EFTPOS reform, but believes that <u>all</u> stakeholders should have an equal voice and that outcomes must be equitable, independently determined and transparent. Above all, the long term health and sustainability of the EFTPOS system must be enhanced by any reforms. No changes which could jeopardise this system should be allowed. Australia currently has one of the best, and most secure, EFTPOS systems in the world and we must ensure this continues.

There are also some issues which impact the ability of new issuers and acquirers to enter the system and these need to be addressed to ensure increased competition over time. It is through increased competition, we believe, that long-term sustainable improvements to EFTPOS will be achieved.

4. Woolworths Limited

Woolworths is a major Australian retailer. It operates a large range of retail stores, including:

- Australia's largest supermarket chain (Woolworths / Safeway)
- general retail (Big W)
- petrol (+Plus Petrol)
- electronics outlets (Dick Smith Electronics, Tandy)
- liquor outlets (supermarket liquor stores, Dan Murphy, BWS and others)

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

In addition, Woolworths operates Ezy Banking which is a joint initiative between Woolworths and the Commonwealth Bank of Australia. Ezy Banking is aimed at taking banking services to the customers by providing these facilities at locations which are convenient for its customers and at low cost.

Woolworths total group sales were $24.5 billion for the 2002 financial year. Woolworths has 145,000 employees and operates more than 1,500 stores, including almost 700 supermarkets.

4.1 Woolworths' Role in EFTPOS

Supermarkets, along with service stations, have historically been key drivers of debit usage, not only in Australia, but around the world. Woolworths has been involved in EFTPOS since its earliest days in Australia and has been crucial to its success in this country.

[Confidential Information Deleted]

Woolworths is a key stakeholder in EFTPOS.

Card usage has continued to increase as a proportion of all payments year on year. We believe that card usage, and particularly EFTPOS, will continue to grow as it meets customers' needs for convenience and security (not needing to carry too much cash). EFTPOS will also continue to play a vital role in our Ezy Banking program which will continue to offer a low cost, flexible "convenience" proposition to our customers.

If the the proposed reforms are implemeted, it will restrict our ability to further develop our payments related services, will significantly limit our flexibility , and the cost to customers would also increase.

5. The Application

The Application relies heavily upon the conclusions of the RBA and ACCC "Joint Study" of October 2000[2]. This high level Joint Study reached only a preliminary conclusion with regard to EFTPOS interchange fees. The Joint Study included no economic data or analysis in relation to merchant operating costs or merchant levels of investment. Neither was any analysis done in relation to the actual costs incurred by cardholders.

Merchants such as Woolworths are a key element of the EFTPOS system in Australia. The secure payments processing infrastructure purchased, developed and maintained by merchants at thousands of points of sale nationally processes the majority of EFTPOS transactions each year. It is therefore essential to include merchant data in any analysis of likely outcomes from the proposed reforms.

The Application includes no analysis of merchant transaction processing costs, investment levels, or on-going operating costs. It does not attempt to provide estimates or analysis of the actual costs to Australian EFTPOS cardholders, despite the fact that the Applicants have all the relevant data available to them. Indeed, the Application consists primarily of a series of claims and assertions with no supporting evidence whatsoever.

It is Woolworths' view that the proposed reforms will not deliver any public benefit, and in fact will be to the public detriment. It is also Woolworths' view that a price-fixing agreement between issuers and acquirers will result in a substantial lessening of competition (as defined by Section 45A of the *Trade Practices Act 1974*).

This Application for authorisation of EFTPOS reforms should be completely rejected by the Commission.

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2 *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

6. Key Reform Issues

6.1 Public Benefit

6.1.1 Reduced Cardholder Costs

The Application claims that the proposed reforms are "likely" to lead to reduced costs for EFTPOS cardholders. This claimed reduction in costs is not guaranteed by the Applicants and indeed, the Application refers to a possible increase in cardholder costs if increased levels of investment were required in the future:

> "*The capacity of financial institutions to finance system-wide expansion or improvements in the EFTPOS network may be constrained by the loss of interchange fee revenues. It may be possible for individual financial institutions to initiate efficient network improvements financed through increased debit card transaction charges and merchant service charges.*"[3]

and that some issuers may prefer to deliver "enhanced services"[4] to cardholders rather than reducing their costs in some way.

The claimed "likely" reduction in cardholder costs is also not substantiated by any data which shows current cardholder costs and the expected costs following the proposed reforms. As cardholders currently receive "*on average, 8 free EFTPOS, ATM and other electronic transactions per month*"[5] (or 96 free transactions per year), and as there was an average of 38 EFTPOS transactions per account in 2002[6], it seems likely that the majority of EFTPOS cardholders currently pay no transaction fees at all.

In addition to this threshold, many EFTPOS cardholders have their fees waived entirely by their issuer if they are a pensioner or a full-time student, or have significant borrowings, or a mortgage with the issuing institution.

Given the above, Woolworths believes it is unlikely that the proposed reforms will significantly reduce the costs to EFTPOS cardholders. It also seems that the issuers are likely to retain at least a substantial majority of the savings they make from the move to zero interchange.

6.1.2 Retail Prices

The Application acknowledges that acquirers are likely to increase merchant service charges in order to recover the loss of interchange revenue that flows from the proposed reforms. Merchants, including Woolworths, will therefore be faced with an increase in their EFTPOS transaction processing costs of around 20 cents per transaction.

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3 *"Submission by the Applicants to the Australian Competition & Consumer Commission in support of Applications for Authorisation of EFTPOS Reforms"*, February 2003, p.22

4 *"Submission by the Applicants to the Australian Competition & Consumer Commission in support of Applications for Authorisation of EFTPOS Reforms"*, February 2003, page 15

5 *Discussion Paper: Options for EFTPOS Interchange Fee Reform*, EFTPOS Industry Working Group, July 2002

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

A merchant currently being paid some fee for delivering transactions at no cost to the acquirer will now have to pay some transaction fee to the acquirer instead. Woolworths believes it is likely to be placed in exactly this position in its relationship with its acquirer. To this point, the acquirer has not communicated to Woolworths any likely outcome from the proposed reforms.

A smaller merchant who is currently paying a small fee per transaction is likely to have to pay a much larger fee per transaction.

All Australian merchants will have their EFTPOS processing costs increased, without exception, whether they have invested in their own secure infrastructure or rent their point of sale equipment from an acquirer. In turn, this means that customers are likely to pay more.

As the Application agrees, it is very unlikely that competition between retailers will allow debit surcharging to occur to any significant degree. Woolworths does not intend to surcharge its customers for paying by EFTPOS. The competitive environment, in our opinion, will not allow this today, nor is it likely to do so in the future. Thus, the only viable option for retailers will be to build these costs into the overall price of their goods.

This means that, if the application is approved, the cost of EFTPOS will be built into the overall cost of goods and all consumers will pay for this, irrespective of their method of payment. **Retail prices will rise.**

The Applicants agree that retail prices will move higher, stating 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...*"[7]

Woolworths believes that it is not in the public benefit to have all consumer prices increased to cover the costs of providing a secure EFTPOS infrastructure to EFTPOS cardholders.

This issue is discussed in more detail in Section 6.4 – Transparency and Pricing Signals.

6.1.3 Lowering the Cost of the Payments System

The Application claims that the proposed reforms will lower the costs of the Australian payments system. As the Application agrees that the costs saved by issuers are likely to be passed on to merchants and then on to all consumers, it is difficult to see how the overall cost of the payments system will be lowered.

Shifting a cost from one area of the system to another does not constitute a saving.

Woolworths believes that the proposed reforms will not result in lowering the costs of the Australian payments system.

Indeed, some of the current level of payments cost transparency to consumers is likely to be lost. This seems to be a step backwards compared to the current position.

7 Ibid p.21.

6.1.4 More Flexible Interchange Fees

The Application claims that the proposed reforms will result in more flexible interchange fee price setting arrangements. Exactly how a move from bilateral, separately negotiated, interchange fees to a multilateral price-fixing agreement will be more flexible is not explained and is certainly not established to any credible degree.

The Applicants propose to "monitor" the impact of a zero interchange fee (and presumably of a price-fixing agreement), but do not explain how they might achieve this. Exactly what will be monitored, by whom, and using what measures, is not explained at all.

The Applicants propose to "review" interchange fee levels after 3 years, or earlier if they deem necessary. What will be reviewed, by whom, using what data, and by what methodology is completely unknown. It is Woolworths' view that the Applicants would have almost complete freedom to amend interchange fee prices whenever they choose, should this proposed reform be authorised.

It is not clear whether, in fact, a change in the interchange fee price level would require a new authorisation or not. This has not been proposed, however, and therefore it appears the Applicants could potentially amend the interchange fee prices as and when they wish, without reference to third parties, including other industry stakeholders such as merchants and cardholders. We understand some of the Applicants are keen to move to a positive interchange arrangement in the future. The current application, if authorised, could allow this to happen.

It is Woolworths' opinion, that far from increasing flexibility in interchange fee price setting, the proposed reforms are likely to lead to a less competitive process and also one which is less sensitive to inputs from merchants and cardholders.

6.1.5 Network Investment & Development

The Application states that "*... the investment effects of lowering interchange fees remain unclear ...*"[8]. The Application further states "*It is also possible that lowering the interchange fee will reduce the immediate returns on those investments and the incentives to undertake the expenditure needed to maintain or improve the present quality and penetration of the network.*"[9]

In fact, the proposed reform is not merely to lower interchange fees, but to eliminate them completely. This will, without any doubt, remove the possibility of a merchant being paid any form of processing fee by acquirers in the future which could be used as an incentive to continue to invest in secure payments infrastructure.

The Application suggests that, as merchant service charges will be increased to compensate for acquirers' loss of interchange income, "*there will still be a flow of revenue to finance investments*" (page 17). Unfortunately, this flow of revenue will only provide income to acquirers, and will be an additional cost to merchants who are major investors in the Australian EFTPOS system. This fact is completely ignored by the Application. This will result in all acquirer investments being paid for by merchants, as well as all merchant

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8 *"Submission by the Applicants to the Australian Competition & Consumer Commission in support of Applications for Authorisation of EFTPOS Reforms"*, February 2003, p.17

9 Ibid, p.17

investments also being paid for by merchants. At the same time, issuers will be contributing nothing to the on-going maintenance of the system which delivers them so many benefits. This is a totally unjust and inequitable outcome of the proposed reforms, and is clearly not to the public benefit.

The Applicants themselves acknowledge that the effects are "unclear" and therefore cannot claim that the present secure Australian EFTPOS system will remain in this condition if the proposed reforms are implemented.

If merchants do not undertake required upgrades of infrastructure, or delay them as long as possible due to the high cost of doing so, the relative level of security of the Australian EFTPOS system is likely to decline. The security of the system is essential to retain high levels of public confidence and therefore high levels of cardholder usage. It is also essential to keep fraud at the current very low levels that make the EFTPOS system less costly and more efficient by comparison with the signature based credit card system.

In 1997 (the most recent figures available), some 16,500 debit card transactions in Australia were reported as unauthorised where the cardholder was liable[10] in a year when 1.4 billion transactions (EFTPOS and ATM) were conducted. In the same year just over 5,000 transactions were conducted fraudulently where the issuer was liable. For debit cards, fraudulent transactions represent 0.0015% of total transactions. No estimate of the dollar amount that these transactions represent is available although these transactions are generally of higher value than average transaction values.

Experience in markets overseas, such as the UK where debit is signature based, have demonstrated clearly the problems that can occur with high fraud costs. A decline in security of the EFTPOS system will lead to a reduction in its efficiency.

The Application tries to imply that there is no longer any need for infrastructure investment, that this investment has been made in the past, and therefore there is no longer any requirement to continue to invest in the infrastructure. This implication is entirely without foundation.

Merchants in Australia today, with their own EFTPOS equipment, are being directed by the Australian Payments Clearing Association (APCA), through their acquirers, to upgrade their card processing infrastructure in order to strengthen the security of the encryption technology currently being used to protect cardholder PINs and the integrity of transaction messages. Most card processing equipment today uses an encryption method known as "DES", the Data Encryption Standard. It has been determined by APCA that this technology is no longer sufficiently secure to properly protect cardholder PINs and transaction messages and therefore a new encryption algorithm known as "Triple DES" has been mandated for all Australian card terminals by 31 December 2005.

The cost for Australian merchants to either upgrade or replace all existing PIN Pads is unknown at this time, but it will be very expensive. Some older equipment will not be able to implement the new encryption algorithm without significantly slowing down customer transaction processing times and therefore this equipment will have to be entirely replaced.

Woolworths is in the position of having to replace all its point of sale EFTPOS equipment in order to meet the requirements of this new standard over the next 2 years.

10 Australian Payment Systems Council Annual Report, 1996/1997

[Confidential Information Deleted]

It is important to note that the drive behind the move to triple DES which requires this expenditure is to reduce the fraud costs incurred by the issuer. In other words, Woolworths (and other merchants) are making this investment to reduce the issuers' potential costs of fraud.

Under the current arrangement, the issuers will reimburse the merchants (and/or acquirers) for this expenditure via the interchange fee. Under the Applicant's proposal, the merchants would now not only have to pay for the equipment upgrade, they would also have to pay the acquirer a transaction fee for processing EFTPOS transactions through their own equipment. The issuer on the other hand will reap the benefits, but not have to pay any fees to anyone. This simply does not make commercial sense.

It is also important to recognise that this equipment requires maintenance and repair, and that, from time to time, the system must be upgraded as new cards enter the market from issuers seeking to offer additional services to their cardholders. In addition to these on-going maintenance costs, the major operating cost in a network of EFTPOS equipment is the communications charges for carrying transaction messages from the merchant's point of sale to the acquirer and back again in "real time". These communications charges are estimated by TransAction Resources to be 6 cents per transaction, on average, for Australian merchants today (refer table in Section 6.3 – Interchange Fee Levels).

If Woolworths did not provide all the point of sale infrastructure and communications links for EFTPOS in its retail outlets, our acquirer would have to provide and maintain them (as used to be the case in Woolworths stores up to 1993). It is for this reason that acquirers have agreed to pay some fees in return for EFTPOS transactions being delivered to them at almost no cost.

It should also be noted that EFTPOS acquirers face on-going investment in their transaction processing platforms to handle increasing transaction volumes without slowing processing times. Not only must the primary platform be regularly upgraded, but the fallback or "disaster recovery" systems must also be similarly upgraded on a regular basis. The Applicants have not provided any data on the annual levels of investment currently being made by EFTPOS acquirers in Australia.

It is also significant that at least 2 Australian acquirers are currently investing in completely new replacement acquiring platforms in order to move to more up-to-date and lower cost transaction processing technology. Both these organisations are making a significant investment at this time while they are still able to earn revenue from interchange fees.

Both of these acquirers will be in a much stronger position to compete with any new acquirers who may enter the market after these new processing platforms have been put in place.

The Application suggests that the Applicants will monitor levels of investment in the EFTPOS network but does not reveal how they will obtain investment data from merchants, or by what method the analysis will be performed. This claim is again not supported by any evidence or methodology whatsoever.

Woolworths believes that the proposed reforms will substantially reduce the incentive for merchants to invest in secure, on-line EFTPOS infrastructure, and that therefore some degradation of the network is likely to take place over a period of time. Again, it seems that the proposed reforms are likely to result in a reduction of public benefit.

The Applicants' submission states that *"EFTPOS interchange fees played some part in encouraging the investment in acquirer-side terminals and other facilities that led to the growth and present ubiquity of EFTPOS facilities in Australian retail markets"*[11]. However, they imply that in a mature market this is no longer required *"until some disruptive occurrence, such as the development of a new product such as a smart card"*[12].

This is simply not true. As discussed earlier, APCA has already mandated that all terminals must be triple-DES-compatible by 2005. This will cost merchants many tens of millions of dollars – and this is only one element. The card industry is facing a huge expenditure on fraud reduction measures and increased network security over the next few years. The banks themselves have admitted the magnitude of this problem. There have been a number of press announcements by the banks and card schemes in recent months relating to this issue. The cost to "upgrade existing card payment systems to more secure alternatives" (ie chip card systems) is estimated to be of the order of $1 billion[13] (this is the cost of the cards plus upgrading ATMs and EFTPOS terminals).

In other words, there will continue to be significant on-going expenditure on the card processing infrastructure for many years to come. Thus it is essential that some form of incentive, such as the current interchange fees, remains in place to allow those who provide the infrastructure to obtain a reasonable return on their investment. Otherwise, the necessary investment simply will not happen and our EFTPOS infrastructure is likely to slowly degrade over time.

It is worthwhile noting that the Bank for International Settlements (BIS), which is comprised of the major central banks around the world, including the Reserve Bank of Australia, also believes that there should be an interchange fee paid by the issuer to the acquirer for EFTPOS transactions in order to provide reimbursement for the cost of the network. BIS defines interchange thus:

interchange fee	transaction fee set by the network organisation and paid by the card issuing institution to the acquiring institution for the cost of deploying and maintaining ATMs and EFTPOS terminals.[14]

The Applicants themselves admit that the current interchange fee is paid to compensate the acquirer for the provision of the service:

> *"Each time a cardholder uses a debit card to make a purchase from a merchant, the cardholder's issuer pays an interchange fee to the merchant's acquirer for providing that service to its customer"*[15]

11 *"Submission by the Applicants to the Australian Competition & Consumer Commission in support of Applications for Authorisation of EFTPOS Reforms"*, February 2003, p.17

12 Ibid, p.15

13 *"Card fund seems a smart move"*, Australian Financial Review, Ben Woodhead, 26 November 2002

14 A Glossary of Terms Used in Payments and Settlement Systems, Bank For International Settlements – Committee on Payment & Settlement Systems, January 2001 (revised July 2001), P.21.

15 *"Submission by the Applicants to the Australian Competition & Consumer Commission in support of Applications for Authorisation of EFTPOS Reforms"*, February 2003, p.6

This view is confirmed by the fact that the acquirers charge a fee to American Express and Diners Club when these cards are processed through the banks' networks. The acquirer is providing a service and receives a fee for that service.

Finally, it is worth noting the comments of Manuel Rio of France, a long standing expert in payment systems and consultant to the French Government in payment systems. Mr. Rio said[16]:

> "The EFTPOS (electronic funds transfer at point of sale) system in Australia is a real time, on line, PIN based, debit card system. **It is considered to be the best in the world in terms of quality, convenience, safety, technological advancements, overall cost, reliability, processing speeds and increased efficiency.** It has been a resounding success in Australia and it has been adopted by the Australian consumer and by merchants with enthusiasm."

Mr Rio goes on to say:

> "Fee flow recognises the economic principle of user pays."
>
> "On top of this, the negative interchange fees, and the reverse merchant fees, both bilaterally negotiated, adequately compensate, on a case by case basis, acquirers and merchants for their investments in infrastructure and the continuing modernization of the system."
>
> "Market forces produce an efficient system."
>
> "The system works well as there are incentives for the network providers to develop and enhance the system and the customer interface. These incentives are not present in the less efficient, less technically advanced and more expensive credit card system."

Woolworths believes that the sustainability and long term health of Australia's EFTPOS network is dependent on providing an on-going incentive for investment and the ability for those investing in infrastructure to be able to make an adequate return on that investment.

6.2 Competition

Section 45A of the *Trade Practices Act 1974* states that a price-fixing agreement is likely to have the effect of substantially lessening competition within a market.

The proposed reforms will lessen competition in 2 markets:

- the market between issuers and acquirers; and
- the market between acquirers and merchants.

As the current EFTPOS interchange prices are based upon separately negotiated bilateral agreements, it is currently possible for any of these prices to be modified at any time without requiring the agreement of all other issuers and acquirers. If the proposed reforms were implemented, however, the agreement of all other issuers and acquirers would be needed, regardless of the individual circumstances of 2 parties who may wish to amend the price between them for some reason.

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16 *"Australia's EFTPOS"*, unpublished submission to the European Commission Enquiry into the Visa MIF, Manuel Rio, Paris, March 30 1999.

It is also important to realise that all the current EFTPOS acquirers are also issuers, and therefore there are no specialist acquirers in the market. This has a big effect upon the so-called "negotiation" of fees paid from issuers to acquirers.

At present, the *average* interchange fee is around 20 cents per transaction, however individual acquirers receive fees over a range of prices from around 19 cents to around 25 cents per transaction. Depending upon the negotiated prices, each acquirer today receives a different amount of income from the transaction stream generated by a particular merchant. Therefore each acquirer has the capacity to offer different pricing to a particular merchant based upon the potential income to be generated from the transactions of that merchant. This provides a competitive element in pricing to merchants that would disappear if the proposed reforms were implemented.

As acquirers are presently able to receive a revenue stream from both merchants and issuers, they have more freedom to compete with other acquirers than they would do if the proposed reforms were implemented. Under the proposed reforms, acquirers would no longer receive a revenue stream from issuers and this area of negotiation and competition would be removed.

For new acquirers wishing to enter the EFTPOS acquiring market, the lack of any revenue from issuers would force them to recover all their start-up investment costs from merchants. This would place them at a cost disadvantage in the market compared to acquirers who have had the benefit of this revenue stream in the past to amortise their investments to date.

Woolworths is of the view that the best way to improve efficiency and lower costs in the EFTPOS acquiring market over time is by increasing the number of acquirers and by the introduction of *specialist acquirers* to the market. This increased level of competition between acquirers will provide an ongoing incentive for a reduction in operating costs and an increase in productivity levels. Any reform which makes it potentially more difficult for new acquirers to enter the EFTPOS market would have the effect of significantly lessening competition.

At present, all the acquirers are also issuers, and therefore the proposed reform which reduces acquirer income and lowers issuer costs has relatively little impact on the bottom line of the current acquirers. It would however, have a marked effect upon the bottom line of <u>a specialist acquirer which is not also an issuer</u>.

The Application provides no data on the estimated bottom line impact of the proposed reforms on each of the current EFTPOS acquirers when their issuing business is taken into account.

6.2.1 Easier For New Entrants

The Application suggests that a multilateral interchange fee (whether zero or some other figure) will make entry to the EFTPOS market easier for new entrants as it will no longer be necessary to negotiate a price with each of the other parties to the network.

The Application correctly identifies the current bilateral agreements as one of the effective barriers to entry for new competitors, but unfortunately the proposed reforms will leave these bilateral agreements in place and introduce a multilateral, co-operative price-fixing agreement.

Woolworths believes that the proposed arrangement effectively leaves all the present barriers to entry (both contractual and technical) in place with no impact whatsoever upon the difficulty of joining the network as a new competitor.

A new entrant today, attempting to negotiate bilateral agreements with existing parties, faces 2 major hurdles in negotiation:

- differing technical standards for each counter-party; and
- lengthy time frames to develop, test, certify and implement each technical interface.

Compared to these 2 obstacles, negotiating a price per type of transaction is fairly trivial.

If a new entrant were to invest in a modern and low-cost acquiring platform, then the ability to negotiate levels of interchange income with other parties that would suit their business model and assist in recovering their investment, would definitely be an advantage.

The proposed reform is for a multilateral interchange fee set to zero. This delivers a price-fixing arrangement that can only be influenced in a small way by a single new entrant and removes the income that could be gained from existing issuers. The new entrant must therefore set merchant service fees that will meet the required margin and also recover the capital investment. Existing acquirers, who have had many years to recover their investment costs, are likely to be able to set their merchant service fees at lower levels. This arrangement seems likely to be a disincentive to new acquirers.

6.3 Interchange Fee Levels

The RBA/ACCC Joint Study of October 2000 suggests that "cost-based methodologies" may be desirable for calculating the appropriate level and direction of interchange fees. This approach has been supported by the RBA in its reforms of the credit card system with the introduction of a method based on defined eligible costs, and an independent price calculation. To achieve transparency for all parties, these credit card interchange fee rates will be made public.

The Application suggests that the Applicants will monitor interchange fee levels, and will review them after 3 years. There is no suggestion of any particular process or methodology to be employed at all, and certainly no proposed cost based methodology. There will apparently be no input from merchants or cardholders and there is no suggestion that the results will be made public. It is not even clear whether a changed (ie. non-zero) interchange rate will require authorisation from the ACCC or whether the Applicants will be free to change the interchange fee whenever they deem it necessary, and in whatever direction they deem necessary.

Industry experts TransAction Resources have calculated the cost of acquiring and processing an EFTPOS transaction. This has been determined to be 21 cents per transaction, based on industry averages across small and large acquirers and merchants. Costs for individual acquirers and merchants will vary according to their size and other variables.

The cost structure (per transaction) is as follows:

Processing and switching costs	3 cents
Telecommunications	6 cents
Other operating costs, including staff	4 cents
Card terminal costs[17]	8 cents
Total	21 cents

Please note that the above figures are the total costs for acquiring the transaction. These may be incurred wholly by the acquirer or, in the case of large merchants, may be partly incurred by the merchants themselves.

These costs are in line with the charges made by third party transaction processors in the Australian market. **The overall cost is also very close to the current average interchange fee, confirming that the interchange fee has been operating at a reasonable level.** This is in line with the approach of the Joint Study which believes that any interchange fees should be cost based.

Since this estimate of 21 cents per transaction was presented by the Australian Institute of Petroleum to the EFTPOS Industry Working Group (of which all the Applicants were members), it has not been questioned or challenged by any party. The Applicants themselves have made no attempt to provide any cost data.

Issuers cannot offer the universal convenience and low cost of an EFTPOS card to their customers as part of their "customer offer" without a connection to the vast national network of secure card processing terminals and communication networks. Why should this infrastructure be provided for their cardholders to use at zero cost?

It should be noted that the Application has provided no data on the current costs of EFTPOS issuers.

The presence of a national and widely available secure on-line EFTPOS network allows issuers of EFTPOS cards to provide all their account holders with an electronic banking transaction card without the need for credit checking. It allows large numbers of transactions for payments and cash withdrawal to be processed outside the issuer's retail branch network and thus lowers branch costs. It also reduces the requirement for ATM investment due to the high volume of "cash out" at retail points of sale *[Confidential Information Deleted]*.

It should also be noted that the banks continue to benefit from significant cost reductions as a result of the introduction of EFTPOS. These cost savings are not mentioned in the Application.

The banks introduced EFTPOS as a means for customers to access their bank accounts without going into a branch. Over the years this has delivered many significant benefits and cost reductions to the banks, including:

- reduction in the number of branches with significant on-going cost savings
- replacement of cheques, particularly for retail purchases
- elimination of paper account passbooks
- move to having salaries paid directly into workers' bank accounts

[17] Includes amortisation of terminal purchase, installation and maintenance costs

- reduction in costs by reducing the handling of paper based transactions for both cheques and credit cards
- new revenue streams from retailers through terminal rental and debit transaction fees.

Any discussion of EFTPOS costs must take these cost savings for the banks into account.

6.4 Transparency and Pricing Signals

The Joint Study into interchange was concerned about sending the correct price signals to consumers and about transparency of fees and costs.

As discussed earlier in Section 6.1.2 - Retail Prices, the likely outcome of zero interchange is increased fees to merchants. As the Applicants state, merchants "*are unlikely to engage in widespread surcharging for the use of direct debit cards*", and Woolworths agrees with this statement.

This means that the outcome of a zero interchange for EFTPOS is likely to be that merchants will build the increased costs into the overall price of their goods. Thus:

- the costs will not be transparent
- the price of goods will increase for <u>all</u> customers for <u>all</u> payment methods due to cost recovery
- the correct pricing signals will not be sent to consumers. In fact, no pricing signals will be sent - consumers will pay the same price for the goods irrespective of their payment method.

This will lead to cash payers effectively subsidising card payers, a situation deemed undesirable by both the Financial System Inquiry[18] and the ACCC/RBA Joint Study. As the Joint Study said in relation to credit cards:

> *"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."*[19]

It is hard to understand why the Applicants would wish to introduce exactly the same situation with debit cards that the Joint Study found so unsuitable for credit cards.

In the past, credit card issuers have been funding their loyalty programs from the interchange income and offering incentives for their customers to use a more expensive payments system. The credit card reforms have addressed this and credit card interchange is now to be calculated based on a number of "eligible costs". These cost categories are specified and the cost of loyalty programs will not form part of the interchange fee.

Thus, any suggested "distortion" in pricing signals between EFTPOS and credit cards has been addressed and corrected by the RBA reforms to credit cards. Banks have already commenced increasing annual card fees and increasing the cost of participation in their

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[18] *Financial System Inquiry Final Report*, March 1997

[19] "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.

loyalty programs and/or providing reduced benefits. Now this "distortion" in price signals has been dealt with, the correct price signals will again be sent to consumers. There is no evidence that any move to zero interchange will improve the price signals.

7. Conclusions

In conclusion, Woolworths believes:

- the submission would result in reduced competition
- the Applicants have not demonstrated any net public benefit
- the Applicants have not provided any data to support their arguments, simply hypotheses and unsubstantiated arguments

We believe the Applicants' submission should not be authorised.