

Approved for Public Register and
to be published on the Internet
YES / NO
[Signature]
24 / 4 / 3

Rejoinder Submission by the Applicants to the
Australian Competition & Consumer Commission
in Support of Applications (A30224 and A30225) for
Authorisation of EFTPOS Reforms

April 2003

CONTENTS

EXECUTIVE SUMMARY	1
1. INTRODUCTION	1
2. KEY ISSUES	2
2.1 PASS-THROUGH OF CHANGES IN INTERCHANGE FEES	2
2.1.1 Pass-through to cardholders	2
2.1.2 Pass-through to merchants	5
2.2 CONDUCT AS CATALYST FOR ABUSE OF MARKET POWER	6
2.3 ACCESS ISSUES	7
2.4 ABSENCE OF INTERCHANGE SETTING METHODOLOGY	8
2.5 FREE HAND TO MULTILATERALLY SET NON-ZERO INTERCHANGE FEES	9
2.6 INDEPENDENT OVERSIGHT AND REVIEW.....	9
2.7 INVESTMENT INCENTIVES.....	10
2.8 INCREASES IN PRICES CANNOT BE IN PUBLIC INTEREST	11
3. RESPONSE TO ACIL TASMAN "CRITIQUE OF APPLICATION"	13
3.1 APPLICATION DOES NOT DEFINE A MARKET FOR EFTPOS	13
3.2 APPLICATION IGNORES THE EXISTING BENEFITS FROM EFTPOS	14
3.3 APPLICATION ASSUMES ISSUER SAVINGS PASSED ONTO CARDHOLDERS	15
3.4 APPLICATION IGNORES IMPACT OF ACQUIRER COSTS ON RETAIL CONSUMERS	16
3.5 APPLICATION UNDERSTATES IMPACTS ON EFTPOS NETWORK	17
3.6 APPLICATION DOES NOT RECOGNISE IMPACT ON PAYMENTS SYSTEM.....	17
3.7 APPLICATION LARGELY IGNORES TRANSACTIONS COSTS.....	18
3.8 APPLICATION DOES NOT ADDRESS ACCESS SIMULTANEOUSLY.....	18
4. CONCLUSION	19

EXECUTIVE SUMMARY

This submission is a response to the Issues raised in the submissions lodged with the Australian Competition & Consumer Commission (ACCC) as part of its public inquiry into the applications for authorisation (Nos A30224 and A30225, submitted on 21 February 2003) (the Application) of a proposal to reform the arrangement for setting interchange fees in EFTPOS transactions.

The proposal results from a review of EFTPOS interchange fees conducted in response to the Joint Study of October 2000 by the ACCC and the Reserve Bank of Australia (RBA) entitled *Debit and Credit Card Schemes in Australia - A Study of Interchange Fees and Access (Joint Study)*.

The proposed conduct is for the Applicant issuers and acquirers to make and give effect to a contract by which they will multilaterally set interchange fees to apply to any EFTPOS transaction in respect of which one of them is an Issuer and one of them is an acquirer. The interchange fees will be set at zero and reviewed after three years. Each Applicant will also use its reasonable endeavours to renegotiate any bilateral EFTPOS agreement it has with a non-Applicant network participant so as to set the interchange fee to zero. New entrants are able to become parties to the contract.

As described in the Application, the proposed conduct will result in significant public benefits:

- 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 the 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.

These benefits will be achieved through:

- changes in relative prices;
- making bilateral agreements easier to negotiate; and
- new entrants facing interchange fees that are the same as those that apply to incumbent issuers and acquirers.

The ACCC received public submissions responding to the Application from a large number of interested parties, including major goods and services retailers, petrol retailers, consumer representatives, community organisations, government ministers and the RBA. Of the parties making detailed submissions, about half supported the Applications, and half of those again did so without qualification. Notably, the Application received support from the RBA, the Australian Consumers Association and the Australian Securities & Investments Commission. Perhaps not surprisingly, all of the submissions from retailers, and industry bodies representing retailers, opposed the Applications.

The key arguments made against the proposed conduct by the submitters cover:

- *The form and level of pass-through of changes in interchange fees to consumers and merchants.*
 - This is, indeed, a key issue. The Application and this Rejoinder submission argue that retail banking and card issuing in particular, is effectively competitive. Consequently, under any realistic market structure, a pass-through would take place.
- *Potential for the creation and abuse of market power as a consequence of the proposed conduct.*
 - No persuasive argument is made that the proposed conduct could enhance the Applicants' market power, if there were any, or change relative bargaining positions.
- *Access to EFTPOS networks by potential entrants.*

- Of itself, the proposed conduct has no implications for access. Access issues are appropriately handled by Australian Payments Clearing Association Limited (APCA) in the context of review of the authorisation of the Consumer Electronic Clearing System (CECS) arrangements, and are in fact already being considered in that forum.
- *The absence of a methodology to justify setting interchange fees at zero.*
 - The proposal is a response to the conclusion in the *Joint Study* that it could not see a continued need for an interchange fee in the debit card network.
- *Whether authorisation of the proposed conduct would give the Applicants a free hand to set a non-zero Interchange fee in the future.*
 - Any future proposal to re-establish an interchange fee (positive or negative) would require authorisation by the ACCC.
- *The form and Independence of proposed review processes.*
 - The ACCC could re-open the authorisation if there were a material change of circumstances. Any attempt to formalise and co-ordinate the responses of acquirers or issuers (or merchants) would, however, chill competition and, in any case, be impractical.
- *The possible loss of incentives to invest in maintenance of, or improvements in, the EFTPOS network.*
 - The importance of incentives is recognised in the proposal for review. However, as long as the EFTPOS system continues to provide benefits to participants, investment can be expected to take place.
- *Whether price increases due to the conduct are in the public interest.*
 - Price increases, tiny as they are, would be more than offset by price decreases due to concurrent credit card reforms and reduced costs of the overall payments system. Nevertheless, they are part of the mechanism for changing relative prices that brings about the public benefits of the proposed conduct.

Each of these issues is addressed in this submission. In many cases the concerns reflect misconceptions about the likely extent of authorisation and the ongoing powers the ACCC will have over the Applicants' proposed conduct. In other cases, the arguments misrepresent the degree of market power held by the Applicants, or by financial institutions as a whole.

Where the submitters qualify their support for the proposed conduct, these qualifications are generally limited to a call for either independent oversight and review of the consequences of the conduct or for guarantees of particular market outcomes.

The Applicants contend that none of the arguments made against the Applications undermines the case made in the Application for the net public benefits expected to follow from the proposed conduct. Moreover, it is expected that those net benefits will emerge without the need for external oversight or any other form of intervention, beyond the residual powers automatically available to the ACCC if authorisation is granted.

1. INTRODUCTION

This submission is a response to the issues raised in the submissions lodged with the Australian Competition & Consumer Commission (ACCC) as part of its public inquiry into the applications for authorisation (Nos A30224 and A30225, submitted on 21 February 2003) (the Application) of a proposal to reform the arrangement for setting interchange fees in EFTPOS transactions.

The ACCC requested submissions from interested parties in its media release of 25 February 2003 announcing receipt of the applications, with an initial due date of 21 March. An extension of the deadline for general submissions until 28 March was subsequently granted to some interested parties. Public responses were eventually received from 34 parties, of which around 23 addressed detailed comments on at least one aspect of the proposed conduct. Of these, about half supported the Applications, and half of those again did so without qualification. The submitters include major goods and services retailers, petrol retailers, consumer representatives, community organisations, government ministers and the Reserve Bank of Australia (RBA).

The ACCC also requested additional information from the Applicants individually, primarily regarding the extent and detail of their involvement in the EFTPOS market and intended responses to the changes to EFTPOS interchange fees in the proposed conduct. That information was provided to the ACCC by the Applicants individually, and generally under a request for confidentiality.

This submission is organised into two main sections. Section 2 outlines each of the key issues raised in the respondent submissions to the ACCC, together with the Applicants' comments. Section 3 responds to each of the points made in the critique of the Application contained in the report, *The EFTPOS Network: Interchange Fees and Access*, commissioned from ACIL Tasman by Coles Myer Limited and included as a schedule to its submission. That report warrants a separate response because it is the only comprehensive attempt to critically assess the Applicants' submission, and because it contains virtually all of the substantive points made in submissions opposing the Application.

Should the ACCC require further information about the proposed arrangements or this submission please contact:

Roger Featherston / Genevieve McMahon
Mallesons Stephen Jaques
Level 60, Governor Phillip Tower
1 Farrer Place
SYDNEY NSW 2000
Telephone (61 2) 9296 2000
Fax (61 2) 9296 3999
E-mail: roger.featherston@mallesons.com
genevieve.mcmahon@mallesons.com

2. KEY ISSUES

The key concerns expressed in the submissions involve:

- the form and level of pass-through of changes in interchange fees to consumers and merchants;
- potential for the creation and abuse of market power;
- access to EFTPOS networks by potential entrants;
- the absence of a methodology for setting interchange fees at zero;
- whether authorisation of the proposed conduct would give the Applicants a free hand to set a non-zero interchange fee in the future;
- the form and independence of proposed review processes;
- the possible loss of incentives to invest in maintenance of or improvements in the quality of the network; and
- whether price increases due to the conduct are in the public interest.

Each of these main issues (recognising that the arguments were repeated, with minor variations, in many of the respondent submissions) is addressed here in turn.

2.1 PASS-THROUGH OF CHANGES IN INTERCHANGE FEES

A primary source of the net public benefits from the proposed conduct arises from effects in the end-user markets for retail and commercial banking services and for retail goods and services generally. Applicants will individually react to the proposed conduct in ways that, taken together, will likely have an influence over some of the market outcomes. Nevertheless, the public benefits also rely on the outcomes in other markets in which the Applicants are not participants and over which they have no direct influence. The effects arising from the proposed conduct are driven by competitive forces in the affected end-user markets and the outcomes in those markets are almost completely out of the control of the Applicants, both individually and collectively.

It is expected that, compared with other means of payment, the cost to consumers of using EFTPOS will be reduced by the proposed conduct, leading to greater use of EFTPOS and increased efficiency of the payments system as a whole. This effect relies upon *both* pass-through by issuers of lower interchange fees into lower costs to cardholders of using EFTPOS *and* the absence of a fully countervailing increase in the cost of using EFTPOS at points of sale.

2.1.1 *Pass-through to cardholders*

Many of the submitters argued that there is no guarantee that savings to issuers will be passed on to cardholders and that consumers will not receive appropriate relative price signals as a consequence. Certain submissions argue that an authorisation should only be given by the ACCC if there is a form of condition attaching to the authorisation, or undertakings given by each of the individual Applicants, that savings will be passed on to cardholders.

The Australian Consumers Association (ACA) probably sums up the concerns of the majority of submitters raising this issue. It stated that ensuring consumers receive clearer pricing signals will require the *full* transmission of savings from the removal of the interchange fee. Absent any compulsion, the ACA is not confident that there is sufficient competition to ensure banks will pass on expected cost savings from the interchange fee removal to their customers, leading to an undesirable outcome on price signals. Accordingly, the ACA recommend that a process of prices oversight must

be a condition of the authorisation¹. Other submitters, including the Consumer Credit Legal Service (WA) Inc (CCLSWA)² endorsed a similar form of oversight.

Other submitters, including the Australian Institute of Petroleum (AIP)³ and Caltex⁴ likewise query whether effective competitive forces in retail banking are actually sufficient to actually lead to cost reductions being passed on to cardholders either in lower fees or enhanced services. The Applicants maintain that competition *is* sufficient to so reduce costs.

Certain parties⁵ also claim that lower charges for debit card transactions over their fee-free allowance would not benefit most users, who rarely exceed their fee-free threshold and do not pay for EFTPOS fees today. The Applicants believe that this is an over-simplified definition of benefits. In particular, this point ignores the fact that financial institutions which attempt to pass on lower issuer costs in ways that did not benefit existing or prospective cardholders would not gain any competitive advantage.

Significantly, support for the Applicants' submission on this issue is provided by the Australian Securities & Investments Commission (ASIC) and the RBA⁶. ASIC accepts that the proposal to reduce EFTPOS interchange fees to zero should result in real savings for consumers and has the potential to encourage consumers to use lower cost payment mechanisms. ASIC recognises that these benefits are dependent upon consumers receiving reduced EFTPOS banking fees, and claims that any authorisation should bolster the chances of such fee reduction being passed on to consumers.

There are two important dimensions to the submitters' concerns about the level of interchange pass-through to consumers. The first is whether the proposed conduct creates market power that is exploited by financial institutions, preserving some of the saving in issuing costs as profits. This point is addressed more generally in Section 2.2 below. The second dimension is whether consumers will actually receive an appropriate price signal (lower costs of using EFTPOS) as a result of the change in interchange fees.

The first point to note about the price signals consumers are likely to face is that, as suggested in the Application (Section 5.2.2), the change in interchange fees will not always necessarily be passed through in an easily observable manner. It is anticipated that the reduced costs of providing debit card facilities associated with zero interchange fees will be passed on in some form – such as in lower retail banking fees paid by cardholders and/or through enhanced services and/or higher transaction account deposit interest rates. However, the fee and charge structures of financial institutions' various transaction accounts are too complex, and too tightly intertwined with the fees and returns on other financial services, to necessarily expect a simple pass-through of "x" cents per transaction from interchange fees directly to transaction charges. It is unlikely that such a change would be observed even if the retail banking market was perfectly competitive⁷, instead of effectively competitive (as discussed in the Application at Section 5.1.2).

¹ ACA submission, pages 1 and 3. Citations here to submissions are those made in response to the Application and listed on the ACCC website: http://www.accc.gov.au/adjudication/currauth_docs/nz_bank_sub/subs.html.

² CCLSWA submission, page 3.

³ AIP submission, Section 4.2.

⁴ Caltex submission, page 12.

⁵ Caltex submission, page 4, and the Australian Retailers' Association (ARA) submission, page 12.

⁶ ASIC submission, page 1; RBA submission, page 2.

⁷ The economies of scale and scope that drive the structure of retail bank charges make it difficult to imagine that the industry could be perfectly competitive in a textbook fashion. Indeed, product differentiation is inconsistent with perfect competition, but is a classic route by which the process of competition is played out. Nevertheless, even if the other conditions – such as the presence of large numbers of similarly sized firms with identical cost functions –

The key step in the argument for net public benefits is that cardholders face lower charges for marginal debit card transactions, not that those charges are necessarily lower by the amount of the change in interchange fees. If this is the case, and provided that no social deadweight costs are created by the change (as might be the case if some abuse of market power could be demonstrated), then the public benefit of reduced cost and increased use of EFTPOS will be realised. Even if some of the reduction in issuers' costs is passed on in other ways (or even retained as increased profits), consumers will have an increased incentive to use EFTPOS over other means of payment.

Although there is scepticism in some quarters about the level of competition in retail banking, there is a real issue of what should be the starting point in reaching a view on this matter. It should not be enough simply to assert that retail banking – or more correctly, card issuing – is uncompetitive. It is not normal practice, nor is it defensible, to take the view that all markets are uncompetitive unless shown to be otherwise. Rather, it should be assumed that in the absence of extreme concentration or conditions for tacit collusion, workable competition is the norm.

Debit card issuing in Australia has many players. The four major commercial banks compete vigorously in debit card issuing and also face numerous smaller competitors. It is not surprising that competition in debit card issuing should be strong, for card issuing is a prime vehicle for gaining retail customers for any financial institution, with the promise of revenue generation across a wide range of services. An examination of products offered, even among only the four major banks, shows that they are far from uniform, and there is also great differentiation in the products of other card issuers.

It is important to recognise that financial institutions compete for retail customers by providing a suite of services comprising borrowing, lending, etc, using a range of payment methods and access to services such as cheque writing, debit and credit cards, Internet banking, etc and bundling these services together in packages designed to appeal to various customer classes, demographics, etc. The charging for these services varies widely, with some institutions focussing on transactions charges while others (such as credit unions) compete by minimising transactions charges altogether, except perhaps for some higher-cost services such as over-the-counter withdrawals.

While this may, admittedly, make it difficult for direct comparisons to be made between the pricing of different offerings, it is nevertheless indicative of healthy competition. Consumers certainly have a wide variety of bundled services to choose from and no shortage of institutions seeking to demonstrate that their package is superior.

As noted by the 1997 Wallis Inquiry into the Financial System:

... the move by deposit taking institutions towards more explicit pricing of transaction services has increased customer value awareness. Customers are increasingly paying transaction fees which more closely reflect the underlying cost of providing the services, and are likely to alter their transaction behaviour accordingly by switching to cheaper, electronic methods of transacting. ...

Final Report of the Financial System Inquiry, page 87.

This increased reliance on explicit pricing of transaction charges by financial institutions has continued since the Wallis Inquiry and so too, most likely, has the heightened consumer awareness it refers to. Consumers are likely to be aware of charges for EFTPOS, amongst other services, when choosing between different types of transaction accounts and also when choosing who they do their banking with. Issuers that did not closely target the pass-through of cost savings in EFTPOS interchange fees to debit cardholders would most likely soon find themselves at a competitive disadvantage. The result would not be uniform or universal but overall the price of EFTPOS transaction fees would drop.

applied, it is still unlikely that all firms would pass on changes in interchange fees directly into transaction charges in the same way.

It is useful to note also that the RBA monitors, in annual surveys, the extent to which financial institutions have substituted explicit transaction charges for reduced interest rate margins⁸. These surveys have consistently found that, although transaction fee income has grown steadily at rates above 10 per cent per annum since the surveys commenced in 1997, the ratio of this income to banks' domestic assets has remained relatively steady. Moreover, the increase in fee income has offset only a small part of the reduction in banks' interest rate margins over the last decade. This suggests both that the overall rate of transaction fees has not increased and that banks have not been able to use the shift to explicit transaction charging as a means of increasing profits. These are signs of healthy competition in the relevant banking sectors.

2.1.2 *Pass-through to merchants*

As noted, the expectation of net public benefits through lower costs to consumers of using EFTPOS also relies on there being no fully countervailing increase in the charges levied at points of sale. This is despite the expectation that competition will allow acquirers to offset the loss of interchange fee revenue with increases in merchant service charges. The Application argued (at Section 5.2.4) that past experience suggests that merchants will not widely surcharge for the use of EFTPOS, and that increases in merchant service charges will be passed on in (insignificantly) higher average prices⁹. There will be no net increased costs to merchants as a result of the reforms and no reason to expect a substantial decrease in the level of acceptance of EFTPOS payment.

Various submitters¹⁰ voiced objections to the Application on the basis that if banks suffer any revenue reduction from the proposals, fees to merchants for their EFTPOS facilities will inevitably rise (and then be passed on to consumer in increased retail prices). There is some speculation that this recovery may be unrelated to the cost of providing such a service. ASIC raises the possibility of consumer backlash against the proposal, particularly if merchant fees increase¹¹.

These views fail to address the wider effects of the EFTPOS reforms and the need to assess net public benefits, allowing for potential sectoral losses. It also ignores the avenues open to merchants to recover industry-wide increases in costs. The arguments are generally consistent with the case made in the Application, but ignore the benefit of a more efficient payments system. The Applicants contend that the cost of the payments system is ultimately borne by consumers, but argue that consumers will then enjoy the benefits of a more efficient allocation of transactions across alternative means of payment.

As with cardholder transaction fees, the exact responses of financial institutions to lost interchange fee revenue will depend on competitive forces and individual institutions' decisions based on the structure of their costs and merchant service charges. Nevertheless, in the absence of strong evidence to the contrary, it can be expected that effective competition in commercial banking will not only limit aggregate increases in merchant service charges to the loss of interchange revenue, but also ensure that there is no unwarranted redistribution of the costs of acquiring between classes of merchants in the process.

⁸ The results of the latest survey of bank fees are reported in the April 2003 edition of the *Reserve Bank of Australia Bulletin* (http://www.rba.gov.au/PublicationsAndResearch/Bulletin/bu_apr03/bu_0403_1.pdf) at page 1.

⁹ It needs to be remembered at all times that the discussion of a pass-through of increases in merchant service charges to higher retail prices assumes all other things being equal. But in fact pressures for lower retail prices will be greater through credit card reforms and through the improved efficiency of the overall payments system that the proposed conduct will bring about.

¹⁰ Australian eCommerce Network submission, page 1; Post Office Agents Association Limited (POAAL) submission, page 1; McDonald's Australia Limited submission, page 1.

¹¹ ASIC submission, page 2.

Another, perhaps more realistic, view on this subject was that retailers are unlikely to surcharge extra costs. Some submissions argue that, in the absence of surcharges, there will be little or no direct price signals to consumers at the point of sale¹². This claim ignores the potential for surcharges to offset the impact of the interchange reforms on the direct bank charges to consumers for using EFTPOS and hence to diminish the incentive to increase use of EFTPOS over other means of payment. The absence of price signals to consumers at the point of sale therefore is an important part of the generation of net benefits through improved efficiency of the payments system.

ASIC maintains that adequate disclosure about the new system is essential, including details on merchants surcharging the Issuer's fee and the implications of reform. It suggests that all parties to the EFTPOS system should provide their cardholders with a clear explanation of the rationale of the reforms¹³. The Applicants discount the likelihood of increased retail surcharging for use of EFTPOS, but agree that commercially appropriate disclosure (in addition to the disclosure regulatory regimes already governing the Applicants' conduct) and information campaigns may be useful and appropriate to help smooth the adjustment to new levels of cardholder fees and merchant service charges.

2.2 CONDUCT AS CATALYST FOR ABUSE OF MARKET POWER

Most of the submitters do not contest that acquirers will attempt to recoup the loss of interchange fee revenue through higher merchant service charges, but are concerned that the proposed conduct will be a catalyst for exploitation by financial institutions of particular groups of retail and commercial customers (as well as of these customers generally). This ignores two issues: first, the fact that at all times the behaviour of financial institutions remains under the purview of Part IV of the *Trade Practices Act* and, secondly, the competitive pressures to hold increases in merchant service charges to a minimum. In some cases the concern lies less with the potential for anti-competitive conduct by financial institutions and more with the possibility that retailers will use the EFTPOS reforms as an excuse to introduce surcharges that recover more than the actual merchant service charges.

Particular concern is expressed that although it may be an "absolute"¹⁴ that merchants will face higher costs, merchants with market power (most particularly supermarket chains, oil companies and others), will impose surcharges to ensure that they do not face increased costs or that costs otherwise likely to be imposed upon them will be able to be shifted. The argument from submitters raising this issue runs that such increases in merchant fees would impact disproportionately on small business without market power to negotiate lower rates with their acquirer¹⁵.

These arguments fail to distinguish existing differences between the acquiring services provided to small retailers compared with their larger competitors (particularly the investments made by larger retailers in their own EFTPOS facilities) and the reliance of small retailers on facilities supplied by their acquiring financial institutions. These differences in services explain some of the differences in merchant service charges. They are also the reason changes in costs will most likely be borne differently across merchants.

There is no reason to expect that the proposed conduct will lead to any change in the bargaining power of financial institutions vis-à-vis retailers. The degree to which acquirers are able to recoup lost interchange fee revenues (through higher merchant service charges) will depend on competitive conditions, and there is no reason to expect that increases in merchant service charges will fall disproportionately on particular classes of merchants.

¹² AIP submission, Section 4.3.

¹³ ASIC submission, page 2.

¹⁴ Motor Trades Association of Australia (MTAA) submission, page 1.

¹⁵ MTAA *ibid.*; MasterCard International submission, page 3; NARGA submission, page ii.

Similarly, no submission has demonstrated – or even clearly argued – that the proposed conduct will increase the market power of any of the Applicants, and there is no reason to believe that it will. This reinforces, and is reinforced by, the case made above about the strength of effective competition and the reasonable expectation that reduced issuer costs will be passed through to cardholders in one form or another. Unless there is some sort of anti-competitive opportunity created by the proposal – and none has been identified, nor is anticipated – no new issue is raised by the submissions referred to above, beyond what has already been addressed in this Rejoinder (including in the later section dealing specifically with ACIL Tasman’s arguments). Merchants will be no worse off (in aggregate or in any particular segment of the retail or commercial customer markets). The result of renegotiation of agreements between acquirers and merchants will naturally depend on relative bargaining power but, again, nothing in this regard is changed by the proposed conduct.

It needs to be stressed that the proposed conduct is part of a package of payments system reforms. The RBA submission puts the loss of interchange fee revenue recouped from merchants by acquirers in the broader context of the reduction in matching service fees from the concomitant reforms to credit card schemes¹⁶. The credit card reforms are expected to reduce credit card interchange fee amounts paid by acquirers by around \$350 million per year, as opposed to the loss of interchange fee revenue received by acquirers under the EFTPOS reforms of about \$150 million per year. Merchants will now be significant direct beneficiaries of debit and credit card reform, taken together, in terms of the net cost incurred in accepting debit and credit cards. Merchants will also see their costs reduced over time as a result of changes to price signals that provide consumers with greater incentives to use lower cost payment methods.

Again, key submitters¹⁷ provide support for the Applicants on these issues: the RBA argues that competition will ensure that the lower costs incurred by merchants will pass through to consumers in the general level of prices and, similarly, the ACA argues that the impact of the reforms on merchants must be set against the much higher anticipated savings from the reforms to credit card interchange.

The Australian Bankers’ Association (ABA) expresses the belief that there is a strong financial incentive for Australia’s merchants, particularly large retailers, to strongly oppose the concurrent introduction of EFTPOS and credit card reforms, as every day that EFTPOS reform lags credit card reform will represent a substantial benefit to merchants because they will get the savings from lower credit card interchange without the partial off-set of potentially higher EFTPOS charges. This advantage will be greatest for the large retailers.

As with the credit card reforms, there will unavoidably be some scope for confusion and uncertainty about the EFTPOS changes. The best protection against this is the use of publicity in the form of disclosure requirements and information campaigns. Consumers, in particular, should be encouraged to shop around and seek out the best possible deals.

2.3 ACCESS ISSUES

The Application concluded (Section 5.4.1) that:

The likely effects of the proposed arrangements are unknown at this stage, but they are unlikely to increase, and are more likely to reduce, the barriers to direct entry into the debit card system as the adoption of multilaterally set fees will likely narrow the scope, and therefore the cost, of bilateral negotiations. This conclusion applies equally to potential direct entry by financial institutions and merchant principals.

¹⁶ RBA submission, page 3.

¹⁷ RBA *Ibid*; ACA *op. cit.*, page 2.

Some of the submitters (specifically the large general goods and petrol retailers)¹⁸ have argued that access to the EFTPOS network is an integral part of interchange fee reform. They continue to argue that this should be addressed as part of the proposed reform package rather than, as was suggested in the Application and is now in progress, for the Australian Payments Clearing Association Limited (APCA) to address this issue as part of its upcoming application for renewal of the Consumer Electronic Clearing System (CECS) authorisation¹⁹. Many of the issues raised in relation to access are unrelated to the proposed conduct.

The RBA²⁰ agrees with the Applicants' argument that eliminating bilateral interchange fees should facilitate access of new entrants to the EFTPOS network, since they will no longer need to negotiate interchange fees as a condition of entry. At the same time, however, the RBA suggests that without interchange fee revenues some incumbents may have less financial incentive to establish interchange links with potential new entrants²¹. The RBA supports the Applicants' approach that access issues should be dealt with in the context of reauthorisation of the APCA CECS regulations and procedures. It is highly desirable that the interchange fee reform proceed at the same time as the credit card reforms. This would not be possible if it were to be tied into broader questions of access. The calls for access reform in many cases amount to arguments that the EFTPOS system should be redesigned as a debit scheme, which would be a very major change. In any case, since the proposed conduct does not of itself impede access, but rather facilitates it, there is no case for requiring interchange fees and access issues to be linked.

It is also relevant that the proposed conduct is conduct only involving the Applicants. Consideration of wider access issues is far more complicated. The appropriate forum for this process is APCA, which, the Applicants understand, has already commenced a detailed examination of access and related issues.

2.4 ABSENCE OF INTERCHANGE SETTING METHODOLOGY

The multilateral adoption of a zero interchange fee by the Applicants should be seen as a practical means of implementing the position implied in the *Joint Study* conclusion that:

Application of formal Interchange methodologies does not provide a convincing case for a debit card interchange fee, in either direction. The study does not see a continued need for an Interchange fee in the debit card network.

Joint Study, page 71.

Certain submitters²², believe that a methodology must be employed to justify the zero rate and the absence of such methodology may impact on how a review of interchange fees will be undertaken, or on a move to a non-zero interchange fee. As the conclusion reached by the *Joint Study* indicates, and as further discussed below in the response to ACIL Tasman, there is no methodology that can provide

¹⁸ For example, AIP *op. cit.* at section 5. See also MoneySwitch submission, page 2; ARA *op. cit.*, pages 16-18; NARGA *op. cit.*, page 3; Caltex, *op. cit.*, page 13; Woolworths submission, page 16.

¹⁹ Australian Competition & Consumer Commission, *Determination of Applications for Authorisation by the Australian Payments Clearing Association Limited in relation to its proposed Regulations and Procedures for the Consumer Electronic Clearing System*, 16 August 2000, <http://www.accc.gov.au/adjudication/Docs/A90620.pdf>.

²⁰ RBA, *op. cit.*, page 4.

²¹ The Applicants note that other means exist, outside interchange fees, for new entrants to provide incumbents with such incentives.

²² MasterCard *op. cit.*, page 1; Caltex, *op. cit.*, page 13.

an unqualified estimate of the “right” level of interchange fee. The RBA²³ accepts that the multilaterally set zero has economic consequences identical to the elimination of the fees.

Setting the EFTPOS interchange fee at zero effectively removes the interchange fee, and the Applicants recognise that the zero rate may not necessarily be the most efficient. If at some future time it was proposed to re-establish a non-zero interchange fee – which would require authorisation by the ACCC – a methodology for determining such a fee may well be appropriate.

It is also important to note, by way of comparison, that the existing interchange fees are also absent any methodology and have never been reviewed.

2.5 FREE HAND TO MULTILATERALLY SET NON-ZERO INTERCHANGE FEES

As noted in Section 2.4 above, setting the EFTPOS interchange fee at zero effectively removes the fee from bilateral network agreements, but does not necessarily mean the zero rate is the most efficient. The proposed conduct therefore makes provision for review that could lead to a proposal for non-zero fees if circumstances warrant.

As mentioned above, some submitters²⁴ have concerns about transparency, and the existence of a review process which permits the Applicants to revisit EFTPOS interchange fees in the future with no methodology in place. For example, CML claims that:

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.

CML submission, page 30

These claims suggest a significant misunderstanding by those submitters of the freedoms granted to parties by the ACCC under an authorisation. The Applicants would have no such discretion.

No authorisation is sought to grant the Applicants *carte blanche* to set interchange fee rates. The Applications clearly identify the proposed conduct as the setting of zero rates of interchange. If the Applicants wanted at some later stage to introduce a non-zero interchange fee, authorisation would again need to be sought under the *Trade Practices Act*, and the ACCC would almost certainly require a methodology and estimates to support any move away from zero. This point is understood in the submissions of the RBA and the CCLSWA²⁵.

2.6 INDEPENDENT OVERSIGHT AND REVIEW

Some of the submitters have argued the need for an independent body overseeing a regime providing for prudential regulation and supervision of EFTPOS participants, and to monitor and review the impact of Interchange fee reform. They also argue a firm methodology should be set for any future amendments to the zero interchange fee.

Various suggestions are made by submitters²⁶ as to the identity of an appropriate body, including the RBA and the Australian Prudential Regulation Authority (APRA). The submitters do not, however, demonstrate how the proposed conduct would lead to increased financial risk in the EFTPOS system warranting such prudential supervision (in any event, a matter for the legislature, rather than the

²³ RBA, *op. cit.*, page 3.

²⁴ Caltex, *op. cit.*, page 13; CCLSWA, *op. cit.*, page 5.

²⁵ RBA, *op. cit.*, page 3; CCLSWA, *op. cit.*, page 5.

²⁶ MasterCard, *op. cit.*, page 2; ACA, *op. cit.*, page 3; CCLSWA, *op. cit.*, page 2; ARA, *op. cit.*, page 15; Caltex, *op. cit.*, page 4.

ACCC). The existing CECS authorisation covers EFTPOS settlement issues and there is no persuasive case made for the introduction of prudential regulation of the conduct in question.

Calls are also made for independent monitoring of merchant pricing and direct consumer charges during the initial authorisation period, with regular reporting to the public and the ACCC as a means of reviewing the impact of the reforms and promoting transparency and public confidence. These calls appear to emerge as a result of concern that review processes will be in the hands of the Applicants who will be neither independent nor representative. These arguments are based on the presumption that banking markets are insufficiently competitive to ensure that the changes in interchange fees are passed on in efficient forms and levels. This issue has already been addressed in the discussion above.

The Applicants expect that the net benefits of reform will emerge without the need for external oversight or any other form of intervention beyond the residual powers automatically available to the ACCC if authorisation is granted. In any event, the ACCC is able to revoke authorisations if there has been a material change in circumstances, so there will always be an avenue for external review if a case can be made that the proposed conduct has led to unforeseen or larger than expected consequences. Moreover, there are other regulatory or statutory avenues which could be pursued if the proposed conduct did not deliver its expected outcomes.

Because there are a variety of approaches taken by EFTPOS card issuers in applying transaction fees to customer accounts, being prescriptive on this issue is entirely impractical. The wide variety of transaction products on the market means it would be extremely difficult to develop a one-size-fits-all approach to passing on potential EFTPOS savings. Similarly, it would be exceptionally difficult to prove (or disprove) after the event that changes in issuers' costs had not been passed through to cardholders in one form or another. It might be possible to undertake comparisons of aggregate issuing costs and revenues, along the lines of the *Joint Study*, but this could not demonstrate that savings had not been passed on in other ways closely related to the use of EFTPOS services.

As mentioned in Section 2.1.1 above, the RBA already surveys financial institutions' transaction fees and charges annually and there has been no evidence that banks have exercised any market power in the setting of transactions fees. Indeed, the evidence shows the opposite is true, with no significant increase in the aggregate rate of transaction fees and competitive pressure on associated interest rate margins.

Indeed, attempts to force issuers' cost reductions to be passed on in an observable quantum are likely to result in a choking of competition. Differentiated conduct would be hindered and the result would be all issuers moving in lock-step rather than seeking ways to gain market share from their competitors by providing more attractive price-service packages.

As previously noted in Section 2.2, however, there will unavoidably be some initial scope for confusion and uncertainty about the effect of EFTPOS changes. The best protection against this is the use of publicity in the form of information campaigns and existing disclosure requirements, rather than prescriptive or intrusive regulatory oversight.

2.7 INVESTMENT INCENTIVES

Some submissions claim that the Applications do not address how incentives to invest, (including ongoing operational and maintenance costs necessary to maintain a "world class" system) will be maintained in the absence of interchange revenue to acquirers. They claim, perhaps not surprisingly, that the major current sources of investment are the large merchants²⁷. Some go so far as to write a

²⁷ AIP, *op. cit.*, Sections 3.4 and 4.3; ARA, *op. cit.*, page 10; McDonald's Australia Limited submission, page 1.

"doomsday list" of potential effects, including suggestions that the EFTPOS infrastructure is likely to degrade, public confidence to be threatened and fraud costs to increase²⁸.

Importantly, however, the RBA states that there is no evidence that EFTPOS interchange fee revenue (at rates largely set in the early 1990s) continues to be required by merchants to recoup the costs of their initial investments or any subsequent upgrades²⁹. If EFTPOS interchange fee revenues are eliminated, investment decisions by merchants would be determined by normal market mechanisms. Merchants would continue to invest in EFTPOS facilities if they perceive direct benefits in doing so. The RBA also suggests that those merchants are free to charge customers directly for cash-out facilities if providing the service did not reduce their cash handling costs. Direct charging in these circumstances would provide a more efficient and transparent set of price signals than current interchange fee arrangements, and would be consistent with proposals in relation to foreign ATM transactions.

The ACA also believes that the costs of developing and growing the EFTPOS system, justifying continued imposition of a fee to issuers, has long since been recovered. The ACA are of the view that the widespread acceptance of EFTPOS by both merchants and consumers is sufficient incentive for its continued promotion³⁰. The ACA also notes that the structure for accepting EFTPOS transactions is generally the same as that employed for credit card transactions, reducing the likelihood that merchants will discontinue their investment in that infrastructure or in their capacity to accept EFTPOS.

The Applicants agree with the analysis of the RBA and the ACA. The cost of investment in EFTPOS systems is shared between financial institutions and merchants through their separate decisions and the terms and conditions of merchant service agreements, and necessarily ultimately falls on consumers. Provided the acceptance of EFTPOS gives merchants a competitive advantage (e.g. by reducing merchant fees through taking on some acquiring functions, or providing faster transaction processing), the investment will continue to be made and avenues will exist for the recovery of the cost.

Nevertheless, the Applicants have provided for a review mechanism to ensure that any unforeseen adverse consequences for investment can be redressed.

2.8 INCREASES IN PRICES CANNOT BE IN PUBLIC INTEREST

The net benefits of lowering the costs to consumers of using EFTPOS relies on additional merchant costs being passed on mostly as higher prices, rather than as surcharges at point of sale. Together with lower transaction fees, this ensures that EFTPOS users receive a price signal that induces increased use of EFTPOS over other means of payment, with consequent improvement in the efficiency of the payments system as a whole. Some submissions have argued that any reforms which are likely to increase retail prices to consumers are not in the public interest, that price signals will be blurred or eliminated by a general increase in retail prices. Others have argued the potential inefficiency of non-EFTPOS customers also bearing increased prices.

Other submitters have a slightly different argument, namely that because it is unlikely that merchants will surcharge, there is more likely to be a general increase in prices, so all consumers are likely to subsidise users of EFTPOS³¹. This argument continues that, if there is a general increase in the price of goods, then price signals in relation to the use of a particular mode of payment will be suppressed.

²⁸ Caltex, *op. cit.*

²⁹ RBA, *op. cit.*, page 3.

³⁰ ACA, *op. cit.*, page 2.

³¹ ARA, *op. cit.*, pages 11 and 12; Caltex, *op. cit.*, page 12; Woolworths, *op. cit.*, pages 8, 15 and 18; NARGA, *op. cit.*, page 4; MasterCard *op. cit.*, page 1; AIP, *op. cit.*, Section 3.1.

These types of argument simply restate the likely consequences of the proposed conduct. It is precisely the fact that merchants would not be likely to surcharge that, combined with the pass-through of lower issuer costs to cardholders, reduces the relative cost of using the EFTPOS system and induces increased use of EFTPOS. The relatively insignificant likely impact of the effects of the proposed conduct on the general level of retail prices was discussed in the Application (Section 5.2.4). As already discussed, increased use of EFTPOS is the key to the public benefit of reduced overall payments system costs, and will be achieved in an environment in which retail prices will likely decrease as part of a broader package of reforms.

The fact that cardholders already have some fee-free transactions needs to be seen in the context of the overall fee/service packages being provided by issuers. The point is that issuers will have the ability and the incentive to provide more attractive packages than at present. Lower fees will likely be part of, but not the entirety, of these packages. To argue that there will be no effective change because cardholders already pay no transactions fees is to argue that issuers currently do not recover the costs of the system from their customers.

It is important to note that the RBA agrees that the Applicants' proposal will have significant public benefits³². In contradiction to the dissenter submitters, the RBA believes that a lowering of transaction fees for debit cardholders will produce a more efficient and transparent set of price signals for consumers choosing between EFTPOS and other means of payment. Although it notes that public benefits will be maximised if the reduction in interchange fees is passed immediately to debit cardholders, the RBA can see no reason why debit card issuers, in a competitive market environment, should not do so. The Applicants agree with this summation.

It should be stressed again that the proposed conduct is part of a package of payments system reforms. The *Joint Study* highlighted that one of the key aims of the reforms is to ensure more efficient pricing in the payments system, i.e. that the price charged for each method of payment (credit cards, debits cards, etc) should closely reflect the cost of that payment method. More efficient pricing of EFTPOS will result in a more efficient payments system, which can only be a benefit to the public.

³² RBA, *op. cit.*, page 3.

3. RESPONSE TO ACIL TASMAN "CRITIQUE OF APPLICATION"

The submission by Coles Myer Limited includes a report, *The EFTPOS Network: Interchange Fees and Access*, commissioned from ACIL Tasman. An Attachment to that report presents a critique of the Application made in support of the Applications for authorisation. Because that is the only comprehensive attempt to critically assess the Applicants' submission, and because virtually all of the substantive points made in submissions opposing the Application are set out there, the Applicants' responses to the points made in the critique are addressed below under the headings used in the ACIL Tasman critique.

3.1 APPLICATION DOES NOT DEFINE A MARKET FOR EFTPOS

ACIL Tasman claims that the Application does not explicitly address the definition of the market in which EFTPOS services are provided, but is solely concerned with competition between debit cards and credit cards. ACIL Tasman argues that this:

"...compounded the mistake of the Joint Study in defining far too narrowly the market in which debit and credit cards operate"

and thus:

"...neglects the scope for cash and cheques to substitute for debit cards".

ACIL Tasman, page 38.

There are errors of fact and analysis in this critique.

In the first place, there is no single market that is relevant to the Application. As mentioned in the introduction to Section 5 of the Application, the proposed conduct has effects and likely effects in the markets for retail banking and the market for goods and services generally, as well as in the EFTPOS network. There is no useful market definition that brings all these markets under a single umbrella, and no reason to seek one.

The essence of analysing the competitive impacts of potentially anti-competitive conduct, or conduct that is alleged to be anti-competitive, is to examine all relevant markets and not to assume that one is paramount or that all the effects of conduct are felt in one market.

Instead the Application carefully and objectively seeks to assess "what is going on here", examining cross-market interactions. The Applicants reject any implication that market definitions were manipulated to facilitate the presentation of favourable analysis³³. Rather, the Application seeks to be expansive in its analysis of the expected impacts of the proposed conduct, including in increasing merchant service charges and hence (to a very small degree) retail prices.

That said, the effects of the proposed conduct need to be examined in the context of the overall payments system, including the use of cash and cheques. That is what the Application does. Indeed, the principal public benefit is to reduce the overall cost of the payments system, taken in its entirety, which was the focus of the *Joint Study* and numerous subsequent statements by the RBA.

ACIL Tasman claims that the failure to define the market in which EFTPOS services are provided is a serious flaw, but identifies only one consequence of the alleged failure, viz. that:

"[t]o the extent that the parallel reforms in both card networks – currently being pursued in part by this Application – were to encourage greater use of cheques, the reforms

³³ Typically, a favourable analysis would be obtained by using an inappropriately broad market definition rather than an inappropriately narrow one, as ACIL Tasman alleges has occurred.

would decrease the overall efficiency of the payments system. This is based on the RBA conclusion that cheques are the most costly non-cash payment instrument.”

ACIL Tasman, page 39.

This statement is incorrect. To decrease the overall efficiency of the payments system it would be necessary not merely for there to be an increase in the use of cheques, but that the costs of that increase more than outweigh the benefit of any switch towards EFTPOS and away from credit cards. (For example, theoretically there could be a switch from credit cards towards both cheques and EFTPOS with a net overall reduction in cost.) More importantly, ACIL Tasman does not provide any evidence – or propound any in-principle arguments – why use of cheques *as a result of the proposed conduct* should increase.

Rather, ACIL Tasman asserts throughout its critique that EFTPOS has replaced the use of cheques and cash. Presumably the idea that the proposed conduct would lead to cheques replacing EFTPOS must be based on expectations about how merchants would react to the conduct, although this is nowhere spelt out. How merchants will react is discussed in detail in the Application and in this Rejoinder, and it is sufficient to note here that there is no reason to believe that merchants would place surcharges on EFTPOS transactions so that they could receive more cheque payments.

3.2 APPLICATION IGNORES THE EXISTING BENEFITS FROM EFTPOS

ACIL Tasman claims that the Application ignores the implications of the two-sided nature of the market in EFTPOS transactions. In fact, the Application not only draws upon the theory of two-sided markets but relies quite heavily on the insights of the theory to make its analysis. As the Application points out (and relies heavily on), the efficient level of pricing in a two-sided market depends on, among other things, demand elasticities of merchants and cardholders. Although ACIL Tasman criticises the Application for not estimating these elasticities it does not discuss the matter further or introduce any quantitative material itself.

While the efficient level of pricing depends on elasticities, theory gives no unequivocal method for actually estimating the efficient prices. In a sense, that is the whole point. As in most other aspects of real world markets, setting prices – in this case, interchange fees, merchant service charges and transactions fees – was a process rather than a matter of analytically calculating a set of efficient prices and then putting them in place. The participants in the market gradually find their way towards efficient prices. Whether they ever get there no-one knows or, in a two-sided market, can know with any certainty. However, what is known is that in establishing the EFTPOS network there was, at least initially, a reason to subsidise acquiring at the expense of issuing – as explained elsewhere in the Application and in this Rejoinder – and that that reason has expired. The cross-subsidy (using the term loosely) survives not because it is needed but because the existence and nature of numerous bilateral agreements make getting rid of it inordinately difficult.

Contrary to ACIL Tasman's claim, the Application does not assume that the network benefits of mature markets are largely exhausted. Rather, it argues why achieving ongoing network benefits no longer requires payments from issuers to acquirers. This is a quite different point. Moreover, the Application does not, as claimed, conclude:

“...that the entry of a new Instrument entering the payments system would require the reintroduction of an Interchange fee for EFTPOS so as to optimise the development and operation of the network”

ACIL Tasman, page 40.

and then ignore that conclusion.

Rather, the Application acknowledges that necessary new investment – e.g. in smart card technology and systems – may go ahead at optimal levels only with some non-zero level of interchange fee. This is one of the reasons a review is proposed. (As explained in Section 2.5 above, such a review cannot

possibly confer on the Applicants the ability to reinstitute an interchange fee by agreement only amongst themselves.)

ACIL Tasman also states that the:

"...mere threat of entry is likely to be enough to require the costs of the EFTPOS network to be redistributed among the network principals so as to forestall the introduction of the new payment instrument".

ACIL Tasman, page 40.

This seems to argue that the Applicants ought to be allowed to foreclose such entry. The proposed conduct, i.e. a zero interchange fee, would, on ACIL Tasman's argument, make entry easier, which is a desirable state of affairs from the public benefit viewpoint.

3.3 APPLICATION ASSUMES ISSUER SAVINGS PASSED ONTO CARDHOLDERS

This is clearly a key issue. For the overall cost of the payments system to be reduced, the use of EFTPOS relative to others means of payment needs to increase. One of the conditions required for certainty that this will occur is that the reduced costs of issuers, due to their being relieved of the payment of interchange fees, are passed on to cardholders.

As the Application makes clear (Section 5.2), certainty is unattainable, and judgements need to be made about the flow-on responses of acquirers, issuers, merchants and cardholders to the setting of interchange fees to zero. This requires, among other things, judgements about the competitive conditions in various markets. Arguments for seeing card-issuing as effectively competitive, and hence for reduced card-issuing costs to be passed on to cardholders, are set out in Section 2.1.1 above.

ACIL Tasman does not analyse these issues in detail but makes two major assertions. The first is that:

"[f]or this to happen [i.e. for it to be true that "...cost savings to issuers from the abolition of EFTPOS interchange fees would be passed onto their debit cardholders in the form of lower cardholder transaction fees and/or enhanced cardholder services"], "...the Australian issuers would have to be earning normal or above normal rates of return on their investment in debit card services. If the rates of return in debit card services were below normal levels, the financial institutions in question would be more likely to seek to retain any cost savings from interchange abolition as enhanced profitability."

ACIL Tasman, page 40.

ACIL Tasman then goes on to claim that sub-normal rates of return are being earned in domestic transactional banking, and a failure to pass cost savings through to customers follows.

This reasoning is flawed. Whatever the current level of returns, financial institutions naturally wish to enhance profitability. The question is whether they are able to do so. Whether cost savings will be passed through depends on the process of competition, not on the level of return currently being experienced (although the level of return may be evidence of the competitive conditions). If it is true that transactional banking is characterised by sub-normal rates of return, this would be evidence that strong competition was at work. On this argument, there would be every expectation that institutions would have no option but to pass savings on.

If the contrary were the case, and institutions had the power not to pass reduced issuer costs on, the question would need to be asked why the institutions have not already exercised that power by imposing higher transaction fees. Taking this line of reasoning further, there is in practice no market

structure in which cost reductions can be entirely captured by producers³⁴. For example, a pure monopoly will produce at a level where marginal revenue equates to marginal cost, with the price being higher than marginal revenue. If costs fall and the monopolist does not reduce its price, it will not be maximising its profit, because it could produce more and the revenue from the additional units would exceed their cost. Thus even a pure monopoly will reduce its price in response to a fall in costs.

It also needs to be remembered that the genesis of the proposed conduct was demonstrably not an attempt by the financial institutions to find some way of exploiting their retail customers. Rather, the proposal is a reaction to a conclusion by the ACCC and the RBA in the *Joint Study* that there is no case for interchange fees to be other than zero.

Another way of looking at claims that cost savings would not be passed on to cardholders is to consider what would happen in the future if interchange fees were re-established, e.g. if authorisation were revoked. Would it then be claimed that such action provided opportunities for passing on more than the increase in costs? Is the implicit position that the current level of transaction fees – and indeed that the current combinations of cardholder services and transaction fees – is somehow optimal in the sense that it should never be altered? Or that cost reductions should never be sought because customers would never benefit?

3.4 APPLICATION IGNORES IMPACT OF ACQUIRER COSTS ON RETAIL CONSUMERS

ACIL Tasman apparently disagrees with the Application's conclusion that the extent of retail price increases resulting from the conduct – as acquirers attempt to pass their higher costs (loss of interchange fee revenue) on to merchants, who try to pass on the increase to their customers – will be small.

However, it is undeniable that the level of EFTPOS interchange fee revenue is tiny as a proportion of the value of retail trade. It is also the case that the increase in retail prices attributable to the pass-through from acquirers to merchants, and thence from merchants to customers, is smaller than the decrease resulting from the concurrent credit card reforms.

The claim that the reasoning in the Application leads to the conclusion that retailers could increase their prices at will is a simple confusion of short- and long-term adjustments. In the long term, prices in a competitive market will adjust to changes in costs, other things being equal. In the short term, all sorts of things may be happening.

The question asked is whether merchants would raise prices at all in response to the proposed conduct. The Applicants believe that such a concern is not relevant. Whether merchants raise prices or not will not affect whether there is a shift towards use of EFTPOS. However, what is relevant to the use of EFTPOS is whether merchants respond differentially to the use of different means of payment, i.e. by across the board surcharging of EFTPOS transactions (it does not matter if only some do). ACIL Tasman does not address this point.

ACIL Tasman does not appear to recognise that, in the long term, all the costs of the EFTPOS network, and indeed of the overall payments system, are met by merchants and consumers. In fact, in competitive equilibrium, all the costs are met by consumers. The presumption of effective competition in banking and retail markets means the key question for the claim of public benefit from the proposed conduct is not *whether* merchants choose to pass on increases in merchant service charges, but *in what form*.

³⁴ The only in-principle exception is the highly unlikely case in which demand is perfectly elastic – i.e. any quantity available will be bought at a fixed price.

3.5 APPLICATION UNDERSTATES IMPACTS ON EFTPOS NETWORK

ACIL Tasman argues that EFTPOS network investment costs will most likely be met by acquirers charging higher merchant service charges, passed on as an increase in retail prices (contrary to the claims made under the previous heading regarding the passing on of higher merchant service charges). It is far more likely that the costs of major new investments would be shared between acquirers and issuers, and passed on as competitive conditions allowed. However, focussing on the acquiring side, ACIL Tasman then claims that the Application assumes that the revenue losses could be made good without the corrective action imposing any additional costs on either the acquirers or the merchant principals in question. Information and search costs are alluded to.

The conclusion seems to be that the rate of return on existing EFTPOS network investment would be reduced, acting as a disincentive to further investment.

Again, this argument amounts to a claim that the level of interchange fees should never be changed: it is somehow optimal or, at least, undesirable consequences – higher search costs – would flow from any change. This is a purely academic point in an environment where prices are constantly changing. Businesses and consumers adapt to, and even accept, the inconvenience of price or cost *reductions* by changing their production and consumption decisions.

ACIL Tasman notes the proposal in the Application that the question of funding necessary future investment merits provision for monitoring and review. But it claims that such a review might not lead to interchange fees being reintroduced (because the ACCC might not agree), or not at the right level. This is another example of the assumption that the current level of interchange fees must be right and that any change must be for the worse.

3.6 APPLICATION DOES NOT RECOGNISE IMPACT ON PAYMENTS SYSTEM

ACIL Tasman's argument here is that the Application:

"...does not consider the impact that its proposals might have on innovation and investment in the rest of the payments system, particularly the introduction of new payments instruments.

In the case of new payment instruments, the network benefits are likely to be significant and those investing in them will need to redistribute those benefits among themselves to ensure balanced incentives to participate in the network. This mechanism is provided by the interchange fee.

To be most effective the putative (sic) network operators need to be able to set the fee at whatever level they believe will maximise the value of the network."

ACIL Tasman, page 43.

There are several points here. The first is that the new payment instrument must presumably be associated with the EFTPOS network, or it is hard to see why EFTPOS interchange fees should fund investment in it. The second is that the Application addresses new investment at length; that is the reason for the proposed review. The third and most important is that ACIL Tasman's comments ignore the crucial question: whether the investment can be funded through bilateral arrangements or whether – as would not be surprising in the case of a network, with its externalities – a co-ordinated approach is desirable.

If the latter, then price-fixing is potentially involved, with the clear requirement for authorisation by the ACCC. The Applicants acknowledge these realities. But ACIL Tasman's approach, which appears to be that the current system of numerous sticky bilateral agreements should continue forever, would be unlikely to lead to efficient levels of investment in new instruments.

3.7 APPLICATION LARGELY IGNORES TRANSACTIONS COSTS

ACIL Tasman appears to take it as given that a key concern is whether transactions costs are increased or decreased by shifting to multilateral determination of interchange fees. It claims the Application:

"...feels able to presume that co-ordinating all the participants in a network at the one time is easier and therefore less costly than doing so two at a time."

ACIL Tasman, page 45.

However, the basic objective of the proposed conduct is to reduce interchange fees to zero, not to minimise transactions costs *per se*. Clearly, reducing interchange fees to zero is, by its nature, a multilateral decision-making process. That is why authorisation has had to be sought. That the process has been successful so far is indicated by the fact that the Application has been lodged. That is, the Applicants have been able to get to the point of reaching multilateral agreement.

The Applicants, however, cannot impose changes to interchange fees on the counter-parties in existing bilateral agreements without their consent.

It is true, as ACIL Tasman points out, that the proposal has only come forward after the publication of the *Joint Study*. That is merely to point out that the proposed conduct has a public benefit that cannot be obtained without co-ordinated action.

Moreover, it is not as if there is a continuing need for a multilateral agreement to be frequently re-negotiated. The processes that have led this far are now a sunk cost. Accordingly, ACIL Tasman's concern is misplaced.

3.8 APPLICATION DOES NOT ADDRESS ACCESS SIMULTANEOUSLY

The Application explains (in Section 5.4.1) why access has not been dealt with simultaneously with the proposed conduct. In short:

- it is true, as ACIL Tasman claims, that logically the price of access cannot be sensibly separated from other terms of access, but that is not what is at issue here, because existing participants already have access; the competition question is the effect on entry;
- access issues are being separately considered by APCA in the context of reauthorisation of the CECS regulations and procedures;
- the reduction in the interchange fee to zero does not, in itself, have major implications for access and the multilateral nature of the proposed conduct is likely to make access easier, reducing the need for bilateral interchange fee negotiations. The proposed contract would allow entrants to become parties to the contract;
- in 2000 the ACCC reasoned that, if a comprehensive access regime were considered necessary, it should be established under Part IIIA of the *Trade Practices Act* or under the *Payment Systems (Regulation) Act*; and
- access reform is a large issue in itself and will take longer to resolve. It is very important that the change in interchange fees go ahead in the same timeframe as the credit card reforms so that only one round of pricing changes is needed; otherwise there will be unnecessary consumer confusion and costly adjustments for merchants.

ACIL Tasman claims that this confirms that overall transaction costs will be increased. But again, this ignores the fact that the objective of reducing the interchange fee to zero – and the associated benefit of reducing the overall cost of the payments system – can only be achieved multilaterally. Far from the existing bilateral approach involving lower transaction costs, that approach is incapable of addressing reform of either interchange fees or access.

4. CONCLUSION

The proposed contract (as described in the Application and the Executive Summary to this submission) will give rise to significant public benefits.

None of the submissions in response to the applications contains arguments that detract from the principal source of net benefits or credibly argue the creation or increase of any public detriment as a consequence of the proposed contract. Significantly, no anti-competitive conduct is identified. In many cases the concerns reflect misconceptions about the likely extent of authorisation and the ongoing powers the ACCC will have over the Applicants' proposed conduct. In other cases, the arguments misrepresent the degree of market power held by the Applicants, or by financial institutions as a whole.

The Applicants contend that none of the arguments made against the Applications undermines the case made in the Application for the net public benefits expected to follow from the proposed conduct. Moreover, it is expected that those net benefits will emerge without the need for external oversight or any other form of intervention, beyond the residual powers automatically available to the ACCC if authorisation is granted.