Response to Draft Determination

Application for Authorisation Nos A30224 and A30225

In relation to the collective setting of EFTPOS interchange fees

September 2003

Coles Myer Ltd.

Executive Summary

Coles Myer ("CML") supports the Australian Competition and Consumer Commission's ("ACCC") draft determination dated 8 August 2003 in relation to Authorisation Applications A30224 and A30225, and the subsequent rejection of those Applications on the grounds that the proposed conduct would not result in a net public benefit if approved.

As stated in a previous submissions to the ACCC, CML supports the rejection of the Applications because:

- the proposal seeks to transfer costs from the card issuer to the retailer, which will in turn be passed on to consumers in the form of higher prices for goods and services
- the proposal only considers one aspect of reform – interchange fees
- the proposal does not provide assurances that reduced costs of issuers will be passed on to cardholders, and that if in fact they were, that those fee reductions would be sustainable
- the proposal reduces price transparency to consumers (a key concern of the Reserve Bank of Australia ("RBA") in relation to credit card reforms)
- the proposal does not address the impact the conduct would have on new entrants seeking to enter the market and subsequent competition issues and in CML's opinion will make access for new entrants more difficult
- the proposal does not address the issue of flexibility of interchange pricing rather it seeks to collectively fix interchange fees at a set price

The Application seeking the collective setting of EFTPOS interchange fees to zero will only benefit card issuers and the Applicants themselves, and seeks instead to transfer costs to retailers and ultimately consumers.

CML therefore strongly supports the ACCC in their rejection of the Application, and believes that a zero EFTPOS interchange fee will not provide a 'net public benefit'.

Introduction

This submission is in response to calls from the ACCC for written submissions following the pre-decision conference held by the ACCC in response to requests for such from the Applicants seeking Authorisation of zero EFTPOS interchange fees.

This submission firstly examines the existing EFTPOS network, and outlines reasons for the network being acknowledged as a world class payments system.

The second section of this submission looks at the claims made by the Applicants in supporting their proposal that a zero EFTPOS interchange fee will result in a 'net public benefit'.

In the third section CML comments on the ACCC's key findings in the Draft Determination.

The fourth section of the submission looks at access to the EFTPOS payments system, and examines the most appropriate forum in which these issues should be resolved. The final section provides comments on issues raised at the pre-decision conference on 1 September 2003.

1.0 The Existing EFTPOS System

The Australian EFTPOS system has been recognised and acknowledged as being a world class payments system, due primarily to it being PIN based, highly secure and having high online availability. As a result the system we have today is trusted, well accepted by consumers and incurs very low levels of fraud in comparison with the signature based credit card payments system.

The existing fee arrangements provide incentives for acquirers and merchants to invest in payments infrastructure. The success of the system can therefore be traced back to the interchange fee providing the incentive for acquirers and merchants to continually invest in new technology needed to maintain and develop the sustainability of the network. As a result Australia has a very high penetration rate of EFTPOS devices, as well as EFTPOS usage.

In the initial stages of the network's development, the banks recognised the need to encourage acquirer and retailer participation in the system, and to do this the banks recognised the need to share the costs of operating and maintaining the network. With the growth of the network came the growth in the acceptance of debit cards by consumers as a payment instrument. The banks subsequently recognised the benefits of the EFTPOS network in enabling them to significantly rationalise their costly branch networks, and hence reduce their operating costs. This was made possible as merchants took on a greater role in the delivery of traditional 'banking' services to bank customers through the provision of 'cash-out' and access to customers' bank accounts for purchases.

1.1 Efficiency Principles

When reforming the credit card payments system the RBA referred to its objective as being to

> *"promote efficiency in the Australian payments system and enhance community welfare"*[1]

The current structure of the EFTPOS payments system in Australia promotes this objective on the basis of the existence of the following recognised economic principles.

1.1.1 User Pays

The current EFTPOS system is representative of the economic principle of "user pays". The operators and owners of the networks are paid a fee by those institutions whose cardholders use the EFTPOS network.

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[1] Reform of Credit Card Schemes in Australia IV, Final Reforms and Regulation Impact Statement, August 2002, RBA page 9.

Large retailers such as Coles Myer that own and operate their own networks and perform the functions essentially of an acquirer, are paid a fee by those institutions utilising the network.

Smaller retailers that rent equipment from acquirers, pay for the services they receive by way of rental payments, and generally low, flat merchant fees. These merchant fees are lower than would be the case if the zero EFTPOS interchange proposal were to be approved.

By way of contrast the credit card system is heavily subsidised by merchants. Cardholders using credit cards to the greatest effect contribute least to the cost of the system. That is, credit card users known as transactors, gain maximum benefits (including loyalty) and contribute least to the costs of the system.

1.1.2 Cost Representative

Fees charged to consumers for EFTPOS services are more reflective of cost than credit card transactions. The RBA has previously stated that where consumers using a debit card pay a fee, it is typically around $0.50 compared with an average cost incurred in providing those services of around $0.415.

1.1.3 Transparency

The current EFTPOS fee arrangements ensure there is greater transparency in the charging of fees. Cardholders and card issuers are charged fees for accessing and utilising the network. Merchants pay fees to their acquirers for merchant services (less any recognition for merchant's own investment in network infrastructure). Hence those parties utilising the services offered contribute to the costs of providing those services.

1.1.4 Future investment

As previously stated, the EFTPOS payments system is an efficient and secure payments network. The current fee structure has played a significant part in ensuring that this is the case, providing reimbursement to the network owners for the continued maintenance and development of the network. The proposal by the Applicants to reduce interchange fees to zero will jeopardise the level of future investment and therefore the integrity of the network. That is not to say that there will be no further investment, but that the level of investment is likely to reduce, lowering the standard of the network in terms of security, maintenance and development that we have today. We believe that a closer examination of other EFTPOS networks around the world, particularly in the UK further supports this conclusion.

2.0 The Applicant's Proposal

Zero EFTPOS interchange fees will create a 'net public benefit'

The following section looks at the claims made by the Applicants in their proposal to the ACCC.

a) *Reduce the overall cost of the Australian payments system by decreasing the cost of EFTPOS for consumers and thereby encouraging the use of EFTPOS*

A key assumption of the Applicants is that reduced card issuer costs will be passed onto cardholders, and as already argued, CML is doubtful that sufficient competition exists in card issuing to ensure that this will be the case. The Applicants in fact can give no more certainty to this occurring other than saying that it is a "likely effect". In fact the Applicants have not produced any analysis or evidence to suggest that this will be the case.

It will be difficult to evidence a pass-through by card issuers of reduced costs to cardholders due to the bundling of services and fees. As already argued, most cardholders do not pay fees, or pay fees only above a stated threshold, therefore cross-subsidisation amongst cardholders will make it difficult to evidence fee reductions.

Further the applicants have given no consideration for the impact of increased merchant service fees on consumer retail prices, which would negate any reductions in cardholder fees. In light of this it is difficult to see how the applicant's can claim that price signals will be more transparent and that the proposal will encourage greater use of EFTPOS.

b) *Make entry as a new card issuer or acquirer easier*

The applicants claim that fixing interchange pricing will make the negotiation of a new interchange agreement easier as there is no longer a requirement to negotiate pricing.

In previous submissions to the ACCC CML has argued that interchange or price negotiation represents only one element of accessing the network. Other factors that must also be included are:

- technical interfaces
- implementation costs
- resource allocation
- commercial incentives

CML is concerned that the proposal by the Applicants will however reduce the incentives for engaging new entrants, and will create new barriers to entry. This will make access for new entrant harder to achieve.

c) *Reducing the inertia that has made interchange fees unresponsive to changes in market circumstances*

CML believes that the proposal by the Applicants will result in a less competitive outcome than currently exists. EFTPOS fees are currently bilaterally negotiated and subject to market conditions. It is difficult to understand how a collective, multi-lateral price fixing arrangement could be said to be more flexible and responsive to market conditions. Further the applicants have not provided any basis or methodology as to how an interchange fee of zero was determined.

3.0 Arguments in Support of Draft Determination

3.1 ACCC Arguments

a) *The proposal put to the ACCC by the Applicants proposes only one element of reform – that is to EFTPOS interchange fees.*

The RBA in its review of credit cards, looked at interchange fees as well as competition and access to the network. The RBA also considered the impact of reforms on merchants, acquirers, issuers and consumers. In CML's opinion the Applicants in their review of EFTPOS, have only considered one aspect of reform, that being interchange fees as it is the only aspect that gives them benefit. Further the Applicants did not give due consideration to the impacts of zero EFTPOS interchange fees to all stakeholders.

b) *The proposed arrangement whereby competitors agree to substitute a series of fees negotiated on a commercial basis with a single interchange fee agreed and implemented on a multilateral basis is likely to lessen competition.*

As previously stated we believe the proposed zero EFTPOS interchange fee reduces incentives for participants to engage new market entrants, making network access difficult for new entrants. This is of concern because as supported by the ACCC, access to the network is important in encouraging more competition to the market.

Again we reiterate that it is difficult to understand how substituting market determined bilateral commercial negotiations, with a multi-lateral price fixing arrangement could be said to have a net public benefit.

c) *The competitive incentives of card issuing institutions to pass on the cost savings resulting from the proposed Agreement are unlikely to be maximised by the current market conditions.*

CML agrees with this analysis by the ACCC, and believes that the cost savings experienced by card issuers will not be passed through to consumers in full. Indeed the applicants themselves concede this point.[2]

Card issuers will not be required to pay acquirers fees for EFTPOS transactions and hence will see a reduction in their costs. The extent to which these cost reductions are passed on to customers of the card issuers, will be dependent on the level of competition in retail banking.

No evidence was provided by the applicants to suggest that there are sufficient competitive pressures across card issuing that would compel card issuers to sustainably pass on lower costs of doing business to their customers. Indeed issuers have a vested interest not to pass on these savings. CML therefore supports the ACCC's position in relation to this.

We would also point out that current fees charged by card issuers are significantly higher than interchange fees in many cases. This would therefore suggest that there are factors other than just interchange fees in determining the fees payable by cardholders. Supporting this is the fact that interchange fees have fallen in real terms yet the fees charged to cardholders have significantly increased.

d) *While agreement on the interchange fee is one important element in the successful negotiation of a bilateral agreement, other commercial and technical aspects must still be negotiated and remain a significant barrier to new entry.*

CML agrees with the ACCC on this matter. Whilst the successful negotiation of an interchange agreement requires the negotiation of price, agreement on a number of other elements is also required.

Technical interfaces – there are a number of technical interfaces that need to be specified, developed, tested and certified in order to facilitate the successful implementation of a new interchange link.

Costs and resource allocation – interchange partners need to be prepared and willing to build interfaces with new partners. Delays in allocating resources could be used by existing participants to delay the connection of new participants.

e) *The Commission considers that in order to recover the income lost as a result of the proposed Agreement, merchant acquirers are highly likely to charge merchants a higher EFTPOS merchant service fee. A consequence of the increase in merchant service fees is an increase in the cost of goods and services to consumers, either in the form of an EFTPOS surcharge or as higher average prices for all goods and services.*

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[2] Statement by Applicants, EFTPOS Interchange Fee Pre-Determination Conference, 1 September 2003, page 3

The Applicants claim that any general price increase passed on by merchants will be inconsequential and that because the market for merchant acquiring is effectively competitive, the aggregate increases in merchant fees will be limited.

The applicants have acknowledged that acquirers are likely to seek to recover lost interchange revenue by increasing merchant service fees. This increase in merchant costs will in turn be passed on to consumers in the form of higher prices for goods and services. The ability for retailers to surcharge will be curtailed by the competitive nature of retailing, resulting instead in an increase in prices payable for goods and services by all consumers. These price increases would negate from any benefits consumers may receive in terms of lower cardholder fees, and would not result in greater price transparency as suggested by the applicants.

CML does not agree with the Applicant's statement that merchant acquiring is effectively competitive and that price increases to merchants will be limited. CML notes that the applicants have not provided evidence to support this claim.

g) The Commission notes that due to the varying mix of payment instruments employed by consumers, certain merchants will be affected by this cost increase to a greater extent than other merchants.

Further to this, the Applicants claim that the proposal will make EFTPOS more attractive to consumers relative to less efficient means of payment, thereby inducing a shift towards the use of EFTPOS and reducing the overall cost of the Australian payments system.

CML supports the ACCC in relation to this point. The Applicants and their supporters claim that retailers stand to benefit substantially from the net impact of credit card reforms and the proposed EFTPOS reforms. This is based on a presumed $350m benefit to merchants from credit card reforms, whilst incurring additional EFTPOS costs of $160m, resulting in a supposed net gain to merchants.

We question the relevancy of netting the "benefits" of credit card reform with this debit card proposal in assessing the net public benefit of this application. The fee reductions likely to result from credit card reform are the result of a long and detailed review of credit card pricing arrangements which were found to be less than competitive and contrary to the public interest.

Notwithstanding, savings from credit card reforms are likely to amount to only $100m for retailers, not the $350m mentioned by many supporters of EFTPOS reform. This is due to the fact that unlike debit cards, credit card acceptance extends much further than retailing such as utilities, telecommunications and council rates. The additional costs to retailers following the implementation of zero EFTPOS interchange fees will be $160m, leaving a 'net' additional cost to retailers following implementation of both reforms to credit cards and EFTPOS of $60m.

For retailers to offset the additional cost of $60m following the implementation of the proposed reforms, there would need to be a significant switch in consumer spending patterns from credit cards to debit cards as outlined in confidential submissions to the ACCC. Such a shift in consumer spending would be unprecedented, and is acknowledged by industry representatives as being unrealistic.

h) *The proposed agreement may have the effect of increasing existing barriers to entry by removing an important bargaining tool.*

CML believes that in the absence of commercial incentives such as the ability to offer discounted interchange rates, an important bargaining tool for potential new entrants will be removed. Much of our own success in entering into interchange agreements has relied on such incentives.

i) *Transparent pricing signals may not be readily observable by consumers.*

This view can be contrasted with that of consumer groups who believe that a reduction in EFTPOS interchange fees will enhance transparency and efficiency and deliver clearer price signals than currently exist.

The Commission is concerned that the complexity of the current pricing structures for retail transaction accounts is likely to result in price signals that are not transparent and therefore difficult to act upon.

It is likely that the proposed Agreement will nonetheless result in an increase in the retail payment instrument pricing distortions that were identified by the Joint Study.

CML would reiterate that the extent to which cardholders would benefit from reduced costs to card issuers is dependant upon the competitive forces that exist between card issuers. CML agrees with the ACCC in that there seems to be insufficient competitive forces to ensure the sustainable reduction of fees to cardholders.

Central to credit card reforms outlined by the RBA was transparency and correct price signals to consumers. If zero EFTPOS interchange fees were to be imposed, retailers would build these additional costs into the prices of goods and services. As with credit cards, fees would be hidden in the prices of goods and services, with all consumers regardless of the payment type used, paying these hidden costs. CML therefore agrees with the ACCC in that correct price signals may not be readily observable by consumers if zero EFTPOS interchange fees were implemented.

Indeed as previously outlined, in those circumstances where cardholders pay no fees, or where fees are bundled into an overall package of banking products and services, it will be difficult for cardholders to see any benefits flow to them from lower interchange fees.

j) *The Commission notes that it has been argued that the cost of upgrades to a party may not reflect the network benefits accruing to all users of the network, and investment may be below optimal levels.*

CML has argued in the past that network owners such as acquirers and merchants have been primarily responsible for creating and maintaining what has been acknowledged as a world class payments system, through their investment and reinvestment in the network. The existing fee structure has provided the incentives for them to do so.

Despite claims to the contrary by supporters of the Application, ongoing investment in the network is required from network owners. However the Applicants have not provided an assessment of how their proposal will impact these necessary investments.

Future Investment Requirements

Significant upgrades to the network are required to maintain the security and integrity of the network.

Triple DES is an industry wide initiative to upgrade the encryption standard used to secure PIN based EFTPOS messages. This initiative requires an upgrade to the infrastructure that supports EFTPOS transaction processing including hardware encryptors, host systems, security control modules and most significantly all EFTPOS terminals in Australia will be required to be compliant with defined standards by the end of 2005. Further significant upgrades are likely to be required in the future to support such initiatives as chip cards.

Implementation of zero EFTPOS interchange fees as proposed by the Applicants makes network upgrades such as Triple DES and chip cards less attractive to network owners such as CML. The major benefits of such upgrades flow to all users of the network and so it is unreasonable to expect retailers and acquirers to incur all costs associated with these initiatives.

We believe that the applicants' proposal will have a significant impact on the level of investment made by network owners. This we believe will lead to a lowering of the standard of the current network in terms of availability, security and future enhancements.

4.0 Access

The Commission considers that, in the event that suitable access reform was to be introduced the proposed Agreement is more likely to be in the net public benefit.

The Commission considers that the proposal does not of itself address the barriers to entry into the EFTPOS network and is concerned that in the absence of effective access reform it may have the effect of increasing such barriers.

The Commission also considers that the proposal is likely to have the effect of reducing the scope for new entrants to negotiate alternative fee proposals.

The Commission is of the opinion that the existence and persistence of these high barriers to entry increase the likelihood that the potential anti-competitive detriment that may result from the proposed Agreement will be sustained over the longer term.

The Commission considers that the historical inertia of EFTPOS interchange fees is likely to be the result of the structure of the EFTPOS network and the competitive disincentives that it has created. The Commission is concerned that the proposed Agreement, by establishing an industry price fixing arrangement and providing for the potential exclusion of parties who wish to adopt non-zero interchange fees, is unlikely to address this inertia.

Access to the EFTPOS network is a key concern of CML as access to the payments network is essential to encourage further competition in the industry. Competition was a key element in the RBA's reform of the credit card payments system, but was not considered by the Applicants in relation to EFTPOS reform. As with credit cards, open access to the EFTPOS payments system is important for the efficiency of the EFTPOS system. Additional entrants should lead to increased competition, which should in turn lead to lower transaction costs and lower costs for merchants and other users.

CML is of the opinion that access should form an important part of any EFTPOS reform process, and should have been considered by the Applicants as part of their proposals.

It has been suggested that APCA consider establishing an access regime that would address the concerns of the ACCC. However CML is concerned that APCA may in fact not be the most appropriate body in which access issues should be resolved. The composition of APCA representatives is of concern to many industry participants, because it is considered that the views of non-members will not be given due consideration.

Therefore CML considers that an industry wide body consisting of card issuers, acquirers, merchants and other interested stakeholders would be best placed to discuss access reform.

5.0 Pre-decision conference

Whilst CML does not believe that any new information was provided by the applicants at the pre-decision conference we make the following comments with respect to some of the issues that were discussed.

It was suggested a zero interchange fee proposal would substantially "level the playing field" enabling smaller institutions to compete more effectively in the card issuing space. The first point we would make is that this argument only relates to existing players and ignores the negative impact of the proposal on potential new entrants to the market.

We would also make the point that interchange represents only part of the costs of providing customers with EFTPOS access that even with zero interchange fees it is unlikely that the relative cost base of smaller institutions compared with larger institutions will change.

The argument also ignores the fact that the larger issuers have made and continue to make significant investments in a merchant network. This investment reduces the need for these issuers to rely on other institutions proprietary networks, and hence reduces their interchange expense.

Those institutions that have made a commercial decision not to invest in a merchant network may regard themselves as being at a competitive disadvantage, however this is a commercial decision they have taken and it would be unreasonable to expect other parties to compensate them.

It was also claimed at the conference that EFTPOS usage is inhibited because consumers are paying too much for debit card transactions, as a result of the current EFTPOS interchange arrangements.

However we believe the incentives for issuers and consumers to shift away from EFTPOS is due to the structure of the credit card payments system rather than with EFTPOS interchange arrangements.

Credit cards have been recognised as having a significant pricing distortion effect on the payment system in Australia. While credit card use had been growing for years, it accelerated significantly in 1995 when co-branding cards and loyalty programs were first introduced. Prior to the introduction of these loyalty programs EFTPOS debit was more widely used than credit.

Once these pricing distortions are removed it is expected that there will be a shift away from credit cards to other tender types including debit cards.

The other point we would make is the fact that whilst arguably EFTPOS interchange fees have fallen in real terms, fees to EFTPOS cardholders have been increasing.