EXECUTIVE SUMMARY

This application for authorisation results from a review of interchange fees in EFTPOS transactions following the Joint Study of October 2000 by the Reserve Bank of Australia (RBA) and the Australian Competition & Consumer Commission (ACCC) entitled *Debit and Credit Card Schemes in Australia - A Study of Interchange Fees and Access (Joint Study).*

The proposed reform, for which authorisation is sought, is to reduce the current interchange fees for EFTPOS transactions to zero. This reform will reduce the costs of EFTPOS for issuers and reduce the income currently received by acquirers. The flow-through effects are likely to make the use of EFTPOS relatively cheaper as a means of payment for consumers.

Currently, for each EFTPOS transaction, the issuer of the end customer's debit card (or its gateway provider) pays an interchange fee (a flat fee per transaction) to the acquirer of the merchant's EFTPOS business. The issuer and acquirer jointly provide the clearing and settlement arrangements for EFTPOS transactions. These arrangements, including interchange fees, are contained in bilateral agreements between issuers and acquirers that provide network interconnections. Other issuers or acquirers, who do not have the requisite network interconnections, can participate by entering into a gateway agreement with an issuer or acquirer that is already interconnected.

The RBA/ACCC *Joint Study* noted that since the early 1990s, while remaining a popular payment system, the volume and value of EFTPOS transactions have not increased nearly as quickly as credit card transactions. The *Joint Study* suggested that one of the causes of the strong preference for credit cards over EFTPOS was the fees charged by issuers to cardholders for EFTPOS transactions resulting from the different direction of interchange fees compared with those for credit card transactions.

At the request of the RBA, the EFTPOS Industry Working Group (EIWG) was convened as an industry forum to develop and implement options for debit card reform. EIWG invited submissions from interested parties and held a stakeholder forum to discuss those submissions. The issues raised by stakeholders have been taken into consideration in developing the proposed reform arrangements.

The proposed reform 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. Initially, the interchange fees will be set at zero, but with this position being monitored each year 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.

The Applicants are seeking authorisation for a period of not less than four years in the first instance. This will allow sufficient time for the outcome of the proposed review to be incorporated into deliberations over the appropriate future form of the contract or arrangements and any application for continued authorisation.

Competitive forces will determine the effect of this reform in end-user markets. The response of individual issuers will be a matter for each issuer, but economic analysis suggests that the likely effect will be for cardholders to face lower transaction fees for the use of their cards for EFTPOS transactions. The proposed conduct will work together with the reforms to credit card interchange fees, scheduled to take effect from 31 October 2003, which are expected to have the effect of increasing the cost of credit card use to consumers.

It is likely that merchants will face higher costs as a result of acquirers independently deciding to seek to cover the cost of providing EFTPOS facilities from other sources of revenue following the loss of interchange fee revenue from issuers. One way in which acquirers may seek to cover their costs is by increasing EFTPOS transaction fees charged to merchants. However, the response of individual acquirers is entirely a matter for each acquirer. Accordingly, no contract, arrangement or understanding has been or will be made about the way in which acquirers might respond to the

adoption of a zero interchange fee. Merchants are unlikely to be discouraged from accepting debit cards relative to credit cards as a result of this reform and are unlikely to engage in widespread surcharging for the use of direct debit cards given the level of effective competition in the retail sector and the widely-recognised benefits of merchants offering EFTPOS to customers.

Consumers are likely to face a lower cost of using EFTPOS relative to other means of payment. This is expected to increase the use of debit cards vis-à-vis other means of payment, particularly credit cards, given the concurrent reform to their interchange fee arrangements.

The proposed conduct will be likely to result in significant public benefits such as:

- reducing the overall cost of the Australian payments system, by decreasing the cost of EFTPOS for consumers and thereby encouraging the use of EFTPOS;
- introducing greater flexibility over time into 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 proposed reform will not result in any lessening of competition. As currently set, interchange fees are naturally less responsive to changes in market circumstances than are prices in end-user markets, a fact that has led to the current inertia. Consequently, the multilateral setting of interchange fees would facilitate more competitive outcomes, by making it easier to amend the fees in response to changes in the market and by making direct entry as a network principal simpler by eliminating from the negotiation of bilateral agreements the need to agree the quantum of interchange fees to be charged.

As the proposed reform will result in a net public benefit, it meets the test for authorisation.

1. INTRODUCTION

This submission is made to the Australian Competition & Consumer Commission (ACCC) by the Applicants listed in Annexure 1, on behalf of themselves and other persons who may become parties to the contract which is the subject of these applications.

The submission is provided in support of two related applications for authorisation pursuant to section 88(1) of the *Trade Practices Act 1974* (TPA), to enter into and give effect to a contract, provisions of which may be exclusionary provisions, or may have the purpose, effect or likely effect of substantially lessening competition, within the meaning of section 45 of the TPA.

In lodging these applications for authorisation, the Applicants do not concede that the proposed contract would fall within section 45 of the TPA but wish to have the certainty and protection afforded by an authorisation.

1.1 PROPOSED CONDUCT

The Applicants propose to make and give effect to a contract by which they would multilaterally set EFTPOS interchange fees.

The interchange fees set by the contract would apply (so far as possible) in respect of any EFTPOS transaction in respect of which one of the parties to the contract is an issuer or one of the parties to the contract is an acquirer.

The contract is structured to allow new entrants to become parties to the contract. Hence, the benefit of the authorisations should extend to potential new issuers or acquirers who become parties to the proposed contract.

In the case of an existing bilateral agreement between two parties to the proposed contract, the proposed contract would override inconsistent terms of the existing bilateral agreement between the parties. In the case of an existing bilateral agreement between a party to the proposed contract and another issuer or acquirer who does not enter the proposed contract, the proposed contract provides that the party will use its reasonable endeavours to amend the bilateral agreement as soon as the bilateral agreement allows so that the interchange fees in the bilateral agreement reflect those set out in the proposed contract.

The proposed contract provides for:

(i) interchange fees to be zero cents per transaction for "sale", "sale/cash-out", "cash out only", "refund", "reversal" and "decline" transactions;

(ii) a review of the above interchange fees after 3 years, or earlier in the case of a material change in circumstances; and

(iii) flexibility so that future parties who wish to be issuers or acquirers can accede to the contractual arrangements and have the benefit of the authorisations granted.

The Applicants are seeking authorisation for a period of not less than four years in the first instance. This will allow sufficient time for the outcome of the review (proposed in point (ii) above) to be incorporated into deliberations over the appropriate future form of the contract or arrangements and any application for continued authorisation.

A copy of the proposed contract is enclosed as Annexure 2.

1.2 STATUTORY TESTS

Sub-section 90(6) of the TPA provides that the ACCC shall not grant authorisation for a provision that may involve price fixing unless it is satisfied in all the circumstances that:

(i) the provision of the subject contract would result, or be likely to result, in a benefit to the public; and

(ii) that benefit would outweigh the detriment to the public constituted by any lessening of competition that has resulted or would result or be likely to result from the contract.

Sub-section 90(8) of the TPA provides that the ACCC shall not grant authorisation for a provision that may be an exclusionary provision unless it is satisfied in all the circumstances that the proposed provision would result, or be likely to result, in such a benefit to the public that the proposed contract should be allowed to be made.

In the present case, the provisions of the proposed contract clearly satisfy both of these tests, as the provisions will result in benefits to the public which will outweigh the detriment (if any) caused by any lessening of competition. Hence, the ACCC should grant authorisation.

1.3 CONTACT

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

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2. WHAT IS EFTPOS AND HOW DOES IT WORK?

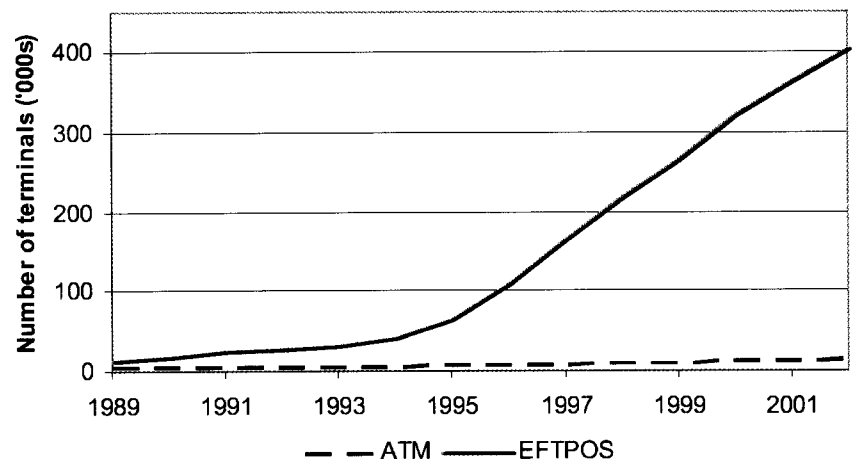
2.1 WHAT IS EFTPOS?

EFTPOS is an acronym for electronic funds transfer (at) point of sale. EFTPOS was introduced in Australia in 1984 and provides a means of payment for goods and services at the point of sale. Payment is made through an on-line debit of the customer's savings or cheque account, and credited to the merchant's account overnight. EFTPOS transactions are PIN-based and are authorised in real-time by the card issuer over a secure electronic network. A large number of merchants now also offer "cash out" services which enable merchants to offer their customers a cash withdrawal facility. This service enables merchants to efficiently reduce their excess cash holdings at the same time as providing a service to their customers.

EFTPOS terminals at points of sale were at first connected to only one financial institution, and could accept only the cards issued by that financial institution. As a result of demand from both customers and merchants, the major financial institutions began to develop communications links between themselves which facilitated the exchange of payment messages and reciprocal acceptance of the cards they had issued. Rather than simply being a single payment system, the Australian EFTPOS system is therefore a network of networks, linked by separate physical interconnections and established through many bilateral commercial and technical agreements. Today, nearly all EFTPOS merchants, regardless of their banking arrangements, accept nearly all debit cards.

Use of EFTPOS in Australia was initially moderate, but grew rapidly in the early 1990s when several major retailers joined the network. This acceleration of EFTPOS terminal diffusion is illustrated in Figure 2-1 which shows substantial growth of the number of EFTPOS terminals compared with Automatic Teller Machines (ATMs), starting around 1994. While the number of ATMs grew nearly four-fold between 1989 and 2002, EFTPOS terminal numbers increased at ten times that rate in the same period.

FIGURE 2-1: ATM AND EFTPOS TERMINALS IN OPERATION, 1989-2002

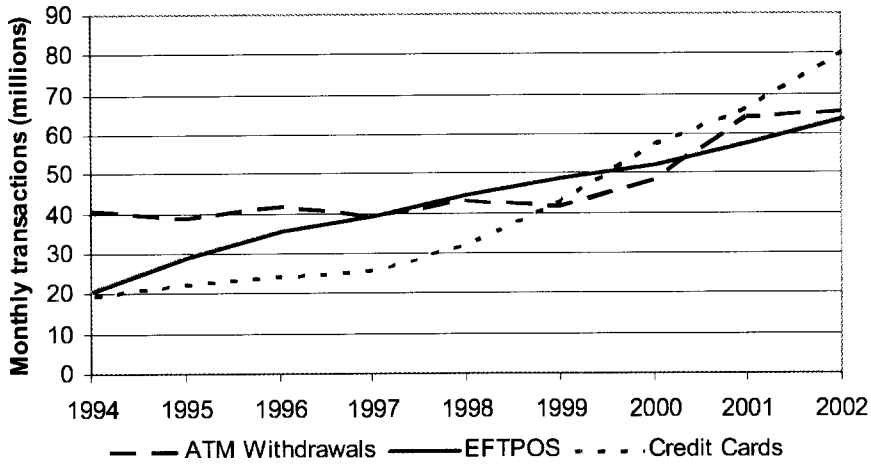


Source: APCA

In the later part of the 1990s, however, debit card transaction growth moderated while credit card transaction growth accelerated. This is illustrated by the relative growth in the numbers of monthly transactions shown in Figure 2-2. Credit and debit cards were used for payments at about the same rate in 1994, about 20 million transactions per month each, and at about half the level of ATM withdrawals. Use of both types of cards subsequently grew faster than ATM use and, despite slow

growth until 1997, the number of credit card transactions exceeded ATM and EFTPOS transactions by 2000.

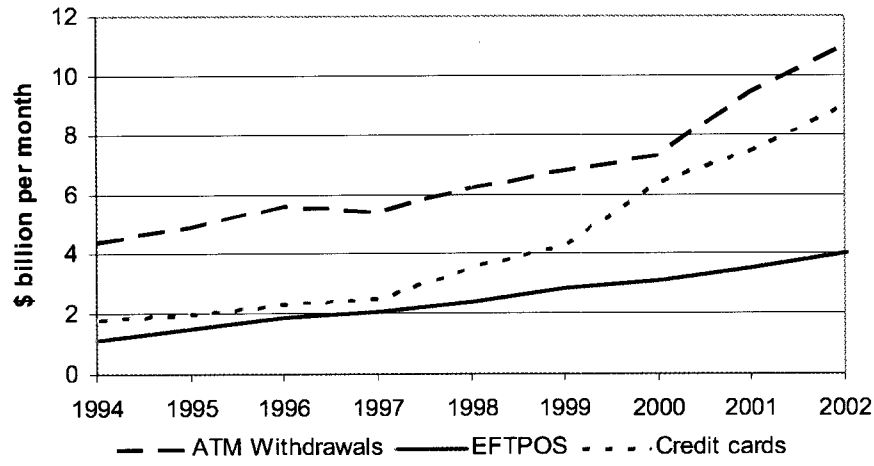
FIGURE 2-2: AVERAGE MONTHLY ATM WITHDRAWALS AND CREDIT CARD AND EFTPOS TRANSACTIONS, 1994-2002



Source: APCA and RBA

The relative growth of credit card use is also evident in the average monthly value of transactions for the three forms of payment, as shown in Figure 2-3. Credit card transactions now total about $9 billion per month – five times the level in 1994. Although the number of EFTPOS transactions increased to the level of ATM use by 1997, Figure 2-3 also shows that this was not matched by the growth in the value of those transactions.

FIGURE 2-3: AVERAGE MONTHLY VALUE OF ATM WITHDRAWALS AND CREDIT CARD AND EFTPOS TRANSACTIONS, 1994-2002



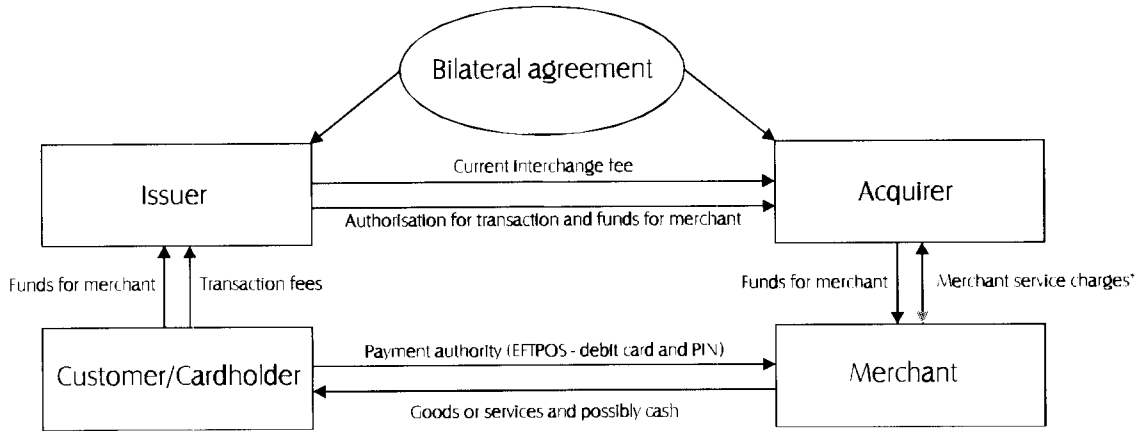
Source: APCA and RBA

At the end of June 2002 there were 402,084 EFTPOS terminals in operation in Australia[1] and nearly 20 million debit cards on issue. According to data collected by the RBA, banks acquired just under 736 million EFTPOS transactions with a value of $45.9 billion[2] in the year to June 2002, an average of $62.37 per transaction.

2.2 How does EFTPOS work?

There are four categories of parties to an EFTPOS transaction which can be illustrated as follows:

Figure 2-4: The structure of EFTPOS transactions



* Some (large) merchants receive rebates from their acquirer instead of paying fees.

- **Issuer** - the financial institution which operates the account from which the funds are withdrawn and provides its customers with a payment instrument (a debit card) that complies with appropriate standards and can be used by a cardholder to withdraw funds or make payments in accordance with terms and conditions specified by the issuer;
- **Customer/Cardholder** - the ultimate customer of the EFTPOS system who makes payment using their card and is both a customer of an issuer and a customer of a merchant;
- **Merchant** - who exchanges goods or services, and may provide cash, in return for the customer's card details and consent to make the payment, together with an on-line authorisation of the transaction. Merchants initiate non-cash payment transactions in accordance with the terms and conditions specified by their acquirer. The merchant receives value for these transactions from the acquirer by payment into a nominated financial institution account and pays their acquiring financial institution a merchant service charge for the use of the facility. In some cases, instead of paying fees, (large) merchants receive rebates from their acquirers for EFTPOS transactions; and
- **Acquirer** - the merchant's financial institution which supports the merchant's participation in EFTPOS by making payments to the merchant and by forwarding transactions to issuers for authorisation and settlement. An acquirer acquires transactions from EFTPOS terminals by obtaining the issuer's authorisation for a card transaction accepted by a merchant, and

1 Source: Australian Payments Clearing Association Limited website, accessed December 2002, http://www.apca.com.au/Public/apca01_live.nsf/WebPageDisplay/Payment_Statistics?OpenDocument.

2 Source: Reserve Bank Bulletin Statistical Tables, Table C.03, accessed December 2002, http://www.rba.gov.au/Statistics/Bulletin/C03hist.xls.

providing financial transaction data to the issuer for posting a debit (or possibly a credit) to a cardholder's account. A merchant that owns the necessary facilities to process and switch transactions directly to some issuers is defined as a merchant principal within the authorised rules governing EFTPOS settlement and clearing.

2.2.1 Settlement

The EFTPOS network is technically a series of proprietary bilateral communications links between institutions which support the secure transmission of transaction data between those institutions in their roles as acquirers or debit card issuers. The bilateral links are supported by bilateral interchange agreements which include standards for the EFTPOS network as well as clearing, settlement and interchange fee arrangements. These links also enable card issuers to authorise transactions almost immediately ("real time"). Real time authorisation and PIN-based identification significantly reduce fraud and credit risk both to issuers and to the merchants receiving payment for goods and/or services. Standards relating to the processing and settlement of EFTPOS transactions are administered by Australian Payments Clearing Association Limited (APCA) through the Consumer Electronic Clearing System (CECS) regulations and procedures[3].

In transactions where the same financial intermediary provides EFTPOS payment services to both the cardholder (as issuer) and the merchant (as acquirer), the intermediary receives the EFTPOS initiated electronic transaction information through a terminal in the merchant's outlet, advises the merchant of authorisation for the transaction (through a signal returned to the EFTPOS terminal), and then debits the cardholder's account and credits the merchant's account. Such transactions are referred to in the industry as "on us" transactions.

Interchange (or "shared", "foreign" or "off us") transactions are those where the issuer and acquirer are different organisations. An acquirer receives the electronic transaction information through its merchant's outlet and forwards it to the issuer. When the issuer authorises the transaction the acquirer advises the merchant who accepts the EFTPOS payment in exchange for the goods or services provided to the issuer's cardholder. The issuer debits the cardholder's account and the acquirer credits the merchant's account, generally via an overnight net settlement of all transactions processed by the merchant. The issuer then must reimburse the acquirer to complete the payment transaction. This settlement generally occurs across the acquirer organisations' Exchange Settlement Accounts (ESAs) at the Reserve Bank of Australia (RBA) on the next working day as part of the 9.00 am settlement process.

APCA's regulations and procedures for CECS also make provision for membership of CECS by merchant principals – merchants whose investment in switching and processing facilities allows them to send EFTPOS transactions directly to financial institution issuers. Merchant principals are therefore able to enter into agreements with issuing network principals to directly send transactions. A merchant principal may, as well, still utilise the services of an acquirer to settle EFTPOS transactions with issuers with which it has not negotiated agreements but undertake a substantial part of the transaction processing itself. The fees and merchant service charge (or rebate) payable to or by a merchant principal may reflect the different level of its network participation as compared with other merchants.

2.2.2 Interchange fees

The clearing and settlement arrangements between issuers and acquirers in the EFTPOS network are referred to as EFTPOS interchange arrangements. Each time a cardholder uses a debit card to make a purchase from a merchant, the cardholder's issuer pays an interchange fee to the merchant's acquirer for providing that service to its customer. These interchange fees, terms of payment and other

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3 The CECS regulations and procedures were granted authorisation by the ACCC on 16 August 2000: see Section 2.2.3 below.

arrangements are currently determined bilaterally by, and set out in bilateral agreements between, the network principals. These agreements form the core of the EFTPOS "network".

One consequence of the bilateral nature of the agreements that form the EFTPOS network is that there is no common definition of "interchange fee". Although there are similarities between them, the agreements cover a number of types of transactions that can occur on the network and not all agreements set interchange fees for all of these transactions. The different transaction types can be roughly divided into "standard" debit card transactions that consist of withdrawal transactions (sales, sales/cash-out and cash-out only), and "supporting" transactions consisting of declined and reversal transactions (including refunds).

Interchange fees are generally a flat fee per transaction rather than an *ad valorem* fee. Unlike credit cards, where the value of the transaction influences the settlement costs incurred (through the credit risk not recovered by interest charges), the costs of settling debit card transactions are almost entirely independent of their value.

2.2.3 CECS Authorisation

To become a member of CECS the party must engage in interchange activity, however, membership of CECS is voluntary and not a prerequisite for participation in the EFTPOS network. Organisations may participate in the EFTPOS network, as an acquirer or as an issuer, by establishing direct bilateral arrangements with other participants or through a gateway arrangement negotiated with an existing participant, or through a combination of direct bilateral arrangements and gateway arrangements.

CECS regulations and procedures are set by APCA. APCA is an industry body which oversees the technical and operational standards for participation by financial institutions and others in the various payment clearing systems, including CECS which is the clearing system through which EFTPOS (and ATM) transactions are cleared. Not only does APCA set the regulations and procedures but it also provides a system of certification to increase the objectivity and transparency of certification.

The CECS regulations and procedures facilitate the conduct and settlement of exchanges of EFTPOS payment instructions between CECS members and all aspects of the related clearing cycle. These standards and procedures are set out in the CECS Manual and are mandatory when CECS members engage in the exchange of EFTPOS transactions with other CECS members, although CECS members may agree to apply divergent standards and procedures, provided they satisfy the CECS Management Committee that the integrity, security or efficiency of CECS as a whole will not be lessened in any material way as a result.

The CECS regulations and procedures were granted authorisation by the ACCC on 16 August 2000[4] (which authorisation is due to expire on 7 September 2003). The authorisation was granted on the basis that:

- minimum mandatory standards and procedures for interchange would have a positive effect on access to debit card networks for issuers, acquirers and merchant principals because their respective interchange partners would not be able to insist they meet more stringent and unjustified standards and procedures; and
- certification for acquirers and merchant principals would enhance the security and integrity of the debit card network.

The CECS regulations and procedures do not however govern the terms of participation in the EFTPOS system by existing or potential issuers and acquirers. In its determination on the CECS authorisation, the ACCC found:

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4 *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*, ACCC (2000).

> *"... that for an industry association to require its members to contract with other members or with non-members that meet certain criteria would be to exceed what is generally required under the competition provisions (Part IV) of the Act. The Commission considered that, to require as a condition of authorisation of the proposed CECS arrangements that Members enter into ATM or EFTPOS interchange agreements with other Members or non-Members that are able to satisfy the proposed interchange standards and procedures under CECS, would not be justified. To do so would be to impose upon CECS, through the authorisation process, elements of a comprehensive access regime for the ATM or EFTPOS networks. In the Commission's view, should such an access regime be considered necessary it should be established under the appropriate legal provisions of Part IIIA of the Act or by the Payments System Board under the Payment Systems (Regulation) Act."*
>
> ACCC (2000), page III.

The CECS regulations and procedures set minimum mandatory standards and procedures for interchange. Accordingly, interchange partners of those network participants cannot insist they meet more stringent and unjustified standards and procedures.

In particular, it should be noted that neither the CECS regulations and procedures nor the CECS authorisation specify the quantum of any interchange fees. The quantum and type of EFTPOS interchange fees have been left, until now, to the bilateral agreements between network principals.

3. WHAT IS THE PROBLEM?

3.1 BACKGROUND

In October 2000, the RBA and the ACCC released a joint study entitled *Debit and Credit Card Schemes in Australia - A Study of Interchange Fees and Access* (RBA/ACCC *Joint Study*).

The RBA/ACCC *Joint Study* argued that EFTPOS is not operating at an efficient and competitive level of use, particularly when compared with other means of payment such as credit cards. The *Joint Study* found that one of the causes of the strong preference for credit cards over EFTPOS was the absence of charges to cardholders for credit card transactions as a result of the different direction of interchange fees between the two means of payment.

EFTPOS represents one of the cheapest forms of payment to merchants (as well as reducing their cash holding costs). EFTPOS transactions are cheaper to process than other card-based transactions and identification through a PIN and the need to present a card make them less open to fraud. Despite these systemic advantages of EFTPOS, the cost to cardholders of using a debit card is more than the cost of using a credit card, in part, because of the transaction fees a debit cardholder pays on transactions beyond any fee-free threshold.

On the other hand, the decision faced by consumers in choosing whether to use a credit card or debit card is likely to be driven not purely by the relative cost to the consumer of those products but also by the value the consumer obtains from using them. Debit and credit cards can both be used as means of payment but represent distinctly different financial services providing different forms of benefits to consumers. However, concentrating on the payments elements of the services, the RBA/ACCC *Joint Study* concluded that consumers are choosing a more costly and, hence, less economically efficient means of payment (namely, credit cards) in preference to a cheaper and more economically efficient means of payment (namely, debit cards). In the view of the RBA and the ACCC the relative price faced by consumers to use EFTPOS needs to be reduced to improve overall efficiency of the payments system.

The issue identified by the RBA/ACCC *Joint Study* does not lie with the EFTPOS system itself, but with a "mis-match" between the allocation of the costs in EFTPOS, as supported by the current interchange fee arrangements, and the allocation in other means of payment. This mis-match is the principal source of what is seen as a distortion of relative prices faced by consumers. While the reforms of credit card regulation promulgated by the RBA will help correct this problem, changes to EFTPOS interchange fees will contribute to lowering the total cost of the payments system as a whole.

3.2 RBA/ACCC *JOINT STUDY*

The RBA/ACCC *Joint Study* findings were the basis for the RBA's proposals for reform of credit card schemes in Australia (RBA, 2001). The key findings of the RBA and ACCC in relation to debit card payment systems were that:

- the Australian system operates bilaterally rather than as a scheme-based system, as occurs in many other countries;
- competitive pressures have not been sufficiently strong to bring interchange fees into line with costs;
- the system of bilateral agreements creates restrictions on entry to the debit card system; and
- there is no convincing case for an interchange fee in the debit card network in Australia in either direction.

The RBA/ACCC *Joint Study* noted that the interchange fees for debit card transactions have hardly changed since they were introduced in the early 1990s, despite reductions in costs during that time. It

argued that this fact indicates that the setting of fees through bilateral contracts has been rigid and unresponsive to transaction volumes and changes in technology.

The RBA/ACCC *Joint Study* claimed that the payment of a debit card interchange fee to acquirers is an arrangement in which Australia is unique since, in other countries, the payment is to the card issuer or there are no interchange fees at all[5].

It also found that competitive pressures in card payment networks in Australia have not been sufficiently strong to bring interchange fees into line with costs. The *Joint Study* postulated that this is because the end-users of these services - cardholders and merchants - have no direct influence over the setting of interchange fees but must rely on their financial institutions to represent their interests. Since the large financial institutions are both issuers and acquirers, and hence benefit from the revenue generated, these institutions have little incentive to press for lower interchange fees. This, according to the *Joint Study*, has meant the price signals and competitive responses that would ordinarily be expected to put pressure on margins in card payment networks have not worked effectively.

The RBA/ACCC *Joint Study* found that the resource costs to provide credit card transactions are significantly greater than the resource costs to provide debit card transactions. Nevertheless, the cost efficiency of EFTPOS is not reflected in the charges faced by cardholders, as the transaction fees a debit cardholder pays on transactions beyond the fee-free threshold are greater than the cost of using a credit card[6]. Although EFTPOS is a relatively low cost means of payment, there is little incentive for a customer to use this means of payment, particularly in preference to credit cards. The credit card network has consequently grown at the expense of debit card transactions, which consume fewer resources. As a result, the *Joint Study* concluded that Australia has a higher cost retail payments system than is necessary and much of this higher cost is borne by consumers who do not use credit cards. It was estimated that the amount of interchange fees paid to debit card acquirers in Australia in 1999 was in the order of $100 million.

The RBA has subsequently argued[7] that, by setting EFTPOS interchange fees to reflect the costs of providing the transactions and lowering the fees paid by issuers, cardholders would be encouraged to use debit cards at a more efficient level than at present.

Further, the *Joint Study* argued that this inefficiency is reinforced by restrictions on entry to the card networks. Access to the debit card network is through a series of bilateral agreements. This can put new issuers and acquirers at a competitive disadvantage. If they cannot successfully negotiate an interchange arrangement and interchange fee with a counterparty issuer or acquirer, they are left having no resort but to negotiate what the *Joint Study* described as "more expensive" gateway arrangements.

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5 Subsequent research by EIWG members and other EFTPOS stakeholders has revealed instances of issuer-paid interchange fees in New Zealand and Italy.

6 Although most credit cards carry an annual membership fee (often waived for customers buying other financial services), there is no transaction fee on standard credit card purchases. Similarly, after allowing for any additional annual fees, rewards programs linked to credit card spending also effectively subsidise credit card purchases. For customers who hold both debit and credit cards, direct financial institution charges and forgone rewards points mean the marginal transaction cost of an EFTPOS purchase will usually be higher (and certainly no lower) than if they used their credit card.

7 For instance, "the pricing structure for debit cards ... discourages consumers from using these cards in preference to credit cards. Debit cardholders face a per transaction fee for using their debit card (beyond a fee-free threshold) while credit cardholders do not face a per transaction fee and earn a rebate (i.e. a negative cost) if they participate in a credit card loyalty program." RBA (2001), page 38.

The *Joint Study* concluded there is an imbalance of costs and revenues of issuers and acquirers. Based on the data made available to the RBA and ACCC and their allocation of costs across payments mechanisms, the *Joint Study* found that debit card acquiring generates a revenue of about 23% mark-up over costs, whilst in the case of debit card issuing, interchange fees paid are largely covered by revenues from transaction fees on cardholders who use their debit cards beyond their fee-free limit each month. The average issuing cost per transaction is substantially lower than that for credit card transactions, yet this is not reflected in their usage.

3.3 EFTPOS Industry Working Group (EIWG)

3.3.1 Origins and composition

The Payments System Board of the RBA commented on the debit card system in its *Annual Report 2000* as follows:

> *The Board acknowledges that interchange fee arrangements in debit card payment networks have been in place for a decade and are under no strong competitive pressure to change. Because the fees are bilaterally negotiated, the industry also lacks a decision-making body with authority on questions of fees. The Board is willing to work with industry participants to bring about more efficient pricing arrangements for debit card payments.*
>
> Payments System Board, *Annual Report 2000*, page 20.

At the request of the RBA, the EFTPOS Industry Working Group (EIWG) was convened as an industry forum to develop and implement options for debit card reform that would address the problems identified in the RBA/ACCC *Joint Study*. Its membership was open to all members of CECS, that is the financial institutions and merchant principals whose bilateral interconnection agreements form the core of the EFTPOS "network". The RBA withdrew from the deliberations of EIWG after the meeting held on 8 August 2002.

3.3.2 Discussion Paper

In July 2002, EIWG published a Discussion Paper titled *Options for EFTPOS Interchange Fee Reform*[8]. This Discussion Paper was prepared to facilitate discussions about options for revisions to EFTPOS interchange fee arrangements. EIWG developed three categories of interchange fee options as the basis for a discussion of interchange reform:

- bilateral fees;
- multilateral fees; and
- no interchange or zero interchange fee.

Stakeholders were invited to make submissions and comments, and were invited to an industry forum held in September 2002[9]. The submissions and views put at the industry forum underpinned the deliberations on the proposed arrangements by the members of EIWG.

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8 This Discussion Paper and the responses to it are available from the RBA website at: http://www.rba.gov.au/PaymentsSystem/PaymentsPolicy/EftposInterchangeFeeReform/index.html.

9 The organisations represented at the forum were: ANZ Bank, Australian Consumers' Association, Australian Institute of Petroleum, Australian Retailers' Association, Australian Settlements Limited, Bank of Queensland, Caltex, Cashcard Australia, Coles Myer Limited, Commonwealth Bank, Credit Union Services Corporation (Australia) Limited (CUSCAL), Financial Services Consumer Policy Centre, Heritage Building Society, IMB, Mobil Oil, National Association of Retail Grocers of Australia (NARGA), National Australia Bank, Reserve Bank of Australia, St George Bank, TransAction Resources, Visa International and Westpac.

4. WHAT IS THE SOLUTION?

4.1 INTRODUCTION

Following the deliberations of EIWG, the Applicants have formed the view that a solution to the perceived problem with the EFTPOS system is to amend EFTPOS interchange fees. The primary purpose of such an amendment is to make EFTPOS more attractive to cardholders (particularly relative to credit cards) than it is at present. The concurrent proposed amendments to credit card interchange fees will assist, but the proposed EFTPOS change will still be beneficial in addressing the problem.

4.2 PROPOSED CONDUCT

The Applicants propose to make and give effect to a contract by which they would multilaterally set interchange fees for any EFTPOS transaction in respect of which one of the parties to the contract is an issuer and one of the parties to the contract is an acquirer. It is proposed that the contract will permit new entrants to become parties to the contract at a future time.

Features of the contract will include:

(i) interchange fees to be zero cents per transaction for "sale", "sale/cash-out", "cash out only", "refund", "reversal" and "decline" transactions;

(ii) a review of the above interchange fees after 3 years, or earlier in the case of a material change in circumstances; and

(iii) flexibility so that future parties who wish to be issuers or acquirers can accede to the contractual arrangements and have the benefit of the authorisations granted.

In order to facilitate the broad adoption of zero interchange fees and, thereby, obtain the maximum public benefit from the proposed conduct, the contract also provides that the parties to it will use their reasonable endeavours to agree to zero interchange fees with non-parties.

5. EFFECT OF PROPOSED CONDUCT

The proposed conduct has potential and related effects on end user markets, such as retail banking and goods and services retailing generally, on incentives to invest and develop the EFTPOS network and on the ease of entry to the EFTPOS or debit card networks. Understanding these effects first requires a brief discussion of the nature of two-sided markets (of which the provision of EFTPOS services is an example) and of the role and impact of interchange fees in those markets.

5.1 THE ROLE AND IMPACT OF INTERCHANGE FEES

Interchange fees have always been part of the bilateral commercial agreements between EFTPOS network participants, and provided a means by which joint costs of establishing the networks could be shared, particularly the (then) high costs of terminal, switching and communications equipment. Interchange fees also influenced fees in gateway agreements, as the interchange fees comprised part of the costs to core network operators of supplying access to interconnecting gateway services.

5.1.1 Two-sided markets

The recent economic literature on the role and effect of interchange fees has emphasised the "two-sided" nature of the markets in which the fees are observed[10]. These markets are generally for intermediation services that bring together parties (i.e., customers and merchants) with a joint interest in consuming the service (i.e., transfer of payment for goods or services), but where there are barriers to the parties sharing the joint cost privately.

Supply of these services has to balance demand on both sides of the market, since attracting too many of one party without the other will lead the market to collapse. Obtaining this balance may require redistributing the direct costs of the intermediation between the parties, so that a side that naturally bears a high proportion is subsidised by payments from the other side.

It is not possible to specify the efficient level of pricing in terms of marginal costs, as in the case of a "normal" one-sided competitive market. Rather, the efficient pricing of the two sides of the market is jointly determined and depends on demand conditions, including the value which customers on each side of the market place on increases in the number of customers on the other side. Thus, even in the presence of accurate cost information, efficient pricing could not be estimated without difficult-to-obtain information on demand elasticities.

In Australia, the growth of the EFTPOS "network" was, at least initially, due to the ability of the network principals to shift internally some of the direct costs of establishing merchants' terminal facilities onto cardholders. Debit cards were already widely issued for use in proprietary ATMs, so the problem to be solved was getting merchants to accept the cards and install the necessary equipment. The internal cross-subsidy implemented by the EFTPOS network principals was then preserved through interchange fees incorporated into the bilateral agreements between them that eventually linked the separate proprietary networks into the current universal "network". Larger retailers were also able to invest in EFTPOS facilities as part of their check out and cash register systems and to negotiate lower merchant service charges (or obtain rebates) from their acquiring financial institution, effectively sharing the cost.

5.1.2 Interchange fee neutrality

In the context of theoretical modelling of credit card interchange fees, the *neutrality* argument states that card schemes will be unable to use interchange fees to exercise market power if changes in the fees can be "undone" in the downstream retail markets. Gans and King (2001b) identify two

10 For instance, see Rochet and Tirole (2001) and Evans (2002).

independently sufficient conditions for interchange fee neutrality[11] in a general, although stylised, model:

- the absence of "price coherence" (that is, differential retail pricing based on means of payment); or
- perfectly competitive retail markets (so that "cash only" suppliers are always able to enter if the interchange fee excessively raises the margins set by card-accepting merchants).

Note also that in this theoretical framework taking advantage of "non-neutrality" requires that the card scheme has market power derived from some other source that allows it to unilaterally set the interchange fee with the intention of generating monopoly profits. In the case of four-party credit card schemes (such as Visa and MasterCard) potential use of this market power would require the combination of all of: network economies of scale; "no surcharge" rules that effectively imposed uniform prices regardless of means of payment; and restrictions on membership of the card schemes.

Similar neutrality conditions apply in the case of EFTPOS interchange fees. If all relevant markets are sufficiently competitive and do not display price coherence, it will not be possible to shift the costs of the system between merchants and consumers, or between EFTPOS users and consumers who do not use debit card facilities. Changes in interchange fees will then be neutralised by offsetting changes in prices in the related markets. In this theoretical world, changing interchange fees would make no difference to relative prices.

In practice, while the retail banking and general retail markets are effectively competitive[12], they are not perfectly competitive in the sense that Gans and King require. Similarly, it is not generally profitable for merchants to differentiate retail prices according to the means of payment chosen by customers. It is therefore likely that decreases in interchange fees paid by issuers will result in changes in the relative cost faced by consumers for using EFTPOS.

5.1.3 Multilateral setting

An interchange fee is, by its nature, important to the efficiency of the two-sided market to which it applies, but it is the product of joint negotiations between parties on the two sides of the market, rather than a natural outcome of their individual actions. There are no automatic means by which the interchange fee can be reset to respond to changes in circumstances. Moreover, even if the appropriate *direction* of the interchange fee might be agreed by the parties (even though they have opposing interests as net issuers or acquirers), they may then have different views on what constitutes the optimal *level*.

Despite the potential importance for efficiency, their joint nature means interchange fees are more likely to be set through collective, non-market processes (that is, multilateral negotiation balancing

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11 There are a number of seminal analytical studies which derive the conditions for the neutrality of credit card interchange fees in payments systems. The recent studies examining the role of interchange fees and the conditions that would allow exploitation of market power are summarised in Rochet and Tirole (1999), and in the papers by Gans and King (2000, 2001a, 2001b) which build on their framework.

12 Economies of scale and scope, together with network effects, can naturally generate a highly concentrated oligopolistic industry structure. A concentrated industry comprised of firms possessing distinct capabilities that are hard to reproduce may be a recipe for high profits, buttressed by tacit or formal collusion. However, rivalry between oligopolistic firms can also be intense – with each seeking to invest in strengthening its distinctive capabilities and acquire new ones, thereby increasing rivals' costs in undermining its business. If government provides an appropriate Trade Practices framework to police extreme behaviour (such as collusion to raise prices or reduce competition and predatory behaviour against weaker rivals and new entrants), this rivalry can lead to all the desirable outcomes of the perfectly competitive model (such as the variety of products sought by consumers, strong innovation and costs and prices reasonably close to the efficient minimum). Concentrated markets can therefore be "effectively competitive".

interests that are partly opposing and partly complementary) than through decentralised market processes (effectively the continuation of bilateral processes). This is especially the case once the two-sided market has evolved to include large numbers of intermediating participants, potential further increases in network externalities are relatively small and participants on both sides of the market (merchants and card-holders) already have strong incentives to be in the market without needing further encouragement and the potential for bilateral negotiation is exhausted.

The costs of renegotiation means interchange fees are likely to remain unchanged from the level that made market sense during a period of market development. In a mature market, the role of interchange fees may be minimal until some disruptive occurrence, such as the development of a new product such as a smart card.

5.2 EFFECTS ON END-USER MARKETS

The proposed change in interchange fees will have direct effects in the market for retail banking through effective competition between financial institutions. Some of those effects will depend on the impact on gateway fees which is, in turn, partly dependent on the effects of the proposed arrangements on EFTPOS network access and competition. There will be indirect effects on the markets for retail goods and services that will depend on how financial institutions adjust merchant service charges and, subsequently, whether merchants respond to these changes by adjusting general price levels or, instead, by introducing or increasing EFTPOS surcharges. This latter response, together with any concurrent changes in the costs of other means of payment, will then determine the net effect on the price signals faced by consumers for EFTPOS relative to other means of payment.

5.2.1 Effect on issuers' costs

The proposed arrangements will directly reduce the cost of issuer-related debit card services for financial institutions that are network principals and parties to the arrangements.

For financial institutions that rely on gateway agreements, too, a zero interchange fee in the bilateral agreements between network principals is likely to be reflected in lower total gateway fees (which may consist of fees designated both as interchange fees and as gateway fees) and therefore should reduce their costs of card issuing and customer transactions. The pressure for change will come from the financial institutions that rely on gateway access.

Consequently, once interchange fees for EFTPOS network services between network principals are set to zero, competitive pressures are likely to drive down the underlying costs of issuing activities for all financial institutions.

5.2.2 EFTPOS transaction fees

Zero interchange fees (and consequential reductions in gateway fees) will ensure that all issuing financial institutions will have lower costs of EFTPOS transactions. Certainly, any network principal that is a net issuer will feel an immediate effect of lower costs. Effective competition in retail banking means the reduced costs of providing debit card facilities associated with zero interchange fees will then be passed on in some form in lower retail banking fees paid by cardholders and/or through enhanced services. What those changes will be, or should be, are questions that need not be addressed by the proposed arrangements; rather, the Applicants believe that the parties should be allowed to develop these arrangements in an effectively competitive retail banking market.

Competition should, therefore, ensure cardholders face lower charges for marginal debit card transactions over their free allowances, or at least a more attractive value proposition for the use of EFTPOS. Using EFTPOS will likely become relatively cheaper vis-à-vis other means of payment.

5.2.3 Merchant service charges

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

merchant service charges to reflect these increased costs. As with retail banking services, it is not obvious what form these changes will take, but they are likely to include higher average fees and increased marginal transaction charges for accepting EFTPOS.

It should be noted, however, that the response of individual issuers and acquirers to changes in the level of interchange fees will be entirely a matter for each issuer and acquirer. Accordingly, no contract, arrangement or understanding has been, or will be, made about the way in which issuers or acquirers might respond to the adoption of a zero interchange fee.

5.2.4 Retail pricing and EFTPOS surcharges

Faced with increased costs of accepting debit card payment through likely increases in merchant service charges, merchants will have the option of no longer accepting the cards or of passing the cost on to customers in some form (most likely as either an increase in average prices or, possibly, surcharges for EFTPOS).

The ubiquity and convenience of EFTPOS suggest that, despite the two-sided nature of the market, reducing or removing the interchange fees is unlikely to cause it to "unwind". The convenience and potential uses for EFTPOS are now well understood by both consumers and merchants and the system has the "critical mass" needed to ensure that users (particularly merchants) have no reason to doubt that they will obtain benefits from incurring the costs of joining the network. Moreover, the widespread use and acceptance of EFTPOS facilities means they are a commonly accepted cost of doing business in retail markets, and are consequently incorporated into the cost structure of retail businesses. An entrant is unlikely to gain any net advantage by forgoing EFTPOS facilities as the loss of business is unlikely to offset the marginally lower prices it might be able to charge. Merchants are therefore more likely to continue to accept EFTPOS payment and pass on the increased cost than to decrease their use and acceptance.

The likely reaction of merchants to any increase in merchant service charges for EFTPOS transactions also needs to be assessed by considering their willingness to continue to accept credit cards, which involve (and are likely to continue to involve) higher merchant service charges and merchant risks than EFTPOS transactions. Hence, it is unlikely that merchants would discriminate against EFTPOS transactions just because merchant service charges were increased.

In competitive markets an increase in costs that is widespread across firms (as this would be) can be passed on to customers by individual firms without it damaging their competitive position. Whether merchants in goods and services retail markets pass on the increased merchant charges directly as EFTPOS surcharges or as higher average prices will depend on competitive conditions and the costs of the alternatives in each sector of retail markets. Past experience suggests that increasing the average price level may be preferred to surcharging in most markets, although this is a market-driven outcome (that is not within the scope of the proposed arrangements).

The relatively insignificant impact of the effects of the proposed changes on total retail costs reinforces this conclusion. As noted in the RBA/ACCC *Joint Study*, EFTPOS interchange fees were around $100 million in 1999. This represents less than 0.3 per cent of the value of EFTPOS transactions in that year[13]. Similarly, even if all of the change in interchange fees passed to merchants as higher costs of accepting EFTPOS payment, the increase would only be 0.07 per cent of the value of total retail turnover[14]. The impact of an increase in EFTPOS costs would vary across retail sectors according

13 The total value of Australian EFTPOS transactions was $36,002 million in calendar 1999, based on data from Reserve Bank Bulletin Statistical Tables, Table C.03, http://www.rba.gov.au/Statistics/Bulletin/C03hist.xls, accessed December 2002.

14 Total Australian retail turnover was $141,223 million in calendar 1999, based on data from Table 1 of *Retail Trade, Australia*, Australian Bureau of Statistics Catalogue No. 8501.0, 6 January 2003.

to the extent that it is accepted as payment. Although the effect of the proposal may be an increase in merchant service charges for EFTPOS use, the consequent impact of passing that increase on in average retail prices will be very small (see below for other offsetting factors).

5.2.5 Net effect

In the unlikely event that nearly all merchants were to choose to levy EFTPOS surcharges, the net effects on consumers and merchants would largely cancel out. Any gain consumers get from lower transaction charges on their EFTPOS-related banking would be offset by higher costs of using their debit card at the point of sale. Merchants' net cost of accepting debit cards would also be unchanged as surcharge revenue would offset the increased merchant service charges. The reform of interchange fees would then be effectively "neutral".

It is much more likely that surcharging by merchants will not be common and that any increase in EFTPOS merchant charges will be passed on in (marginally) higher average prices. In these circumstances, EFTPOS users will effectively see only the decrease in transaction fees. Note also that the likely effect of credit card reform will be (marginally) to reduce retail prices[15]. To the extent that changes in EFTPOS interchange fees are concurrent with the proposed reform of credit card schemes, the net effect of both sets of changes on retail prices is likely to be a small decline.

Competition in goods and services retailing will ensure merchants are generally no better off, but the reduced EFTPOS interchange fee will have effectively corrected some of the anomalous allocation of the current costs of EFTPOS systems across consumers.

While the total cost to consumers and merchants of using EFTPOS will be unchanged, the proposed arrangements are likely to mean consumers face a lower relative cost of using EFTPOS compared with other means of payment. As argued by the RBA, this will give rise to public benefits through improvements in the efficiency of the payments system as a whole because the current balance of costs borne by EFTPOS users is already distorted.

5.3 Effects on network investment and development

It is generally accepted that the EFTPOS interchange fees played some part in encouraging the investment in acquirer-side terminals and other facilities that led to the growth and present ubiquity of EFTPOS facilities in Australian retail markets. It is also possible that lowering the interchange fee will reduce the immediate returns on those investments and the incentives to undertake the expenditure needed to maintain or improve the present quality and penetration of the network.

However, the likely response to lower interchange fees is that acquiring institutions will raise merchant service charges to offset the loss of revenue, although competition between institutions and the bundling of acquiring services with other services means the level and structure of the offsetting increases will not necessarily reflect the current impact of the interchange fee. This means that there will still be a flow of revenue to finance investments in acquiring facilities, but that the pattern of returns, and the associated investment, may be changed.

Because the investment effects of lowering interchange fees remain unclear, certain safeguards have been built into the proposed arrangements to address possible adverse outcomes. These include:

- monitoring the proposed arrangements each year to determine whether they are causing unforeseen effects or inequities;

15 In response to questioning at the House of Representatives Standing Committee on Economics, Finance and Public Administration hearing on the Reserve Bank of Australia Annual Report 2001-02 held in Warrnambool on Friday, 6 December 2002, the Governor of the RBA stated that the likely effect of the credit card reforms on retail prices "would be taking off 0.1 per cent, 0.2 per cent or 0.3 per cent" (Proof Committee Hansard, page EFPA 30, downloaded from: http://www.aph.gov.au/hansard/reps/committee/R5987.pdf).

- a review after three years of the impact of the reduction in interchange fees on the EFTPOS system (including the incentives to incur maintenance costs and make new investments); and
- the possibility of an earlier review if there is a material change in circumstances (which would include any significant drop in investment in EFTPOS).

5.4 Effects on network access and competition

There are two ways in which an entrant can participate in the market for EFTPOS services. An entrant can establish itself as an EFTPOS network principal (direct access) or it can enter into a gateway agreement with one of the existing network principals (indirect access). The choice of the form of entry will depend on the entrant's objectives as well as the relative costs of the alternatives.

To the extent that a direct entrant into the EFTPOS market may currently face barriers to entry due to the need to negotiate bilateral agreements with incumbent network principals, the proposed arrangements will reduce those barriers by removing the need to negotiate one significant part of the terms of the necessary bilateral agreements.

5.4.1 Direct access

The process that an entrant network principal must undertake to participate directly in the EFTPOS network can be divided into statutory and commercial steps. Statutory steps do not constitute a barrier to the entry of a suitably qualified organisation.

The statutory steps (from an issuer's perspective) include:

- becoming an Authorised Deposit-taking Institution (ADI); and
- establishing an Exchange Settlement Account (ESA).

A specialist acquirer needs only to establish an ESA.

The commercial steps for direct access include:

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

The market for EFTPOS equipment is international and there are no obstacles to financial institutions or large merchant retailers purchasing all of the facilities needed to physically establish a proprietary EFTPOS network and to issue cards for use on that network. The availability of this equipment does not consequently constitute a barrier to direct access. To the extent that many of the relevant costs of establishing a network, issuing cards and outfitting merchants with equipment are both fixed and sunk, the need to incur them does constitute a deterrent that affords incumbent providers with some protection from competition. However, the nature and extent of this deterrent to entry is a feature of all capital intensive industries, and it is arguably a smaller deterrent here than in many.

As the EFTPOS network is currently structured, a direct entrant must also negotiate bilateral technical and commercial agreements and establish physical interconnections with incumbent network principals. Interconnection with the existing EFTPOS network principals is essential. Although an entrant could establish a new proprietary EFTPOS network, limited to "on us" transactions between its own customers and merchants, it would be unlikely to succeed.

As noted in Section 2.2.1, APCA's regulations and procedures for CECS make provision for participation by merchant principals – merchants whose investment in switching and processing facilities allows them to settle EFTPOS transactions directly with financial institution issuers. Merchant principals can directly access the EFTPOS network by entering into agreements with issuing network principals. Although the agreements that merchant principals have to negotiate with network principals are

different from those between financial institution network principals (i.e. they are "one way"), the barriers to direct merchant access to the EFTPOS network are no different.

Theoretically, an artificial barrier to entry into the EFTPOS market could be created by incumbent network principals raising the cost of negotiations, including by engaging in lengthy negotiations, by proposing unreasonable terms and conditions, by demanding exorbitant contributions towards the costs of interconnection facilities or, ultimately, by refusing to negotiate at all. Note that the ACCC has previously commented[16] that standards or procedures are not inappropriate barriers to entry and recall also the comment (quoted in Section 2.2.3 above) that mandating access would exceed the competition provisions of the TPA. Under the CECS regulations and procedures, CECS members cannot refuse to enter into a new bilateral arrangement based on technical grounds if the new member states that the technology will be in accord with the CECS manual/standards.

If it has been the case that incumbent network principals have been slow to implement new or improved access, this may be attributable to a lack of commercial incentive to expand the already (effectively) ubiquitous network. The negotiation of commercial interconnection agreements and establishment of links would have carried considerable mutual benefits while the original proprietary EFTPOS networks were first being connected. Now, however, the incumbent network principals have less to gain indirectly from interconnecting a new entrant.

Broad reform to improve the ability of potential entrants to join the EFTPOS network is beyond the scope of the current applications for authorisation and would require the development and approval of a third-party access regime within a multi-party network agreement (instead of preservation of the existing bilateral agreements and associated multilaterally set procedures). Although the agreements between the network principals are becoming more reliant on common processes, formally moving to a multilateral scheme structure would still be a quantum change from the existing arrangements, one that could not be agreed and implemented in the timeframe of credit card reforms. The Applicants believe that the concerns expressed by some stakeholders about the need for reform of EFTPOS access are best addressed by requesting that, as part of the application for renewal of the current authorisation of the CECS regulations and procedures (due before 7 September 2003), APCA consider technical and procedural amendments that would improve the processes for and timeliness of establishing interconnections for EFTPOS entrants.

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.

5.4.2 Indirect access

Contrary to the conclusion of the RBA/ACCC *Joint Study*, accessing the debit card network through gateway agreements should not necessarily be seen as a more expensive alternative to direct access. Although it adds to the cost of transactions, the entrant saves many of the associated investment costs of establishing interconnection, switching and processing facilities and does not have to bear the (one-off) costs of negotiating bilateral agreements[17].

The proposed arrangements will be likely to lead network principals and other financial institutions to review and renegotiate their gateway agreements to reflect the reduction in interchange fees.

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16 In the context of the CECS Authorisation (ACCC, 2000, Para 7.91, p. 46 and other parts of that section).

17 The nth entrant has to negotiate (n-1) new bilateral agreements – one with each of the existing network participants. The number, and therefore the cost, of these negotiations clearly increases quickly with growth in direct network participation.

5.4.3 Net effect

The proposed arrangements are likely to reduce one of the barriers that currently exist to direct entry into the debit card system. To the extent that a direct entrant into the EFTPOS market currently faces barriers to entry due to the need to negotiate bilateral agreements with incumbent network principals, the proposed arrangements will reduce those barriers by removing the need to negotiate one significant part of the terms of the necessary agreements. Provision for interchange fees will be by reference to the level of fees set multilaterally under the authorised arrangements and these are likely to flow through to the indirect gateway arrangements.

6. PUBLIC BENEFITS AND POTENTIAL DETRIMENTS

The proposed conduct will be likely to result in a number of benefits to the public, including:

(i) making EFTPOS more attractive to consumers relative to less efficient means of payment, particularly credit cards, thereby inducing a shift towards the use of EFTPOS and reducing the overall cost of the Australian payments system;

(ii) introducing greater flexibility into the setting of EFTPOS interchange fees, reducing the inertia that has made them unresponsive to changes in market circumstances, and providing an explicit mechanism for reviewing interchange fees; and

(iii) making entry as a new issuer or acquirer of EFTPOS transactions easier by simplifying the negotiation of bilateral interchange agreements.

No anti-competitive detriments arise from the proposed conduct. These points are elaborated below.

6.1 PUBLIC BENEFIT OF INCREASED USE OF EFTPOS

Currently, issuers pay an interchange fee to an acquirer in respect of each EFTPOS transaction. Under the proposed conduct, the issuer would not pay any sum by way of an interchange fee to an acquirer, thereby significantly reducing the issuer's costs of each EFTPOS transaction.

As explained above, effective competition between issuers in the retail banking market is likely to lead to those cost reductions being passed on to cardholders.

Acquirers are likely to increase merchant service charges so as to replace the income stream previously provided by interchange fees. Effective competition in retailing is likely to see merchants recover their higher costs through a general (although inconsequential) rise in the price of goods and services, rather than through surcharges for the use of EFTPOS.

The proposed conduct is therefore likely to mean consumers face a lower relative cost of using EFTPOS compared with other means of payment. This is likely to lead to substitution by consumers towards use of debit cards and away from credit cards in their payment for goods or services. As argued by the RBA, this will give rise to public benefits through improvements in the efficiency of the payments system as a whole.

Note that if, instead, merchants responded to increased merchant service charges by imposing surcharges, customers using EFTPOS would find the reduced cost of cardholder services offset by the higher price they were paying for goods and services. However, the ubiquity and attractiveness of EFTPOS to customers and merchants makes this a highly unlikely reaction on the part of merchants. In any event, if a merchant were to impose a surcharge on EFTPOS transactions, the merchant would also be likely to impose a (higher) surcharge on credit card transactions. In those circumstances, the proposed conduct would still be likely to lead to a net increase in the customers' use of EFTPOS.

The outcome would be in line with the conclusions of the RBA/ACCC *Joint Study* that it could "not see a continued need for an interchange fee in the debit card network"[18]. The RBA has also suggested on many occasions that "more efficient pricing arrangements" for debit card transactions would shift the balance of costs towards merchants (in the first instance) and would therefore help to correct the perceived imbalance between the relative costs to consumers of debit cards compared with other means of settlement (including credit cards, cash, cheques and direct debits)[19].

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18 RBA/ACCC (2000) Page 71.

19 See RBA (2001), page 38, op cit.

Some of the costs of the EFTPOS system would effectively be shifted away from EFTPOS users and onto users of other means of payment (as merchants increase average prices). On the basis of the reasoning of the RBA/ACCC *Joint Study*, this gives rise to a public benefit because the current balance of costs borne by EFTPOS users is already distorted.

The proposed conduct would work together with the reforms to credit card interchange fees scheduled to take effect from 31 October 2003[20], which are expected to have the effect of increasing the cost of credit card use to consumers.

Some EFTPOS stakeholders have suggested that there should be a staged transition from current interchange fees to zero rates rather than a single step. The Applicants believe the proposed timing has a number of merits over transition. In particular:

- the public benefits associated with lowering the relative cost to consumers of using EFTPOS would be delayed by a transition to lower interchange fees, so the discounted value of the public benefits of the reforms would be reduced; and
- there are likely to be adjustment costs associated with changing or renegotiating charges and agreements in downstream markets in response to the proposed reforms that, although not necessarily increased in proportion to the number of steps of transition, would be minimised by a single adjustment.

6.2 Public benefit of more flexible interchange fees

One of the problems with the current arrangements whereby interchange fees are set as part of the bilateral agreements between issuers and acquirers is that the difficulty of renegotiating those agreements creates an inertia that discourages any review and change in the interchange fees, despite changes over the years in market circumstances such as costs.

The capacity of financial institutions to finance system-wide expansion or improvements in the EFTPOS network may be constrained by the loss of interchange fee revenues. It may be possible for individual financial institutions to initiate efficient network improvements financed through increased debit card transaction charges and merchant service charges. System-wide initiatives would, however, be difficult to coordinate in the absence of all network principals increasing fees and charges for EFTPOS-related banking services.

Under the proposed arrangements, on the other hand, system-wide change could be negotiated far more easily through an appropriately set non-zero interchange fee than if all existing bilateral agreements had to be renegotiated to fund the improvement. This constitutes a public benefit as a response to the conclusion of the RBA/ACCC *Joint Study* that competitive pressures have not been sufficiently strong to bring interchange fees into line with costs.

A further benefit of the proposed conduct is that the parties to the contract will review the level of the interchange fee after three years. The proposed conduct would also enable them to review the level of interchange fees earlier if there was a material change in circumstances.

The flexibility to review interchange fees at an earlier point in time is considered to be a sensible precaution against unforeseen consequences of the proposed reduction in the current interchange

20 As scheduled in the RBA's announcement of credit card reform measures on 27 August 2002 (RBA Media Release 2002-15). The provisions for implementation and review of the revised credit card interchange fees (RBA, 2002, Section 8, page 39) require that the cost benchmark for each scheme must be calculated by 1 October 2003 and that interchange fees must not exceed the applicable benchmarks as at 31 October 2003. Note that there is a possibility that the reforms will not be implemented, or not implemented on the RBA's specified timing, depending on the outcome of legal challenges to the reforms in the Federal Court by both Visa International and MasterCard International.

fees to zero, and also a safeguard against what could otherwise be an inability to fund large investments in the EFTPOS network, e.g. to accommodate and implement major technological change. For example, the introduction of higher security on transactions or greater functionality of cards might require large capital investments in new equipment by issuers, acquirers and possibly some merchants .

6.3 Public benefit of making entry as a new issuer or acquirer easier

The adoption of multilateral interchange fee setting under the proposed arrangements would ameliorate the extent of natural barriers to direct entry into the EFTPOS market. Bilateral agreements should be easier to negotiate as an element of the negotiations would be removed. This would make direct entry – as a network principal - to the EFTPOS system easier for both potential new issuers and acquirers because no negotiation would be required on the level of the interchange fees.

6.4 Potential anti-competitive detriments

In considering the effects of the proposed contract, it is important to distinguish the impact of the proposed contract – affecting the setting and level of interchange fees – from pre-existing CECS arrangements. Thus it is necessary to examine whether the proposed contract in any way adds a new anti-competitive detriment or increases an anti-competitive detriment associated with the CECS arrangements. Such an anti-competitive detriment would be constituted by a lessening of competition as a result of the contract.

The discussion above has shown that the proposed contract does not have any adverse impact on the natural barriers to entry facing potential issuers or acquirers, or on the CECS arrangements. There is no reason to expect the proposed contract to result in any withdrawal from the market of existing participants (whether issuers, acquirers or merchants), nor any lessening in competition between them.

Further, because the interchange partners that are party to the contract have agreed to use their reasonable endeavours to negotiate zero interchange fees with new entrants, those interchange partners would not be able to insist that a new entrant issuer pay more in interchange fees than those set by the proposed contract. This would eliminate any market power that an existing network principal might otherwise have been able to exercise in respect of this element of negotiations. By the same token, however, a potential new issuer would not have available to it a possibly valuable negotiating tool: viz. the ability to offer to acquirers a higher interchange fee to induce them to enter into a bilateral agreement with the potential new issuer. On the other hand, the new issuer would be able to offer lower prices to cardholders than if it agreed to higher interchange fees and would have the benefit of being on the same interchange fee footing as other issuers.

Similarly, potential new acquirers would, as a result of the proposed contract, not receive the prospective revenue stream from interchange fees that was available to existing acquirers when they entered the market. Potential new entrant acquirers would, however, be on the same footing as existing acquirers in negotiating fees with merchants.

Thus potential new entrants with efficient costs would suffer no detriment as a result of the conduct. They would necessarily be exposed to the realities of economies of scale and competitors whose costs were already sunk, but those factors have no effect on the setting of interchange fees.

Consequently, while the first-round effect of the proposed conduct – the removal of a revenue flow from issuers to acquirers – would appear to disincent potential new acquirers and attract new issuers, once likely flow-on impacts on merchant service charges and cardholder fees are taken into account, as discussed earlier, the main impact is seen to be on the process of negotiation of bilateral and/or gateway agreements. If anything, that process appears to be facilitated by removing one issue from the negotiation and placing the new entrant on the same interchange fee footing as existing issuers and acquirers.

7. CONCLUSION

The proposed contract will give rise to significant public benefits. These public benefits are effectively those identified by the RBA/ACCC *Joint Study*, and subsequently in statements by the RBA, as following from the setting of interchange fees at zero.

The major public benefit will be a lowering in the overall cost of the payments system in Australia by inducing a shift towards the use of EFTPOS, identified by the RBA as a lower cost means of payment.

Another significant public benefit will arise from reducing the inertia in the responsiveness of interchange fees to changed circumstances.

The proposed contract will not give rise to any anti-competitive detriment. Such a detriment would have occurred if the contract involved the fixing of a price that would otherwise be set competitively. However, as the RBA/ACCC *Joint Study* noted, EFTPOS interchange fees negotiated bilaterally are not currently responsive to competitive forces. Indeed, as this application has explained in terms of the two-sided nature of the market, EFTPOS interchange fees could not be expected to reflect marginal costs.

Rather, the multilateral setting of interchange fees will facilitate more competitive outcomes.

It follows that there will be a net public benefit resulting from the making and giving effect to the proposed contract.

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ANNEXURE 1 – LIST OF APPLICANTS

The Applicants that are parties to the proposed contract are:

Australia and New Zealand Banking Group Limited

Australian Settlements Limited

Bank of Queensland Limited

Bank of Western Australia Limited

Bendigo Bank Limited

Cashcard Australia Limited

Commonwealth Bank of Australia

Credit Union Services Corporation (Australia) Limited

National Australia Bank Limited

St George Bank Limited

Suncorp-Metway Limited

Westpac Banking Corporation