

'cancels' itself out. The ARA submit that of the total \$150 million, \$45 million is paid by small institutions who earn \$22.5 million from their acquiring operations, leaving them collectively \$22.5 million better off under the proposal.

- 5.55 The ARA submits that no evidence has been provided to support the proposition that the proposed arrangement will result in an increased usage of EFTPOS. In particular the ARA notes that recent statistical information published by the RBA demonstrates that debit card usage, on a per capita basis, in a negative interchange fee environment (New Zealand) is almost double that of usage in a zero interchange environment (Canada) and is almost three times the usage of a positive interchange fee environment (the United States). The ARA also notes that recent data released by the RBA shows that debit card transactions in Australia are increasing at a faster rate than credit card transactions (29% and 26% respectively, 2002:2001). The ARA considers that the relative increase in debit card usage to credit card usage will maintain its growth as the RBA credit reforms continue to be implemented with consequent increases in charges by card issuers. The ARA submits that the incorrect pricing signals promoting the move toward credit cards have now been corrected and efficiency is being restored to the payment system without the need for EFTPOS interchange fee reform.
- 5.56 The ARA also submits that recent data published by the RBA in relation to market concentration suggests that current interchange fee arrangements have not acted as an impediment to smaller institutions gaining an increased share of card issuing. The ARA considers that the current concentration levels evidenced in merchant acquiring are an issue of access and not interchange fees. In particular the ARA considers that the removal of current barriers to entry will enable new entrants as well as existing smaller financial institutions to compete on a more equal basis with large incumbent acquirers. The ARA submits that irrespective of the magnitude of the interchange fee small acquirers using gateways will always be at a cost disadvantage relative to the major acquirers and will be unable to exert real competitive pressure on the majors.
- 5.57 The ARA considers that on-going incentives for investment in acquiring infrastructure are essential to the long-term health of the EFTPOS system and to ensure that the system continues to provide significant public benefits. The ARA submits that the current interchange fee arrangements have been crucial to the high levels of investment which have resulted in the world class EFTPOS system that Australia now has. The ARA submits that infrastructure costs are not one-off and that sustainability over the long term is a key objective in any review of the EFTPOS system.
- 5.58 The ARA also submits that the rationale for the zero interchange fee proposal is inconsistent with the principles established by the Joint Study and considered by the RBA as part of its designation of the credit card schemes. In particular the ARA submits that the zero interchange fee proposal is arbitrary and that neither the Applicants nor the RBA have attempted to provide any cost based justification for the rate to be set at zero. The ARA further submits that the Joint Study itself was a preliminary examination of interchange fees and access

arrangements and that its findings were not proposed as 'final' – further work was required. The ARA submits that Joint study does not demonstrate that there would be a public benefit in removing EFTPOS interchange fees.

- 5.59 Brennans' Mitre 10 Home & Trade, Noni B, Ed Harry Menswear, Suzanne Grae, Collins Booksellers, Bracey's (Lithgow), Fashion Fair, Kibblers, Best & Less, Associated Retailers, Spend-less Shoes and Spark's Shoes provided submissions supporting the submission by the ARA. These parties noted that, while some change to the current EFTPOS fee structure is required, they do not support a wholesale change to zero EFTPOS interchange fees. These parties note that under the proposed Agreement all retailers will be required to pay higher bank fees for EFTPOS transactions and that these higher costs will in turn be passed on to consumers through higher prices for goods and services.
- 5.60 Coles Myer submitted that it strongly agrees with the draft determination and that in its view the interchange fee proposal by itself does not represent EFTPOS reform, and in particular noted that the RBA recent credit card reforms considered interchange fees, price transparency and access. Coles Myer considers that the Applicants in developing the interchange fee proposal did not give due consideration to the impact of a zero interchange fee on all stakeholders. Coles Myer further submits that the proposal to reduce EFTPOS interchange fees to zero only shifts costs from banks to merchants and that merchants will be required to pass this cost increase on to all consumers, irrespective of the payment method adopted.
- 5.61 Coles Myer considers that it is doubtful that sufficient competition exists in card issuing to ensure that the reduced costs of card issuers are passed on to consumers and note that the Applicants have failed to provide any certainty that pass through will occur. Coles Myer notes that fees charged by card issuers to cardholders are in many cases significantly higher than interchange fees, suggesting that factors other than interchange fees are considered in determining fees payable by cardholders, and that in real terms interchange fees have fallen yet the fees charged to cardholders have significantly increased. Coles Myer submits that it will be difficult to evidence pass through by card issuers due to the bundling of services and fees and the cross subsidisation of retail banking products. Coles Myer does not consider that the proposed Agreement would substantially level the playing field between smaller card issuing institutions and larger card issuing institutions. Coles Myer notes that this proposition ignores the fact that interchange fees are only one aspect of the costs incurred in providing debit card services and that it is unlikely that the relative cost base of smaller institutions compared with larger institutions will change.
- 5.62 Coles Myer submits that no evidence has been presented by the Applicants to support the contention that merchant acquiring is competitive and does not agree with the Applicants' submission that merchant service fee increases will be limited. Coles Myer submits that the Applicants have given no consideration as to the impact of increased merchant service fees on consumer retail prices and that these increases will negate any reductions in cardholder fees.

- 5.63 Coles Myer questions the relevance of netting the benefits that may flow to merchants as a result of the RBA's credit card reforms against the detriments that will flow to merchants as a result of the proposed Agreement. In this regard Coles Myer notes that the credit card reforms are the result of a detailed process which found that credit card pricing arrangements were less than competitive and were contrary to the public interest.
- 5.64 Coles Myer also notes that the assumption that retailers will be a net beneficiary of credit card and EFTPOS reform fails to take account of consumer spending habits. Coles Myer submits that, contrary to submissions made by some parties, the savings likely to result from credit card reform for retailers will not exceed the likely cost increase should the proposed Agreement be authorised. Coles Myer submits that retailers will receive a net additional cost of \$60 million should the EFTPOS reforms be implemented. Coles Myer further considers that a shift in consumer spending to mitigate this loss would be unprecedented and is acknowledged by industry representatives as being unrealistic. In any event Coles Myer considers that the recent trend in consumer spending away from debit cards was as a result of credit card pricing practices and was not as a result of debit card interchange arrangements. Coles Myer expects that once credit card pricing distortions are removed that there will be a shift away from credit cards to other tender types including debit cards.
- 5.65 It is Coles Myer's view that EFTPOS access reform is relevant in considering the proposed interchange fee arrangements and in particular whether these arrangements are likely to result in a net benefit to the public. Coles Myer considers that the move to zero interchange fees would make access to the EFTPOS network more difficult as it would take away a financial incentive between new entrants and incumbents. In this regard Coles Myer notes that it considers that much of its success in entering into interchange fee arrangements has relied on such incentives.
- 5.66 Coles Myer considers that access to the EFTPOS network is essential to encourage further competition in the industry and notes that competition was considered to be a key element in the RBA's credit card reforms but was not considered by the Applicants in relation to EFTPOS reform. In particular Coles Myer considers that additional entrants should lead to increased competition, which should in turn lead to lower transaction costs and lower costs for merchants and other users. Coles Myer considers that the APCA is not the most appropriate body to consider EFTPOS access reform and that the composition of the APCA representatives may mean that the views of non-members will not be given due consideration. Coles Myer considers that an industry wide body consisting of card issuers, merchant acquirers, merchant principal, merchants and other stakeholders would be best placed to discuss access reform.
- 5.67 Coles Myer further submits that the investment of network owners (including merchant acquirers and merchant principals) has been primarily responsible for creating and maintaining what has been acknowledged as a world class payments system. Coles Myer notes that significant upgrades to the network are required to maintain the security and integrity of the network. It is Coles Myer's view that the existing fee structure has provided the incentives for

network owners to provide this investment, however it considers that the Applicants have failed to provide an assessment of how the proposed Agreement will impact upon these necessary investments. In particular Coles Myer considers that the proposed Agreement if implemented will lead to a lowering of the standard of the current network in terms of availability, security and future enhancements.

- 5.68 Caltex agrees with the draft decision proposing to deny authorisation to the interchange fee Agreement. However Caltex does not consider that a commitment to suitable access reform would address the uncertainties associated with the proposal, nor does it consider that the APCA review provides a suitable forum in which access reform may be addressed as it is representative of financial institutions only. Caltex submits that access reform should be considered by a fully consultative process in which all stakeholders, including merchants, are involved.
- 5.69 Caltex further submits that if there were open access to the EFTPOS system, there would be no need for the collective setting of EFTPOS interchange fees as these fees would be determined by the market which would develop in an open access regime. Caltex notes that whilst it agrees that access is a key issue, it does not consider that access reform would address any uncertainty associated with the proposed Agreement; rather it would render the proposed Agreement completely unnecessary.
- 5.70 In relation to network investment Caltex disputes the proposition that, in the absence of an interchange fee, other beneficiaries of an upgrade to the network would have an incentive to contribute to the costs. Caltex submits that examples in both Australia and overseas demonstrate that 'other beneficiaries' have not contributed to upgrade costs even in circumstances where there has been a strong case for them to do so. In this respect Caltex notes that the introduction of triple DES encryption, as mandated by the APCA, provides direct benefits to card issuers yet Caltex has received no contribution to the substantial costs it will incur in carrying out this upgrade. Caltex further notes that it was not consulted by the APCA in relation to its decision to introduce the triple DES requirements.
- 5.71 McDonalds Australia submits that it supports the draft decision proposing to deny authorisation to the interchange fee Agreement. McDonalds notes that under the proposed Agreement its franchisees would be required to pay higher bank fees for EFTPOS transactions and that these higher fees would ultimately be passed on to its customers. McDonalds considers that the only beneficiaries under the proposal are the Applicants themselves as it would see a cost transfer from the Applicants to retailers.

- 5.72 Woolworths<sup>16</sup> submits that, while it firmly considers that current access arrangements should be amended to remove barriers to entry, access reform should not be linked to reform of interchange fee arrangements. In particular Woolworths considers that any benefits that result from the liberalisation of access will largely occur irrespective of the level of interchange fees and are quite separate from changes to these fees. Woolworths considers that an open access regime, while desirable, will not change the price fixing elements or the lack of a public benefit from a move to zero interchange fees. Woolworths also considers that the APCA is not the appropriate body to conduct the review of the current access arrangements as it has a clear conflict of interest.

#### *Industry regulators*

- 5.73 The RBA submits that a move to zero interchange fees for the EFTPOS network provides the potential for benefits to debit cardholders and to society as a whole through a more efficient set of price signals to the Australian payments system. The RBA also considers that the public benefit will be best served by improving access to the EFTPOS system as this would promote competition in debit card issuing and acquiring and thus the pass through of the benefits of zero interchange fees to society.
- 5.74 The RBA considers that merchant acquiring is less competitive than card issuing and that because of this EFTPOS access reform is important. The RBA also notes that EFTPOS access arrangements have significant practical implications for the credit card access arrangements as it is necessary for new entrants seeking to provide acquiring services to merchants to obtain access to both the EFTPOS and credit card networks. The RBA strongly supports efforts by the APCA to establish an access regime to facilitate effective access to the EFTPOS network by new card issuers and merchant acquirers. The RBA advises that it is watching the APCA's progress closely and, if it were to falter, the RBA would seriously consider designating the EFTPOS system with a view to imposing an access regime under the PSRA.
- 5.75 The RBA has also noted that the purpose of interchange fees is to transfer costs and benefits and that, ultimately, it is consumers who meet these costs. It is the RBA's view that under the current EFTPOS arrangements consumers are paying too much for the use of the debit card system and that this has led to the trend away from using debit cards to credit cards, which have themselves not been priced efficiently. The RBA considers that the proposed reduction of interchange fees would lead to more appropriate pricing signals for debit cards relative to credit cards. The RBA further considers that interchange fees are not the sole determinant of investment decisions and pointed to the example of the Canadian Interact model where there are no interchange fees.

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<sup>16</sup> The submission by Woolworths was made in relation to the application for revocation and substitution lodged by the APCA in relation to the CECS arrangements (A30228 and A30229) however it raises issues directly related to these applications.

## *Government Ministers*

*Treasurer – the Australian Capital Territory - The Hon. Ted Quinlan MLA*

*Treasurer – Tasmania – The Hon. Dr David Crean*

*Minister for Consumer Affairs – South Australia – The Hon. Michael Atkinson MP*

*Minister for Fair Trading – Queensland – The Hon. Merri Rose*

- 5.76 Submissions provided by Treasurers Quinlan and Crean and Ministers Atkinson and Rose provided broad support for the Commission's draft decision. In particular Minister Rose noted that she was particularly concerned about any arrangement that may lead to cost increases for consumers and considered that, in principle, increased competition should lead to cost reductions being passed on to consumers.

## *Others*

### *Australian Payments Clearing Association (APCA)*

- 5.77 The APCA advised that it has given priority to developing practicable and equitable access rules and that a working group had been established to consider the EFTPOS access issue and to develop the parameters in which access reform may be achieved. The working group comprises the members of the CECS, as well as the RBA, Shell, the Australian Institute of Petroleum, the ARA and Woolworths. The APCA noted that it has not sought to include a broader range of parties in its considerations of access reform as it was concerned that by doing so the working group could become too big and ultimately unworkable.
- 5.78 The APCA advise that the working group is trying to build a set of principles from which access rules could be devised and that the principles the working group is trying to develop are more detailed than those proposed by the RBA. The APCA notes that it is difficult to predict what the outcome of this process may be, but that it considers the outcome would be likely to cover connection rights, cost allocation, timing and technical standards. The APCA notes however that developing rules which govern access to the EFTPOS network is complex as each organisation has a different view, it nevertheless considers that it will be able to come up with a model for EFTPOS access.
- 5.79 The APCA notes that it has no jurisdiction to consider alternative EFTPOS system structures and that further it is concerned that looking at changes to the current physical architecture of the EFTPOS network would take time and may result in nothing being achieved. The APCA notes that the EFTPOS network is underpinned by a complicated physical architecture and that the brief by the APCA Board to the EFTPOS access working group is to consider how access rules could be worked into the existing structure of the EFTPOS network. The APCA considers that it would be inappropriate for it to determine the technical solutions to be applied by industry participants in interconnecting to the network.
- 5.80 The APCA submits that it is likely that parameters for developing access rules will be developed by early 2004 and that it will use its best endeavours to

complete this process within 12 months. The APCA notes however that given the complexity of the issues to be considered and the different views of stakeholders this timeframe may not be achieved.

- 5.81 In relation to comments made about CECS membership, the APCA notes that as the four major banks contribute around 80% of transaction values their views are extremely important in the APCA processes. The APCA advise that checks and balances exist within its structure to ensure that a major bank alone could not block a proposal made to the APCA Board.

*Australian Bankers' Association (ABA)*

- 5.82 The ABA submits that debit card issuing is competitive and that it considers that the proposed conduct will increase the use of debit cards in relation to more expensive payment instruments.

*MoneySwitch Limited (MoneySwitch)*

- 5.83 MoneySwitch submits that the level of interchange fee is relevant to access negotiations as setting a fee allowances can be made to contribute to the cost of interconnection. It is MoneySwitch's view that the ongoing contribution provided by the current interchange fee arrangements allow for more costly interconnections to be undertaken.
- 5.84 MoneySwitch submits that open access is essential in order to reduce the current high levels of EFTPOS merchant service fees but that it considers that the membership of the APCA has competing self interests that create an incentive for the APCA's members to delay the necessary access reforms. It is MoneySwitch's view that access reform should not be considered by the APCA but would be more appropriately considered under the auspices of the RBA, the Commission and the Commonwealth Treasury. MoneySwitch further submits that access reform should consider issues of changes to the physical infrastructure and in particular is concerned that the APCA has ruled out such considerations given the proprietary interest of its members. MoneySwitch also notes that there are no potential new access seekers represented on the APCA access working group.

*Transaction Resources*

- 5.85 Transaction Resources submits that it supports the draft decision proposing to deny authorisation and in particular that it does not consider there are any public benefits likely to flow from the proposed arrangement. In particular, Transaction Resources submitted that:
- whilst price signals are currently limited, they are correct. Transaction Resources submits that the proposed conduct would result in the loss of cardholder price signals;
  - the proposed arrangement, by removing a revenue stream currently open to new entrants, will diminish the potential for new entry and therefore the potential for competition to be increased;

- interchange fee and access arrangements are separate issues. Transaction Resources considers that the significant reductions in Canadian merchant service fees (from \$0.15 to \$0.05 for large merchants) have resulted from the liberalisation of access and resulting increased competition;
- access should not be reviewed by the APCA as its members have a conflict of interest in deciding how and when to open access. Furthermore, Transaction Resources considers that the decision by the APCA Board to exclude consideration of the physical infrastructure of the EFTPOS network has excluded consideration of the predominant barrier to entry;
- the costs of the EFTPOS infrastructure are not 'one-off' and the proposed Agreement is likely to lead to a reduction in investment in the existing infrastructure, leading to an overall deterioration; and
- the proposed arrangement will not increase the efficiency of the EFTPOS network as it is a cost transfer only. Transaction Resources considers that the liberalisation of access will promote greater efficiency by driving down merchant acquirer costs.

*Peter Mair*

- 5.86 Mr Mair submits that it is important that the business of acquiring and switching card transactions be opened up to players that are not conventional banks as increased competition will result in cheaper services to merchants.



## Commission evaluation

- 6.1 The Applicants have sought authorisation for an agreement to reduce EFTPOS interchange fees to zero. Arrangements that have the purpose or likely effect of fixing, controlling or maintaining the price for goods or services are deemed by the Act to substantially lessen competition
- 6.2 The Applicants have also sought authorisation of a contract, arrangement or understanding that contains an exclusionary provision. Essentially an exclusionary provision, sometimes referred to as a primary boycott, involves an agreement between competitors which has the *purpose* of preventing, restricting or limiting the supply of goods or services to, or the acquisition of goods or services from, particular persons or classes of persons. Such agreements are a *per se* contravention of section 45 of the Act, that is, no assessment as to the effect on competition is required in respect of this type of conduct. In order to obtain the broad adoption of zero interchange fees, the Applicants will use their reasonable endeavours to amend bilateral EFTPOS contracts with non-Applicant parties to include a zero interchange fee. The Applicants have advised that the requirement that they use reasonable endeavours to amend existing contracts that are inconsistent with the zero interchange fee may be viewed as an exclusionary provision and have accordingly sought immunity for this conduct.
- 6.3 The extent of the detriment and public benefit that results from the price fixing and boycott provisions within the proposed Agreement is linked to the relevant market structure, including the level of current and proposed competition among both card issuers and merchant acquirers.
- 6.4 The Applicants, as card issuers, compete with each other (and other card issuers who are not Applicants) in the provision of retail transaction/savings accounts and the associated card facility that enables cardholders to make purchases and withdraw cash via the EFTPOS network. The level of competition between card issuers is considered further at paragraphs 6.53 to 6.50 of this determination.
- 6.5 As merchant acquirers the Applicants compete with each other to provide financial services to merchants including the commercial relationship that supports merchants' participation in the EFTPOS network. The level of competition between merchant acquirers is considered further at paragraphs 6.51 to 6.73 of this determination.

### Scope of the Commission's considerations

- 6.6 As a preliminary matter the Commission notes that a number of submissions, particularly by Coles Myer, the ARA, and the AIP raise concerns about the EIWG process. In particular, they express concerns that this process did not provide a genuine opportunity for participants in the EFTPOS network other than the financial institutions to have their interests included in the debate. Further, concerns were expressed that all the possible options for reform were

not properly debated and considered by the EIWG. For example, Coles Myer has submitted that the failure to consider alternative options is significant in that when assessing the net public benefit of a proposed arrangement the test is one of benefit to the community generally not just those who have brought the application before the Commission.

- 6.7 Interested parties have also submitted that the APCA is not the most appropriate body to consider EFTPOS access reform. In particular it has been submitted that the composition of the members of the APCA may mean that the views of non-members, in particular potential new entrants, will not be given due consideration. Interested parties submit that access reform should be considered by a more representative body, for example one consisting of card issuers, merchant acquirers, merchant principles, merchants and other stakeholders, and that such consideration should be conducted under the auspices of an independent regulator such as the RBA or the Commission.
- 6.8 The role of the Commission is to apply the statutory test in section 90 of the Act to determine whether or not authorisation should be granted (or granted subject to conditions) to the application before it (see paragraphs 1.9 to 1.11) rather than the process by which it was (or is being) developed.
- 6.9 It is also relevant to note the observation of the Australian Competition Tribunal in *Re: 7- Eleven Stores Pty Ltd, Independent Newsagents Association, Australasian Association of Convenience Stores Inc*, in respect of the Commission's role in authorisation matters:
- "... the Commission's role is not to design for others business arrangements that can be authorised, nor insist on optimum arrangements before granting authorisation, but rather to assess formally whether some proposed conduct that might breach the provisions of the Act yields a net public benefit, and therefore can be authorised."*<sup>17</sup>
- 6.10 Following the draft determination the Applicants submitted that the Commission had failed to adhere to this role and that the Commission had proposed to deny authorisation in order to achieve optimum reform. In particular the Applicants consider that barriers to entry were not relevant to the Commission's considerations. The Commission rejects this suggestion. In the draft determination the Commission considered that, in light of the level of actual and potential competition in card issuing and merchant acquiring, it could not conclude with certainty that the public benefits resulting from the proposed Agreement would outweigh the anti-competitive effects. The Commission therefore proposed to deny authorisation to the interchange fee arrangements. The Commission however considered that suitable access reform may lessen the anti-competitive effect of the proposed Agreement and may increase the likely public benefits, such that authorisation could be granted to the arrangements. In proposing to deny authorisation to an arrangement the Commission may, if it

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<sup>17</sup> *Re: 7- Eleven Stores Pty Ltd, Independent Newsagents Association, Australasian Association of Convenience Stores Inc* (1998) ATPR 41-666, at page 41.481.

considers it appropriate, indicate to the applicant and any interested party, amendments to the proposed conduct that may influence the balance of benefits and detriments such that authorisation may be granted. In relation to the interchange fee proposal the Commission considered that the current and likely market conditions had influenced its assessment of the conduct but that this assessment would be likely to change if those conditions were to change.

#### **Future with-and-without test**

- 6.11 In order to identify and measure the public benefit and public detriment generated by the proposed conduct, the Commission applies the “future with-and-without test”. This requires a comparison of the public benefit and public detriment that the proposed conduct would generate in the future if the authorisation is granted with the position if the authorisation is not granted. The prediction of how the relevant markets will react if authorisation is not granted is referred to as the ‘counterfactual’.
- 6.12 In the context of these applications for authorisation, the Commission considers that the most likely counterfactual in the foreseeable short to medium term is the market without the proposed multilateral agreement that provides for a zero interchange fee – that is the status quo. This is particularly as the Applicants have indicated that a number of features of the Agreement include exclusionary provisions and price fixing between competitors. Accordingly, in the absence of authorisation, the Applicants would be at risk of breaching the Act and would therefore be unlikely to engage in the proposed conduct.
- 6.13 An outline of the current environment in which EFTPOS transactions take place (status quo) is provided in section 2 of this draft determination. Briefly, this environment is characterised by:
- a network of bilateral interchange agreements between issuers and acquirers covering both technical and commercial arrangements;
  - common standards relating to the processing and settlement of EFTPOS transactions are administered by the APCA through the rules of the CECS. Observance of these rules or membership of APCA does not however automatically enable participation in the EFTPOS network (bilateral arrangements remain necessary); and
  - interchange fee arrangements that generate revenue above costs for acquiring institutions.
- 6.14 The Commission notes that barriers to entry to the EFTPOS market, in particular for merchant acquirers, have historically been high. However, following the draft determination the APCA has advised that it is currently developing practicable and equitable access rules as a priority. Further details outlining the APCA’s review process have subsequently been provided to the Commission on a confidential basis. The RBA has also advised that it strongly supports efforts by the APCA to establish a regime that will facilitate access to the EFTPOS network. However, should APCA’s efforts falter, the RBA has advised that it would seriously consider, in the interests of promoting efficiency

and competition in the Australian payments system, designating the EFTPOS system under Section 11 of the PRSA with a view to imposing an assess regime.

- 6.15 Accordingly the Commission considers that voluntary action to reform access by the APCA, or in the event that this falters regulatory action by the RBA, will continue regardless of the Commission's decision in relation to these applications. Obviously this will change the EFTPOS environment that is likely to exist in the future.
- 6.16 The Commission also notes that following the Joint Study a number of EFTPOS reform proposals have been debated. Accordingly the Commission considers that it is unlikely that the current environment for EFTPOS would continue in the same form in the longer term, if authorisation were to be denied.

### **The relevant market**

- 6.17 Consistent with the statutory test (see paragraphs 1.9 to 1.11), the Commission must assess the public benefits and detriments and competitive effects of the arrangement for which authorisation is sought. This assessment is conducted in the context of the relevant market(s) and as such a first step for the Commission is to identify the boundaries of the relevant market(s), to the extent necessary to enable the Commission to undertake the required analysis.
- 6.18 The Applicants have submitted that the relevant markets for the purpose of assessing the proposed Agreement are the market for retail banking and the market for the retail supply of goods and services. It is the Applicants' view that there is no useful market definition that would bring these markets under one umbrella and that there is no useful reason to seek one. Following the Commission's draft determination the Applicants indicated that they considered appropriate the Commission's approach to assessing the applications by looking at the direct effects of the conduct and the flow on effects of this conduct in areas of relevant competition.
- 6.19 The Commission notes that some interested parties have submitted alternative definitions of the relevant markets affected by the proposed conduct.
- 6.20 Caltex Australia Limited (Caltex) has submitted that there are at least four markets affected by the proposed arrangements, being;
- a) the card issuer / merchant acquirer market;
  - b) the merchant principal network / merchant acquirer market;
  - c) the merchant / merchant acquirer market; and
  - d) the card issuer / cardholder market.
- 6.21 Caltex submits that the proposed Agreement is likely to have an anticompetitive effect in the card issuer / merchant acquirer market and the merchant principal network / merchant acquirer market.

- 6.22 Woolworths submits that the proposed agreement will limit competition in two markets, being the market between issuers and acquirers and the market between acquirers and merchants.
- 6.23 The report prepared by ACIL Tasman Pty Limited (ACIL Tasman) and provided as part of the submission by Coles Myer has criticised the Applicants' market definition (and the Joint Study) as having failed to explicitly take account of payment instruments other than credit cards with which debit card products compete, in particular cash and cheques. It is ACIL Tasman's view that the Applicants' proposal has failed to consider the likely effect of the conduct on the Australian payments system as a whole, in particular whether the proposal would encourage increased use of cheques resulting in a decrease in the overall efficiency of the payments system.
- 6.24 The Commission accepts that each of the various payments instruments (for example debit cards, credit cards, cash and cheques) are substitutes to varying degrees in both demand and supply for consumers and merchants. However, the Commission considers that it is difficult without considerably more detailed information to determine whether the various payments instruments are sufficiently close substitutes to be considered in the same market. For instance, when determining the extent of substitutability it is also important to recognise that price is not always the main determinant. Both debit and credit cards are supplied with a range of additional features, such as loyalty programs, which offer benefits to users over and above the direct benefit associated with an ability to access the payments system. These additional benefits would need to be taken into account when considering substitutability. The value of benefits may also change over time, or in particular instances. For example, a loyalty program attached to credit card usage may be less valuable when high fees or interest is payable compared with when they are not.
- 6.25 Furthermore, financial products are often supplied by institutions as part of a bundle of financial services provided to customers. This bundle may include, among other things, debit cards, loans and credit cards. In theory, customers pay a fee to their financial institution (issuer) for the use of the debit card, for example. However, in practice a customer who acquires a debit card as part of a package of financial services may be exempted from paying all, or part, of the debit card fee. A notional rise in a supplier's debit card fees will not necessarily induce customers to switch to suppliers of close substitutes because: (a) they may not actually pay the fee; or (b) the fee is just one component of the entire cost of the financial package that is supplied. This means that even if a cardholder does observe an increase in fees, it will not necessarily be apparent that this is the result of a rise in debit card fees.
- 6.26 The Commission further notes that, the provision of merchant acquiring services is generally integrated with card issuing services. Although, the reverse is not necessarily the case as many small card issuers are not merchant acquirers.

- 6.27 All these characteristics mean that it is difficult to apply a SSNIP<sup>18</sup> test to accurately delineate the relevant market/s. However, in this instance the Commission does not consider it necessary to identify the overall scope of the relevant market/s. That being said, there are areas of close competition and in particular the Commission considers it likely that there are sub-markets for card issuing and merchant acquiring and the Commission has primarily examined the impact of the proposed Agreement on these sub-markets. Indeed it is in these sub-markets where the direct effects of the conduct occur.
- 6.28 The proposed arrangement is an agreement made between card issuing institutions and merchant acquiring institutions that the interchange fee in respect of EFTPOS transactions be fixed at zero. This agreement has flow on implications for card issuers in their dealings with their cardholders. This in turn can impact on consumer usage of payments instruments. The agreement also has flow on implications for merchant acquirers in their relationship with their merchant/retailer clients which in turn has flow on consequences for retailers in the pricing of goods and services to consumers.
- 6.29 The Commission is also of the view that it is appropriate to consider the applications for authorisation within the broader context of the credit card reform process that is currently underway, particularly given the integrated nature of the credit card and debit card payment systems and the proposals for their reform. The Commission notes in this respect that the test set out under sections 90 (6) and 90 (8) of the Act requires that the Commission be satisfied that 'in all the circumstances' the conduct for which authorisation has been sought would result in a net public benefit before making a determination granting authorisation.

### **Effect on competition**

- 6.30 Under the proposed Agreement card issuers and merchant acquirers will no longer negotiate an EFTPOS interchange fee as part of their bilateral agreements (although a range of both technical and commercial aspects will still need to be negotiated and agreed between the parties). In particular the proposed Agreement provides that interchange fees will automatically be set at zero where both parties are applicants to this authorisation and that the applicants will use their reasonable endeavours to amend their remaining bilateral agreements to include a zero interchange fee where one or more of the parties to the agreement are not applicants. The Commission also notes that while the proposed Agreement does not make specific provision for non-existing (or new) contracts, it is understood from the Applicants' submission that it is intended that the zero interchange fee will apply to bilateral arrangements entered into between incumbents and potential new entrants.

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<sup>18</sup> The process of market definition can be viewed as establishing the smallest area of product, functional and geographic space within which a hypothetical current and future profit maximising monopolist would impose a Small but Significant Non-transitory Increase in Price (SSNIP).

- 6.31 The proposed Agreement also provides for a review of the level of the interchange fee by the Applicants and, where there is agreement by 75 percent of the parties in number, to change the interchange fee. As the proposed Agreement does not provide any methodology for determining a non-zero interchange fee the Commission is unable to consider the competitive effects of any change in the level of the interchange fee pursuant to clause 3 of the proposed Agreement. However the Commission notes the statement by the Applicants that "No authorisation is sought to grant the Applicants *carte blanche* to set interchange fee rates".<sup>19</sup> The Applicants acknowledge that if they wanted to introduce a non-zero interchange fee they would need to seek fresh authorisation at that time and provide methodology to support any move away from zero. Accordingly the Commission has not assessed the ability for the Applicants to change, upon agreement, the level of the interchange fee from zero as part of the current applications for authorisation.
- 6.32 On one level an agreement between competitors to substitute a series of commercially negotiated bilateral interchange fees with a single multilateral interchange fee could result in a less competitive outcome. For example, Caltex submitted that a move from a large number of bilateral agreements to a single multilateral pricing arrangement will remove any possibility of price variation (as currently exists) and would therefore result in a less competitive outcome than existing interchange fee arrangements.<sup>20</sup>
- 6.33 The Commission notes however, that interchange fees under the current bilateral arrangements are largely uniform and are not readily re-negotiated. The Joint Study found that interchange fees for debit card transactions had hardly changed since they were introduced in the early 1990s and that newer interchange fee agreements appeared to have been based on earlier agreements, without regard for changes in costs that may have warranted a revision to interchange fees.<sup>21</sup> In this respect the Commission notes that confidential submissions provided to it indicate that average interchange fees have remained broadly consistent with the fee levels considered by the Joint Study.
- 6.34 Indeed the Applicants claim that one of the problems of the current bilateral interchange fee arrangements is that the difficulty in renegotiating these agreements creates an inertia that discourages review and change in the interchange fees. It is the Applicants' view that the proposed Agreement will improve this situation by providing for system-wide interchange fee negotiation and by providing for a review of the zero interchange fee after three years (or earlier as described by paragraphs 3.9 to 3.11).

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<sup>19</sup> Applicants' submission, April 2003, at page 9.

<sup>20</sup> Caltex Australia Limited, submission dated 28 March 2003, at page 9.

<sup>21</sup> *Debit and Credit Card Schemes in Australia – a study of interchange fees and access*, Reserve Bank of Australia and the Australian Competition and consumer Commission, October 2000, at page 62.

### *Card issuing*

- 6.35 As a result of the proposed Agreement card issuers agree that they will no longer pay an interchange fee to merchant acquirers in respect of EFTPOS transactions conducted by their cardholders. While a number of institutions are both merchant acquirers and card issuers, for those institutions that are net card issuers the proposed Agreement will create a direct cost saving. For those institutions that are both merchant acquirers and card issuers, it is possible that they may elect to 'balance' the saving to their debit card issuing portfolio against the cost increase to their merchant acquiring portfolio. The Commission notes that the Applicants submit that competition between card issuers is likely to result in the cost savings being passed on to cardholders, while several interested parties submit that there is a lack of competitive pressure between card issuers to ensure the pass through of the benefits to cardholders. The Commission considers that the competitive response of net card issuers will influence the approach to these cost savings by those institutions providing both card issuing and merchant acquiring services.
- 6.36 The Applicants have submitted that the market for card issuing is highly competitive and the four major commercial banks compete vigorously in debit card issuing and face numerous small competitors. The Applicants claim that the products offered by these institutions are not uniform and demonstrate broad differentiation which is indicative of healthy competition. Further, the Applicants claim that the presence of smaller financial institutions ensures continued pricing innovation and operates as a significant competitive constraint on the four major banks.
- 6.37 The Applicants have submitted that the proposed Agreement will not lessen competition in card issuing, that is, make competition worse than under the status quo. Further, in the Applicants' view, it is not enough to simply assert that card issuing is uncompetitive, as a number of interested parties have done. The Applicants also consider that the Commission, in its draft determination, understated the level of competition in card issuing and accordingly has misconstrued the effects of the proposal. In the Applicants' view it should be assumed that, in the absence of extreme concentration, or conditions for tacit collusion, effective competition is the norm.
- 6.38 Data from the RBA<sup>22</sup> indicates that, for the provision of payment services to consumers (card issuing), the four major banks account for about 70 per cent of debit card transactions,. The RBA data shows that there has been some market share loss by the four majors in favour of non-banks where customers of building societies and credit unions now account for 14 per cent of debit card transactions. The RBA however considers that improved access to the EFTPOS system would promote competition in debit card issuing.

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<sup>22</sup> Reserve Bank of Australia Bulletin, 'The Changing Australian Retail Payments Landscape', July 2003, pages 6-7.



- 6.39 The Commission considers that competition in card issuing has been gradually increasing over recent years. In addition the savings accruing to net card issuers are likely to give rise to a (relative) cost advantage which may slightly strengthen their competitive position vis a vis net merchant acquirers. However, the Commission considers that this may not significantly improve competition in card issuing because of the difficulties in getting consumers to switch (as price is only one aspect of a consumer's decision). The Commission is also concerned that debit card issuing remains concentrated and the strength of competition between card issuers is affected by significant barriers to entry.
- 6.40 To obtain access to the EFTPOS network as a card issuer, an organisation must:
- be an Approved Deposit-taking Institution (ADI) and maintain customers' deposit transaction accounts, which the customers can draw upon in EFTPOS transactions;
  - issue transaction cards (payment instruments) to its customers/cardholders for their use in making EFTPOS transactions;
  - enter into bilateral interchange agreements with each acquirer in the EFTPOS network, or enter into a gateway agreement with an issuer; and
  - establish an Exchange Settlement Account (ESA) to settle its clearing obligations with each acquirer, or draw on the ESA of another institution in the case of indirect access (under a commercial agreement).
- 6.41 It is the Applicants' view that the statutory requirements of becoming an ADI and establishing an ESA do not constitute a barrier to the entry of a suitably qualified organisation. The Commission has previously considered that the CECS arrangements relating to the establishment as an ADI and an ESA as requirements for access to EFTPOS as issuers do not raise additional barriers but reflect what is a necessary requirement in practice for such access<sup>23</sup>.
- 6.42 Therefore the main barrier to direct access faced by new entrant card issuers appears to be the need to negotiate bilateral agreements covering technical and commercial arrangements with each merchant acquirer in the EFTPOS network. A new entrant may seek indirect access requiring only one bilateral agreement with the gateway provider. However gateway fees can make this an expensive option. The Commission understands that gateway services are predominantly utilised by the smaller card issuing institutions.
- 6.43 The Applicants have submitted that while the likely effects of the proposed Agreement on access are unknown at this stage, it is unlikely that it will increase barriers and is more likely that it will reduce the barriers to direct entry to the EFTPOS system. In particular, it is the Applicants' view that the proposed Agreement is likely to narrow the scope, and therefore the cost, of bilateral negotiations. The Applicants also consider that the proposed Agreement is likely to have a flow on effect and may therefore reduce the cost

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<sup>23</sup> APCA CECS final determination page 41 16 August 2000

of indirect access (via gateway arrangements) to the EFTPOS system by lowering the level of current gateway fees<sup>24</sup>.

- 6.44 The RBA however considers that, while the elimination of bilateral interchange fees should facilitate access of new entrants to the EFTPOS network (since they will no longer need to negotiate interchange fees as a condition of entry), at the same time the removal of interchange fee revenues may lower the financial incentive of incumbents to interconnect with new entrants.
- 6.45 The Commission considers that the fact that in some instances the same parties are card issuers and merchant acquirers may lessen the incentive for incumbents to negotiate with new entrants. For example, the Applicants note that an artificial barrier to the direct entry as a card issuer (or merchant acquirer) could theoretically be created by incumbent merchant acquirers (or card issuers) raising the cost of negotiations, including by engaging in lengthy negotiations, by proposing unreasonable terms and conditions, by demanding exorbitant contributions towards costs of interconnection facilities, or ultimately by refusing to negotiate at all. The Applicants further acknowledge that as the EFTPOS network is already established there is a lack of commercial incentive for incumbent card issuers and merchant acquirers to expand the network and interconnect a new entrant. The Applicants have however submitted other means exist outside interchange fees for new entrants to provide incumbents with interconnection incentives and that the proposed Agreement would only exclude a financial incentive that has been set on a per transaction basis along the lines of interchange fees.
- 6.46 The Commission acknowledges that even where the incumbent has the best of intentions the current access arrangements are not ideal. Connecting a new entrant imposes costs relating to the negotiations as well as software and hardware changes. The Commission understands that it is also the case that each additional participant can make the task of maintaining network links more complicated due to the need to accommodate multiple technical connections and requirements.
- 6.47 Finally, once a new entrant achieves access it faces the difficulty in gaining customers due to the general reluctance on the part of consumers to switch banks once they have set up their banking relationship. It is generally recognised that consumers tend to be reluctant to change banks, particularly due to complex fees and charges which add to search costs and create uncertainty as to what the alternatives can offer thereby creating consumer inertia. Bundling debit products with other financial services can also increase customer loyalty and discourage switching.
- 6.48 The Commission notes that these access barriers exist independent of the proposed Agreement, but is concerned that, to the extent the proposed

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<sup>24</sup> This application does not establish a collective agreement in relation to the pricing of gateway fees following the giving effect to of the interchange fee agreement.

Agreement reduces an incumbent's incentive to interconnect a new entrant card issuer, the proposed Agreement may have the effect of increasing entry barriers. For example, the Applicants advise that the proposed Agreement provides that an incumbent will not accept an interconnection payment that is established on a per-transaction basis (along the lines of an interchange fee)<sup>25</sup>. However a new entrant may offer an incumbent an up front (or higher up front) payment as an incentive for access.

- 6.49 The Applicants submit that the proposed Agreement is likely to narrow the scope of negotiations between new entrants and incumbents, thereby reducing barriers to entry. The Commission however is concerned that any reduction in the entry barriers that this may create is likely to be small as there still remain many technical and commercial aspects to negotiate. Further, as mentioned above, new entrants may now face higher upfront payments in order to negotiate access with merchant acquirers, and with whom they compete in card issuing. Should the proposal result in higher upfront payments being required for access to the network such sunk costs may put an efficient entrant at a disadvantage compared with incumbent firms. It may also be the case that any benefits from a narrower scope may be offset by a reduction in either party's flexibility in negotiating bilateral agreements. If this is the case, then ultimately barriers to entry may be higher as a result of the Agreement.
- 6.50 In the draft determination the Commission considered that the existence of high entry barriers increased the likelihood that the potential anti-competitive detriment that may result from the proposed Agreement would be sustained over the longer term. The Applicants submitted that this detriment may be offset to some extent by the potential liberalisation of access to the EFTPOS network as part of the APCA review of the CECS arrangements. The Commission was concerned however that the outcome of the APCA review process was, in the circumstances, uncertain. The Commission therefore did not consider it to be appropriate to attach a lesser weight to this detriment. Following the draft determination, the APCA advised that it is giving priority to developing an access regime. The RBA has also provided a submission indicating that, if voluntary reform were to stall, it would seriously consider designating the EFTPOS system with a view to imposing an access regime. In light of submissions provided by the RBA and the APCA following the draft determination, the Commission is satisfied that access reform will occur in the short to medium term and the Commission is able to attach a lesser weight to the likely anti-competitive detriment.

#### *Merchant acquiring*

- 6.51 Under the proposed Agreement merchant acquirers agree that they will no longer receive interchange fee revenue from card issuers in respect of EFTPOS transactions. The Commission notes that the RBA has estimated that the loss of EFTPOS interchange fee revenue to merchant acquirers will be around \$150

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<sup>25</sup> Applicants' submission, 19 September 2003, at page 8.

million per annum.<sup>26</sup> The Applicants and interested parties have stated that in order to recoup this loss of revenue it is likely that merchant acquirers will increase EFTPOS service fees charged to merchants. 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.

- 6.52 The Applicants have advised that in seeking authorisation for the proposed Agreement it is not their intention to reach collective agreement in relation to the pass through by merchant acquirers of the likely cost increases to merchants. The Applicants have however submitted that the market for merchant acquiring is effectively competitive and that it can therefore be expected that this competition will limit aggregate increases in merchant service fees. The Applicants have submitted that this cost increase is relatively insignificant – amounting to 0.07 per cent of total retail turnover<sup>27</sup> and that in any event it will be offset by the cost savings to merchants following the implementation of the RBA's credit card reforms.
- 6.53 The ability of an institution, providing both merchant acquiring and card issuing services, to recoup its lost merchant acquiring income is influenced by its bargaining power vis-a-vis merchants relative to its market power as a card issuer. Submissions provided by the Applicants and interested parties indicate that a merchant acquirer is highly likely to recoup its lost income from merchants.
- 6.54 The Applicants note that the result of the renegotiation of EFTPOS merchant service fees will depend upon the relative bargaining power of merchant acquirers and their merchants, but consider that competition will ensure that there is no unwarranted redistribution of costs between classes of merchants. The Applicants consider that the interchange fee proposal will act as a catalyst for the renegotiation of merchant service fee agreements and disturbing the status quo will provide a strong incentive to merchants to compare alternative offers. The Applicants note that, while the ability of merchants to play acquirers off against each other will be influenced by their size and attractiveness to acquirers, they consider that there is no clear reason to expect that merchants in general, or small merchants in particular, will be adversely affected by the renegotiation process. It is the Applicants' view that the proposed Agreement will not affect the relative bargaining positions of merchants and merchant acquirers and that no evidence has been provided to suggest that the Agreement will result in an increase in the market power exercised by merchant acquirers.<sup>28</sup>

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<sup>26</sup> Reserve Bank submission dated 21 March 2003, at page 3.

<sup>27</sup> Applicants submission, February 2003, at page 16.

<sup>28</sup> Applicants' submission February 2003 and rejoinder submission April 2003 at pages 13 – 23, and pages 2 – 7, 13 – 16 respectively.

- 6.55 A number of interested parties have however expressed concern as to the likely effect of the proposed Agreement on the existing level of competition between merchant acquirers and the potential for the proposed Agreement to result in an inequitable allocation of the resulting cost increase.
- 6.56 It is the Commission's view that where authorised conduct results in an increase in costs, an important consideration in assessing whether the proposed conduct is in the net public benefit is whether the value and allocation of the cost increase is governed by competitive pressures. In this respect the Commission notes that concern has been expressed in relation to the effectiveness of the current competitive pressures operating in merchant acquiring, in particular in relation to small business. The Commission accepts that there may be differences in the costs of providing EFTPOS services to small retailers as opposed to larger retailers. However the Commission would be concerned if the cost increases resulting from the proposed Agreement went beyond cost recovery due to the relative bargaining strengths between merchant acquirers and small retailers and as a result otherwise efficient small retailers lost market share. In this regard the current and future levels of competition in merchant acquiring are relevant.
- 6.57 Merchant acquiring is highly concentrated with a small number of large institutions dominating. In particular, the four major banks provide about 85 per cent of merchant credit and debit card acquiring services, although according to RBA data this share has been falling gradually in recent years.<sup>29</sup> The Commission is concerned however that merchant acquirers seeking to recoup the cost increase resulting from the proposed Agreement are unlikely to be a significantly constrained by competition, in particular in relation to small business banking customers.
- 6.58 As with card issuing there are significant barriers to entry for merchant acquiring. The Commission notes that a new merchant acquirer seeking to participate in the EFTPOS network must:
- enter into bilateral interchange agreements (which include standards for the EFTPOS facilities provided to merchants by the acquirer, as well as clearing, settlement and fee arrangements) with all issuers in the network, or enter into an arrangement with a 'gateway' acquirer that has bilateral interchange agreements with issuers in the network;
  - have the means of settling its clearing obligations with each issuer, in practice this would require the organisation to either have its own ESA or have access (under a commercial arrangement) to another institution's ESA.
- 6.59 Similar to card issuing, a major barrier to entry for a new merchant acquirer is the ability to enter into bilateral interchange agreements with existing card issuers. The Applicants submitted that under the proposed arrangement a card issuer would require a new entrant acquirer to provide less incentive in order to

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<sup>29</sup> *The changing Australian retail payment landscape*, Reserve Bank of Australia, July 2003, at page 7.

achieve a successful bilateral agreement. The Applicants consider that the proposed arrangements will provide greater certainty as to the cost of interconnection as there will be no requirement to negotiate over the interchange fee. The Applicants submit that this is one of the means by which the proposed conduct will reduce barriers to entry.

- 6.60 The Applicants further consider that the draft determination, in considering the potential for bilateral interchange fee negotiation between incumbents and new entrants, fails to take account of commercial realities. In particular the Applicants consider that the potential result of such negotiation, for example fees flowing from a new entrant card issuer to an incumbent acquirer and/or from a new entrant acquirer to an incumbent card issuer, were they to become known within the industry would lead to claims for the re-opening of long-standing contracts among incumbents. The Applicants consider that it is unlikely that incumbents would expose themselves in this way rather than adhering to the traditional level and direction of the interchange fee.
- 6.61 Coles Myer expressed concern that the proposed Agreement will reduce the incentive of incumbents to engage in interchange activity with new entrants, thereby making access to the EFTPOS network more difficult. In particular it has been submitted that by reducing a new entrant's capacity to offer financial incentives to prospective interchange partners, the proposed Agreement increases existing barriers to entry.
- 6.62 The Applicants consider the proposition that the proposed Agreement removes an incentive for existing issuers and acquirers to deal with a new entrant to be flawed. In particular the Applicants consider that other factors are important in such a decision, and these other factors can be used by a new entrant to gain access without the need to rely upon accepting a disadvantageous interchange fee. The Applicants also consider that it has not been explained why a card issuer, who had an incentive to negotiate an agreement with a new entrant acquirer under the present arrangements, would cease to have an incentive to negotiate an equivalent agreement if the proposed Agreement were given effect to.
- 6.63 New entrants also face the difficulty of securing merchant clients because of the switching costs involved. For example, a November 2003 report *Small Business Banking in Australia*<sup>30</sup>, found that while there had been a 25 per cent increase in the number of business transaction account providers over the last two years, 83 per cent of Australia's 1.2 million small businesses still choose to do their banking with a major bank, with only 11 per cent switching banks in the past two years. The report further noted that of those small business who did switch banks, 61 per cent changed to a major bank rather than a smaller institution. Further, a recent *Small Business Banking Issues Paper* compiled by the Financial Services Consumer Policy Centre (FSCPC) concluded that the

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<sup>30</sup> *Small Business Banking in Australia 2003 – research report*, KPMG, November 2003, commissioned by the ABA.

- level of competition in the small business banking market is very poor.<sup>31</sup> It is the FSCPC's view that this is because a small number of large institutions dominate the small business banking market and fail to compete with each other on either price or service. The FSCPC also considers that the lack of mobility and "stickiness" of small business banking customers has made it hard for smaller players and new entrants to compete for reasonable market share, even though these participants might have superior products.
- 6.64 The Commission accepts that, even without the proposed Agreement, barriers to entry for merchant acquiring are already high. The Commission is concerned however that, to the extent that the proposed Agreement hinders the negotiation of bilateral agreements by new entrants, it may increase barriers to entry.
- 6.65 At the time of lodging their applications, the Applicants submitted that the detriment arising from the proposed Agreement may be offset to some extent by the potential liberalisation of access to the EFTPOS network as part of the APCA review of the CECS arrangements.<sup>32</sup> However at the time of issuing its draft determination the Commission was concerned that the outcome of the APCA review process was, in the circumstances, uncertain. Accordingly the Commission considered that it would be inappropriate to attach a lesser weight to the likely anti-competitive detriment resulting from the proposed Agreement on the basis of the APCA review. In light of submissions provided by the RBA and the APCA following the draft determination, the Commission is satisfied that access reform will occur in the short to medium term and the Commission is able to attach a lesser weight to the likely anti-competitive detriment.
- 6.66 More generally the Commission notes that the RBA has submitted that EFTPOS access arrangements have significant practical implications for the credit card access reform. In particular the RBA submits that it is necessary for new entrants seeking to provide acquiring services to merchants to obtain access to both the EFTPOS and credit card networks.
- 6.67 The Commission also notes that some interested parties have submitted that the proposed Agreement is likely to have an anti-competitive effect by deterring efficient investment in the EFTPOS network.
- 6.68 The Applicants acknowledge that EFTPOS interchange fees play some part in encouraging investment in acquirer side terminals and other facilities.<sup>33</sup> The Applicants have submitted that it is possible that lowering the interchange fee will reduce the immediate returns on those investments and the incentives to undertake the expenditure needed to maintain and improve the present quality and penetration of the network. However, the Applicants consider that the likely response to lower interchange fees is that acquiring institutions will raise

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<sup>31</sup> *Small Business Banking - Options for Reform*, Financial Services Consumer Policy Centre, September 2002, at page 10

<sup>32</sup> Applicants submission, February 2003, at page 19

<sup>33</sup> Applicants' submission, February 2003, at page 17.

merchant service fees to offset the loss of revenue. It is the Applicants' view that this will mean that there will still be a flow of revenue to finance investments in acquiring facilities, but the pattern of returns, and the associated investment, may be changed.

- 6.69 The ARA has argued that the only course of action available to retailers under the proposed EFTPOS interchange fee reform is to:
- reduce expenditure on EFTPOS networks as far as possible; and
  - pass on both their own network costs and the higher acquiring institution costs to consumers. The most likely outcome is an increase in the general prices of goods and services.
- 6.70 Submissions received from Coles Myer, Woolworths and Caltex have further stated that if merchants do not undertake required upgrades of infrastructure the relative level of security of the Australian EFTPOS network is likely to decline. For example, Caltex disputes the proposition that, in the absence of an interchange fee, other beneficiaries of the upgrade would have an incentive to contribute to the upgrade costs.
- 6.71 However, the RBA has noted that no evidence was presented to the Joint Study, or subsequently, that EFTPOS interchange fee revenue continues to be required by merchants to recoup the costs of their initial investments or subsequent upgrades. The RBA has submitted that if EFTPOS interchange fee revenues are eliminated, investment decisions by merchants would be determined by normal market mechanisms. The RBA considers that merchants will continue to invest in EFTPOS facilities if they perceive direct benefits in doing so, such as savings in merchant service fees by undertaking some acquiring services themselves, or greater customer satisfaction through improved transaction processing speeds.
- 6.72 The ACA has also submitted that the costs of developing the EFTPOS network have long been recovered. The ACA also notes that infrastructure for accepting EFTPOS transactions is generally the same as that employed for credit cards, reducing the likelihood that merchants will discontinue their investment in EFTPOS infrastructure.
- 6.73 The Commission considers that the future investment decisions of EFTPOS network participants will be determined by market conditions. For example new entrants can be expected to promote efficiency gains and technological innovation in the EFTPOS network. The Commission considers that such developments will prompt a competitive response from incumbents and that network investment is likely to continue.

#### **Conclusion on anti-competitive detriment**

- 6.74 The Commission considers that the cost savings resulting from the proposed Agreement may slightly strengthen the competitive position of those institutions that are a net card issuer vis-a-vis those institutions that are net merchant acquirers. The Commission considers however that this is unlikely to significantly improve competition in card issuing because of the difficulties in



getting consumers to switch institutions (as price is only one aspect of a consumer's decision), and already high barriers to entry. The Commission is further concerned that a cost increase to merchants that is likely to result from the proposed Agreement, is unlikely to be significantly constrained by competitive forces. The Commission also considers that to the extent the proposed Agreement results in the introduction of higher upfront payments or hinders the negotiation of bilateral agreements it may have the effect of increasing (the already high) barriers to entry, thereby sustaining the potential for anti-competitive detriment in the longer term.

- 6.75 However in light of submissions provided by the RBA and the APCA following the draft determination, the Commission is satisfied that access reform will occur in the short to medium term and the Commission is able to attach less weight to the anti-competitive detriment that may otherwise have arisen as a result of the proposed Agreement.

### **Public benefits**

- 6.76 To grant authorisation the Commission must be satisfied that any lessening of competition is outweighed by the benefit to the public arising from the proposed conduct. The public benefits claimed by the Applicants are detailed at paragraphs 4.5 to 4.14. In particular, the Commission has considered the claims by the Applicants that the proposed Agreement would:

- make 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 reduce the overall cost of the Australian payments system;
- introduce greater flexibility into the setting of EFTPOS interchange fees; and
- make new entry to the EFTPOS network easier by simplifying the negotiation of bilateral interchange agreements.

### *Making EFTPOS more attractive/Improving the efficiency of the Australian payments system*

- 6.77 The Joint Study concluded that the current pricing signals for Australian retail payment services (ATM, credit cards, EFTPOS) are distorting consumer payment choices. Consumers make decisions about which payment instrument they use on the basis of a range of factors such as convenience, type of payment being made, personal preferences and the relative prices of alternative instruments. For cardholders who do not face a cash constraint a debit card is a close substitute for a credit card. For these cardholders the choice between the two types of card will be influenced by their relative price and other incentives (such as fee free transactions, loyalty points).
- 6.78 The Joint Study found that the credit card network has been encouraged to grow at the expense of the debit card— a less costly alternative (albeit that debit card acquiring generates revenues above average costs). For example, the cost to

merchants in accepting a credit card averages \$1.78 for a \$100 transaction, while the merchant fee for debit cards for merchants who do not provide any acquiring infrastructure is around \$0.80. Merchants who operate their own infrastructure receive a share of the interchange revenue paid to their financial institution by issuers and hence receive revenue from accepting debit cards.

- 6.79 As a result of the distorted payment signals facing consumers, the Joint Study concluded that Australia has a higher cost retail payments system than is necessary.
- 6.80 As indicated in the draft determination, the Commission accepts that there is a clear benefit to the public through improved payment system efficiency and that the promotion of the increased usage of EFTPOS as a less costly payment alternative relative to other payment instruments is likely to contribute to the attainment of this benefit.
- 6.81 The Commission considers that, to achieve this benefit, price signals that reflect efficient costs of the various payment instruments must be readily observable by cardholders. The Commission considers that the following factors are relevant in assessing the extent to which the proposed Agreement will facilitate this:
- pass through of card issuer cost reductions to cardholders; and
  - the transparency of pricing signals.

Pass through of card issuer cost reductions to cardholders

- 6.82 Currently when a cardholder uses a debit card to make a purchase from a merchant the card issuing bank will pay an interchange fee (on average between \$0.18 and \$0.25) to the merchant acquiring institution. Accordingly the proposed Agreement, by reducing EFTPOS interchange fees to zero, will result in cost savings for EFTPOS card issuers.
- 6.83 The Applicants claim that effective competition between card issuers is likely to lead to at least part of the cost reduction being passed on to cardholders. The Applicants consider that the form of the pass through should be allowed to be developed by card issuers in an effectively competitive retail banking market and not by collective agreement. The Applicants note that this pass through may take the form of lower retail banking fees and/or enhanced services but that it is unlikely that this pass through will occur in an easily observable manner due to the complexity of retail transaction accounts.

- 6.84 The Applicants consider it implausible to suggest that card issuer cost savings will not be passed on to card holders in some manner. In particular the Applicants note that even if it were to be assumed that the market for card issuing was characterised by the presence of pure monopolists, a pure monopolist is nonetheless likely to reduce prices in the face of a reduction in costs, as to not do so would be to forgo increased profits through higher sales. The Applicants further note that, while it may be true that a monopolist would not pass on the full reduction in costs, it is their view that a full pass through of card issuer cost savings would not be required in order for there to be an overall reduction in payment system costs.
- 6.85 The Applicants have also noted that, ultimately, all costs of EFTPOS are borne by consumers (not necessarily just cardholders). The Applicants submit that under the proposed Agreement they have sought to limit future EFTPOS cost increases by exposing these fees to greater competition. In particular by reducing interchange fees to zero, the remaining fees (being fees to cardholders and fees to merchants) are exposed respectively to competition between card issuers and competition between merchant acquirers. The Applicants consider that this competition will ensure that there is a pass through of at least some of the savings by card issuers, as either lower fees or as some other aspect of an improved price/service/quality bundle provided to cardholders.
- 6.86 A number of interested parties have however expressed concern as to the level of competition between existing card issuers, in particular in relation to the potential for competition between existing card issuers to ensure the pass through to cardholders of the full benefit of the cost reductions that will accrue as a result of the proposed Agreement.<sup>34</sup>
- 6.87 These interested parties submit that the benefits of increasing the use of EFTPOS as a lower cost payment mechanism depend upon cardholders receiving the benefit of reduced EFTPOS banking fees. However as the proposed Agreement does not provide a mechanism to ensure that fee reductions are passed on to cardholders, these parties consider that the Commission should impose a condition upon the grant of authorisation requiring those Applicants who are card issuers to pass on the benefit of the interchange fee cost savings to cardholders and that a prices oversight body should be established to ensure, and report on, ongoing compliance with the pass through requirement.
- 6.88 Further, a number of interested parties have also noted that RBA data suggests that the majority of EFTPOS cardholders do not exceed their fee free transaction threshold and that as a result of this it is highly unlikely that the majority of EFTPOS users will benefit from the pass through of card issuer savings as they do not currently pay transaction fees. The ARA submits that in any event the potential savings to cardholders that may result from the proposed Agreement have been overstated. In particular the ARA notes that, once

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<sup>34</sup> For example submissions provided by CLC(V), the CFA, the ACA, Coles Myer and Woolworths.

transfers between those larger institutions providing both acquiring and issuing services have been taken into account, an estimated net saving for smaller financial institutions of \$22.5 million arises and a deficit of \$22.5 million is incurred by larger institutions. The ARA submits that for the majority of cardholders there would only be a small saving or no saving at all. The ARA considers that a partial pass through as acknowledged by the Applicants, will mean that most EFTPOS cardholders receive no benefit at all.

- 6.89 As discussed at paragraphs 6.35 to 6.50, the Commission considers that competition among card issuers is currently constrained, due in part to the level of concentration among the four major banks and high barriers to entry. As such in the draft determination the Commission expressed concern over whether the benefits from the proposed zero interchange fee reform would be passed through to the community in a significant and lasting manner rather than dissipated over time. On this basis the Commission proposed to reduce the weight that it may otherwise have attached to this claimed public benefit.
- 6.90 Following the Commission's draft determination the RBA advised that it considered that the public interest would best be served by improved access to the EFTPOS system as this would promote competition in debit card issuing and acquiring and thus the pass through of the benefits of zero interchange fees to society. The RBA indicated that should the efforts by the APCA to establish an access regime falter the RBA would seriously consider designating the EFTPOS system to impose an access regime under the PRSA.
- 6.91 In light of submissions provided by the RBA and the APCA following the draft determination, the Commission is satisfied that access reform will occur in the short to medium term and accordingly that the competitive pressures that may be exercised by potential new entrants will be improved. As such the Commission considers that it is able to be more certain that a benefit to the public from the pass through of cost savings will occur on an ongoing basis. Accordingly the Commission now attaches a greater weight to this benefit than was proposed in the draft determination.
- 6.92 As a result of the likely access reform that will increase (potential) competition the Commission considers it more likely that competition will ensure lasting pass through occurs. The Commission therefore does not consider it necessary to impose a condition requiring the pass through of cost savings to cardholders. In this respect the Commission notes that the Applicants' have advised that the fee and charge structures of the various transaction account products offered by financial institutions are too complex to necessarily expect a simple pass through of 'x' cents. For example the Commission notes that an enhancement of services would be likely to be of benefit to the public however it would be difficult to monitor and attach a monetary value to such a benefit.

#### Improving the transparency of pricing signals

- 6.93 In their submissions the Applicants have argued that the proposed conduct will lead to an overall improvement in payment method pricing signals and will promote increased debit card usage by encouraging consumers to shift away