

# Payments system regulation and reform in Australia: the competitive effects of the interchange fee and surcharging policy options

RBB Economics, 24 April 2015

# 1. Executive Summary

Minter Ellison is assisting American Express Australia (“**Amex**”) in responding to the March 2015 Issues Paper (“**the Issues Paper**”) by the Reserve Bank of Australia (“**the RBA**”) concerning the policy options for card payments regulation (“**the Policy Options**”).<sup>1</sup> Some of the Policy Options follow the recommendations of the Financial System Inquiry (**the “Inquiry”**) as they relate to the regulation of the Australian payments system.

RBB Economics has been instructed by Minter Ellison to provide an economic report which assesses the implications for competition and consumers of the Policy Options relating to interchange and surcharging regulation in Australia, and which specifically considers the implications of applying such regulations to three-party schemes.

Our report first considers the Policy Options relating to interchange and then turns to surcharging.

## 1.1. Interchange

In Section 2, we summarise the current regulations and the proposed Policy Options on interchange fees (“**IFs**”). The critical change from the perspective of Amex is that where it acts as an acquirer but not an issuer, its payments to issuers may be capped as *if* they were IFs. Put differently, despite Amex having confidential and bilaterally determined agreements with each of its (relatively few) issuers, and despite Amex not setting IFs, it would nonetheless be subject to regulation designed for four-party schemes whose issuers typically charge an identical IF to acquirers.

Section 3 then assesses the impact that the IF Policy Options would have on competition and consumer welfare. We find that Amex has no market power; its share is low and it is not a must-take card. The implication of these facts is that its merchant service fees (“**MSFs**”) are not excessive; higher fees must be matched by higher merchant benefits. Intervention to disrupt its differentiated business model would force Amex to operate at a less efficient scale and a lower level of quality.

In turn, if implemented, the Policy Options are likely to harm Amex’s ability to compete with Visa and MasterCard. Including Amex in the new IF regulations proposed in the Policy Options, therefore, is contrary to the RBA’s objective to promote competition.

Further, we find that the available evidence suggests that the current IF and associated surcharging regulation has likely made cardholding consumers worse off, without any clear evidence of lower retail prices for non-cardholders. Indeed, given the prevalence of cardholders, this indicates a plausible reduction in consumer welfare caused by the current IF regulation.

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<sup>1</sup> RBA, ‘Review of Card Payments Regulation’, March 2015.

We also explain that the claim that efficiency would be improved by shifting funds from premium cardholders to non-premium cardholders is not convincing. Evidence has not been presented to demonstrate that different MSFs on premium and non-premium cards reduces consumption and it seems particularly unlikely that IF caps applied to Amex would give rise to a substantial increase in consumption.

Importantly, we note that to the extent that the aim is to force Amex to lower MSFs, it is sufficient to regulate the IFs of four-party systems; the evidence to date shows clearly how IF regulation of four-party systems has induced Amex to correspondingly lower MSFs.

We conclude that the Issues Paper has not provided a sound basis for including Amex within the IF Policy Options. On the contrary, including Amex within the regulations would harm competition within the payments system, contrary to the RBA's mandate.<sup>2</sup>

## 1.2. Surcharging

Section 4 summarises the current regulations and Policy Options on surcharging. One Policy Option is to introduce a three-tiered system of surcharging, with cards being subject to (i) no surcharge; (ii) a surcharge up to a set level determined by the RBA; or (iii) a surcharge up to the "reasonable cost" of acceptance. The RBA also invites views on targeted changes to reduce particular cases of excessive surcharging, further easing of "honour-all-card" rules to allow merchants to decline to accept cards with high IFs, and the facilitation of differential surcharging by merchants.

Section 5 then assesses the Policy Options relating to surcharging. As a matter of principle, Amex is opposed to the Merchant Pricing Standard prohibiting all schemes from preventing merchants from surcharging. Where payment schemes (such as Amex) have no market power, preventing merchants from surcharging can reduce merchant free-riding and allow smaller three-party schemes to compete more effectively with larger, four-party schemes. This is the case regardless of whether or not Amex's issuing fees are regulated; Amex has no market power and its MSFs are constrained by those charged by MasterCard and Visa.

If the Merchant Pricing Standard was to remain, there is not a strong case for amending it. The further amendments to the Merchant Pricing Standard (introduced in 2013) have had limited time to bed down. Card schemes have both the incentive and ability to educate merchants as regards what surcharge would be the reasonable cost of acceptance. To impose yet another change in the Merchant Pricing Standard seems excessive at this point in time.

Moreover, the three-tiered surcharging option risks the unintended consequence of *greater surcharging* on medium and higher cost cards, thereby raising the price level and, in the process, harming consumers.

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<sup>2</sup> The Reserve Bank Act 1959, Section 10B, available at <http://www.comlaw.gov.au/Details/C2014C00518>. The Act states that the RBA must exercise its powers in such a way that will best contribute to, *inter alia*, "promoting competition in the market for payment services."

For the reasons above, and given that the RBA appears unwilling to allow card schemes with no market power to ban surcharging on their cards, there is a strong case for leaving the Merchant Pricing Standard unchanged.

### **1.3. Conclusion**

Overall, we find that there is no convincing reason for applying IF regulations to three-party schemes or for changing the current Merchant Pricing Standard. We therefore conclude that three-party schemes should continue to be excluded from IF regulations and that the proposed amendments to the Merchant Pricing Standard are unwarranted.

## 2. Summary of the current regulations and the Policy Options regarding IFs

By way of introduction, this section describes the current laws regulating IFs as well as the IF Policy Options and their implications for whether the Amex card scheme is likely to be subject to additional regulation.

### 2.1. Current IF regulations

In 2000, the ACCC instituted proceedings against National Australia Bank Limited, relating to the IFs being set by various financial institutions as members of credit card schemes. The ACCC was concerned that IFs were being used to control MSFs, and that the collective setting of IFs by competitors amounted to price-fixing.<sup>3</sup> The RBA then designated the MasterCard and Visa credit card schemes in April 2001,<sup>4</sup> and introduced an interchange fee standard on 1 July 2003 that led MasterCard and Visa to lower their interchange fees from 31 October 2003.<sup>5</sup>

The key aspects of the current IF regulations are as follows:

- **Amex is currently not regulated.** In particular, transactions made using an Amex card – whether issued by Amex or by an issuing partner – are not subject to IF caps. Visa and MasterCard are the only credit card schemes currently designated and regulated under the Payment Systems (Regulation) Act 1998 (the “PSRA”). The reason for Amex not being regulated is because (as noted above) the aim of the regulation was to address IFs collectively set by competitors within each of the four-party networks of Visa and MasterCard. In contrast, Amex was not regulated because it operates a three-party system without IFs.<sup>6</sup>
- **The IF cap that applies to credit card schemes is a weighted-average cap of 0.50%.** To be more specific, every three years, or at the time of any other reset of IFs, the average IF must not exceed 0.50%, with weights based on the transactions of the most recent financial year. This has been the case since November 2006, following the introduction of a common benchmark for IFs.<sup>7</sup>

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<sup>3</sup> ACCC, ‘ACCC alleges price fix by bank’, Media Release, 4 September 2000, available at <https://www.accc.gov.au/media-release/accc-alleges-price-fix-by-bank> and ACCC, ‘ACCC recommends Reserve Bank consider using powers to reform credit card schemes’, Media Release, 21 March 2001, available at <https://www.accc.gov.au/media-release/accc-recommends-reserve-bank-consider-using-powers-to-reform-credit-card-schemes>.

<sup>4</sup> RBA, ‘Designation of Credit Card Schemes in Australia’, 12 April 2001, <http://www.rba.gov.au/media-releases/2001/mr-01-09.html>.

<sup>5</sup> RBA, ‘Interchange fees for the Bankcard, MasterCard Visa Credit Card Schemes’, 31 October 2003, available at <http://www.rba.gov.au/media-releases/2003/mr-03-14.html>.

<sup>6</sup> RBA, ‘Reform of Credit Card Schemes in Australia – A Consultation Document’, December 2001, Section 5.3, p. 117.

<sup>7</sup> The common benchmark of 0.50% was to apply for three years from 1 November 2006 (RBA, ‘Interchange Fees for the MasterCard and Visa Schemes’, 29 September 2006, available at <http://www.rba.gov.au/media-releases/2006/mr-06-08.html>). On 10 December 2008, the RBA amended the standard relating to surcharging to give it the power to waive the requirement for it to calculate the benchmark rate and waived the requirement to do so in 2009 (RBA, ‘Payments System Reform’, 10 December 2008, available at <http://www.rba.gov.au/media-releases/2008/mr-08-28.html>). The RBA also waived

- **The IF cap is calculated using the issuers' costs methodology (ICM).** The idea behind the ICM is that the IF paid in service of a transaction should reflect the (variable) cost to the issuer of enabling this transaction.<sup>8</sup>

## 2.2. IF Policy Options

We understand that the IF Policy Options contemplate the following measures, which draw on the Inquiry's recommendations:

- **Automatically regulating schemes with annual transaction volume and/or market shares over certain thresholds.** The Issues Paper does not disclose exact levels of these thresholds but it states that "[s]uch thresholds could potentially apply to providers such as American Express".<sup>9</sup> Amex considers that its Global Network Services business, which works with financial institutions that want to issue cards on the Amex network, could be captured by the regulations. In this case, the issuer fees Amex pays to these banks would be capped (whereas currently they are not).
- **Capping all the types of fees paid by system providers to issuers (i.e. "net compensation").** The Policy Option proposes to include the service fees that schemes pay to issuers as well as so-called "incentive payments", which are present in all schemes, including Amex's Global Network Services business.
- **Reduce the upward "drift" in average IF rates inherent in the current three-year reset cycle whereby Visa and MasterCard ensure they comply with IF caps at benchmark compliance points but allow rates to increase between those points.** The Issues Paper suggests that one option would be to shift to more frequent benchmark observance, such as annually or even quarterly. The Issues Paper claims that this would ensure that average IFs were closer to the benchmark, but may not narrow the gap between the highest and lowest rates.
- **Lowering IF caps.** The Issues Paper contemplates lowering IFs (defined to take into account net compensation) below the current average level of 0.50%. It notes the Inquiry's claim that this will improve efficiency and reduce the degree of cross-subsidisation.

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the requirement to recalculate the common benchmark in 2012 and in 2015 (respectively: RBA, 'Payments System Issues', 16 December 2011, available at <http://www.rba.gov.au/media-releases/2011/mr-11-29.html>); RBA, 'Waiver of Interchange Benchmark Recalculation', 4 March 2015, available at <http://www.rba.gov.au/media-releases/2015/mr-15-04.html>). As a result, the current benchmark applies to 1 November 2018, absent changes to the regulation.

<sup>8</sup> The IF caps proposed recently by the European Commission, on the other hand, were calculated using the "Merchant Indifference Test" (the "MIT") (European Commission, 'Impact Assessment of the proposed Payment Services Directive and IF Regulation', 24 March 2013). The MIT says that IFs should be capped at that level that would make the average merchant indifferent between accepting a card and accepting cash as payment. In other words, whereas the ICM uses issuing costs as its benchmark, the MIT purports to use the *value* to the average merchant of accepting card payment (over and above the value it gets from accepting cash only). However, we question whether this MIT approach adequately captures the true "value" of card acceptance to merchants.

<sup>9</sup> Issues paper, p. 35.

- **Applying IF caps on a per-transaction basis, rather than applying to the three-year weighted-average IF.** The Issues Paper notes that Visa and MasterCard are meeting the current caps by charging high fees for transactions involving smaller merchants without market power, while setting low fees for merchants with market power and high transaction volumes. The aim of per-transaction IF caps would be to redress this imbalance.
- **Applying a cap that is the lesser of a fixed amount and a fixed percentage of the transaction value.** Applying fixed-value caps to credit systems, in addition to fixed-percentage caps, would have the effect of lowering the proportional cost of fees as the value of the transaction rises. The Inquiry notes that this would be a significant change and therefore suggests a transition period should this policy option be adopted.
- **Allowing for “buying groups” of smaller merchants to group together (subject to competition law restrictions) to negotiate for IFs that are otherwise only accessible to larger merchants.** The aim of this would be to alleviate the large differences in the IFs faced by different types of merchants, should they persist. The Issues Paper notes that a similar measure was part of a settlement between US merchants and MasterCard and Visa in 2012, but this only required that the card companies meet with merchant buying groups and not that they must offer them the same IFs as those enjoyed by large merchants with similar transaction volumes.

### 3. Assessment of the impact of the IF Policy Options on competition and consumer welfare

The RBA's mandate is to promote competition and efficiency in the payments system and the Issues Paper states that the Policy Options might be considered to address concerns in these areas.<sup>10</sup> This section comments on the IF Policy Options. In particular, it assesses the extent to which their impact on three-party systems, and in particular Amex, promotes or hinders competition and efficiency in the payments system.

#### 3.1. Impact of the regulations on competition for system providers

##### 3.1.1. Competitive neutrality must be assessed against the impact of the Policy Options on competition

It is important to recall why the RBA introduced the IF regulation in the first place, namely to deal with an allegation by the ACCC that the multilateral IF arrangements adopted by Visa and MasterCard were anti-competitive.<sup>11</sup> In other words, understanding the impact on competition (and how that ultimately impacts on consumers) is an important backdrop for assessing the merits of the Policy Options.

In Australia, Amex operates both: (i) a proprietary card scheme, where it acts as both issuer and acquirer on its own network; and (ii) a Global Network Services business, where it licenses issuers while remaining the sole acquirer. When Amex licenses an issuer, the terms are agreed confidentially and bilaterally; there is no default level multilateral IF established that could amount to collective price setting. In other words, the Amex three-party scheme is fundamentally different from the four-party schemes that IF regulation was originally designed to regulate.

It is because of this fundamental difference – that three-party schemes do not have collectively set IFs – that Amex was not subjected to IF regulation. Specifically, the RBA's rationale for not imposing IF regulation on the three-party schemes (such as the scheme operated by Amex) in the early 2000s was that:

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<sup>10</sup> Issues Paper, p. 2.

<sup>11</sup> ACCC, "ACCC alleges price fix by bank", Media Release, 4 September 2000. ACCC, 'ACCC recommends Reserve Bank consider using powers to reform credit card schemes', Media Release, 21 March 2001. In its Issues Paper (p. 4), the RBA recognises the importance of collective fee setting. It states that its Joint Study in October 2000 with the ACCC found that "three aspects of credit card scheme rules seemed to be impeding the efficiency of the overall payments system: the collective setting of interchange fees; 'no surcharge' rules that prevented merchants from passing on the cost of accepting credit cards; and restrictions on membership that appeared to be stronger than needed to protect the integrity of the schemes" (emphasis added).



- they “do not have a process under which competitors collectively agree to set a price which then affects, in a uniform way, the prices each of the competitors charges to third parties”;<sup>12</sup> and
- “regulating the payments that flow between American Express and Diners Club and their partners would be likely to have little effect on merchants’ costs of accepting the cards”.<sup>13</sup>

The objective of “competitive neutrality” should be understood in this context. The Issues Paper notes that the Inquiry suggested regulating the fees of three party schemes that work with outside issuers on the basis that it would “enhance competitive neutrality” but to assess whether or not this might be the case it is important to properly define “competitive neutrality”. In our view, it means that regulatory intervention should either be pro-competitive (strengthening competition among payment system operators) or *at worst neutral* (i.e. demonstrably having no adverse impact on competition). Where an intervention would harm competition, this is not in the interest of competitive neutrality but, rather, is against it.

### 3.1.2. It is contrary to the objective of promoting competition to impose IF regulation on firms without market power

As a general principle of competition law and economics, firms that do not have market power individually or collectively *cannot* act in a way that has a harmful effect on competition. Firms without market power:

- set competitive prices and choose competitive non-price features such as quality, range and service;<sup>14</sup>
- do not have substantial market power in their markets and therefore cannot misuse their market power or otherwise have the purpose, effect or likely effect of substantially lessening competition by setting excessive prices or engaging in exclusionary behaviour; and
- are presumed to contract with their distribution partners in a way that is *pro-competitive*, i.e. their vertical agreements are usually presumed to give rise to production and distribution efficiencies, thereby making them more effective competitors.<sup>15</sup>

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<sup>12</sup> RBA, ‘Reform of Credit Card Schemes in Australia – A Consultation Document’, December 2001, p. 117.

<sup>13</sup> RBA Media Release 2005-02, 24 February 2005, available at <http://www.rba.gov.au/media-releases/2005/mr-05-02.html>.

<sup>14</sup> OFT Competition Law Guideline, ‘Assessment of market power’, December 2004, para. 1.4 (this guideline has been retained by the Competition and Markets Authority, see <https://www.gov.uk/government/publications/assessment-of-market-power>).

<sup>15</sup> See, for example, ACCC, ‘Merger Guidelines’, November 2008, which state at paragraph 5.28 that “An integrated or conglomerate firm will generally only be able to engage in foreclosure if it has sufficient market power at one or more functional levels within the vertical supply chain, or in one or more of the related markets post-acquisition.” See also the European Commission guidelines on vertical restraints which state: “For most vertical restraints, competition concerns can only arise if there is insufficient competition at one or more levels of trade, i.e. if there is some degree of market power at the level of the supplier or the buyer or at both levels. Vertical restraints are generally less harmful than horizontal restraints and may provide substantial scope for efficiencies” and “[w]hen a company has no market power, it can only try to increase its

For these reasons, competition law requires contractual restrictions to be considered on a case by case basis in their specific market context; in particular, competition law does not aim to shackle firms without market power, such as those firms which have a persistently low market share.<sup>16</sup>

By the same token, regulation in the name of “competitive neutrality” that raises the cost of a firm that has no market power is liable to harm competition. Put simply, firms without market power: (i) have no means of harming consumers by restricting competition or setting excessive prices; and (ii) constrain larger firms making it less likely that those larger firms are able to harm competition and/or consumers. Imposing higher costs, via regulation, on firms without market power reduces the scope for them to constrain other firms, weakening their competitive strength and thereby causing (all else equal) upward pressure on prices and, importantly, reduced scope for greater quality and innovation.

### 3.1.3. Amex does not have market power

The following four facts, together, strongly suggest that Amex does not have market power:

- **Amex’s share of overall credit card transaction value is low, both in absolute terms and in relative terms (i.e. when compared to Visa’s and MasterCard’s).** Amex’s lack of market power in Australia is reflected in its relatively low share of credit card transaction value around 18%. In contrast, Visa and MasterCard’s combined share is around 81%.<sup>17</sup>
- **Amex does not have a must-take brand.** Amex’s low share indicates that it is not a must-take brand. This is also reflected in the degree of “multi-homing” between Amex and Visa/MasterCard; the most recent RBA survey found that “over 90% of Amex and Diners Club cardholders also held a credit card from another network.”<sup>18,19</sup> As such,

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*profits by optimising its manufacturing and distribution processes, with or without the help of vertical restraints*”. European Commission Guidelines on Vertical Restraints, 2010, paragraphs 6 and 99, respectively, available at [http://ec.europa.eu/competition/antitrust/legislation/guidelines\\_vertical\\_en.pdf](http://ec.europa.eu/competition/antitrust/legislation/guidelines_vertical_en.pdf).

<sup>16</sup> In Europe, for example, in the case of vertical agreements, where the contracting parties have shares in their respective markets below 30%, the agreement is presumed to be legitimate (outside some special cases of hard-core restrictions which do not apply to Amex). See European Commission Guidelines on Vertical Restraints, paragraphs 87-92. Further, a firm is unlikely to be considered dominant where it has a share below 40% (European Commission, ‘Guidance on the Commission’s enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings’, 24 February 2009, paragraph 14). This is because persistently low market shares are consistent with the absence of market power (as, for example, set out in the OFT Competition Law Guideline, ‘Assessment of market power’, at paragraph 4.2).

<sup>17</sup> RBA, ‘Statistical Table: Market Shares of Credit and Charge Card Schemes – C2’, 13 April 2015. Shares have been computed on the basis of annual transaction value in the credit card and charge card segment. Amex and Diners Club’s combined average share in 2014 was 19.2%. MasterCard and Visa’s combined average share in 2014 was 80.8%. Based on total value of purchases made with credit and debit cards, Amex and Diners Club combined had an even lower 10.5% share in December 2014 and an average combined share of 11% for 2014. This is calculated using a combination of the following RBA primary data sources: RBA, ‘Credit and Charge Card Statistics - C1’, 13 April 2015; RBA, ‘Statistical Table: Market Shares of Credit and Charge Card Schemes – C2’, 13 April 2015; and RBA, ‘Debit Card Statistics - C5’, 13 April 2015. These sources are available at <http://www.rba.gov.au/statistics/tables/#payments-system>.

<sup>18</sup> RBA, ‘The Changing Way We Pay: Trends in Consumer Payments’, June 2014, p. 37.

<sup>19</sup> Visa and MasterCard cards, on the other hand, are “must-take” cards. This is reflected in their combined share of Australian credit card volume of 81%. It is also reflected in the fact that, with the exception of those few credit card packages offered by

Amex cards are not “must-take”; merchants would be free to not accept Amex if Amex began charging unreasonably high service fees, safe in the knowledge that the customer would most likely have another credit card.

- **Amex does not operate on the basis of collective practices that could give rise to market power.** In other words, Amex’s behaviour cannot be construed as collective price setting and is fundamentally different from the practices that gave rise to IF regulation in the first place.<sup>20</sup> Put simply, in contrast to four-party schemes where acquirers pay issuers a common IF set by the four-party network, Amex either operates as (i) the sole issuer and acquirer or (ii) operates as the sole acquirer with confidential and bilaterally negotiated agreements with its issuers.

It follows from the preceding discussion that **Amex does not have the market power required to compel merchants to pay unreasonably high service fees.** To the extent that Amex charges higher fees, this must then reflect the additional value and services that Amex provides, including the fact that Amex customers spend on average around 37-44% more per transaction than Visa or MasterCard customers.<sup>21</sup>

What is more, the view that Amex does not have the market power required to compel merchants to pay unreasonably high service fees appears to be shared by the RBA:

*American Express cards are not as widely accepted as MasterCard and Visa cards, and are more often surcharged, or are surcharged at a higher rate. Merchants appear to be more comfortable declining acceptance or surcharging because they can be reasonably confident that an American Express cardholder is also holding a MasterCard or Visa credit card; the Bank’s 2013 Consumer Use Survey indicated that this was true in around 95 percent of cases.*<sup>22</sup>

### **3.1.4. Imposing IF regulation on Amex is contrary to the RBA’s objective to promote competition**

The preceding discussion explains that regulation in the name of “competitive neutrality” that raises the cost of a firm with no market power is liable to harm competition. It further explains that Amex has no market power. It follows that imposing IF regulation on Amex is contrary to the “competitive neutrality” objective; it is liable to harm competition and weaken Amex’s ability

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Amex’s four partnering banks, all bank-issued credit cards are either Visa or MasterCard.<sup>20</sup> RBA, ‘Reform of Credit Card Schemes in Australia – A Consultation Document’, December 2001, p. 117.

<sup>20</sup> RBA, ‘Reform of Credit Card Schemes in Australia – A Consultation Document’, December 2001, p. 117.

<sup>21</sup> Based on RBA, ‘Statistical Table: Market Shares of Credit and Charge Card Schemes – C3’, 13 April 2015, available at <http://www.rba.gov.au/statistics/tables/#payments-system>. The figures rely on a rolling 12-month average of the ratio of Amex/Diners value per transaction to MasterCard/Visa value per transaction for the 12 months up to and including March 2010 to the 12 months up to and including February 2015.

<sup>22</sup> Issues Paper, p. 33.

to constrain Visa and MasterCard, larger networks which the ACCC has viewed to have engaged in anticompetitive conduct.<sup>23</sup>

Amex lacks market power. It competes with Visa and MasterCard, whose cards are far more widely held by cardholders and accepted by retailers than Amex cards. This means that Amex must offer cardholders a better value proposition than Visa and MasterCard to induce them to take and use an Amex card, while offering retailers greater services or higher spending cardholders so as to make it worth their while accepting an Amex card. Put differently, since Amex does not have the scale to match Visa and MasterCard, to compete effectively it must differentiate itself by offering a higher quality product.

Caps on the fees Amex pays issuers would be likely to substantially harm Amex's ability to exert a competitive constraint on Visa and MasterCard. By restricting Amex's ability to remunerate issuing banks, a cap on the fees Amex pays its issuing partners would harm issuers' incentives to reward Amex cardholders. In turn, this would weaken the Amex scheme's ability to attract cardholders, making the scheme less attractive (i.e. lower quality) in the eyes of retailers. Lower retailer acceptance would further harm Amex's ability to attract cardholders.

- **The RBA should take special care to allow different business models to survive to promote consumer choice, product differentiation and ultimately greater scope for innovation.** IF caps for cards issued by banks on the Amex network would hinder the business model employed by Amex to compete to date. Regulation should not force all business models to be the same, in particular where a scheme lacks market power. Competitive neutrality is not well served by trying to commoditise the payments system market and forcing Amex to attempt to replicate the larger Visa and MasterCard schemes. Such "commoditisation" of Amex's offer would not increase competition but would reduce it. Amex cannot match the scale of Visa and MasterCard; it would be folly to try to take on such platforms with a commodity product given their vastly greater networks. Amex must compete by offering a differentiated product, with the fee structure that best suits that differentiated model.
- **Amex's merchant fees are justified by its higher quality and range of service.** Amex cardholders gain the benefits of extended credit terms, rewards, purchase protection, fraud protection and world class customer service, and Amex merchants gain the benefits of valuable high-spending customers, business insights, marketing, relationship management, superior fraud services and value of association with the Amex brand. A merchant who does not agree that Amex is worth its price premium need not accept Amex – which is what many Australian merchants do. Where merchants choose to accept Amex, however, it is because they are willing to pay a premium in return for its differentiated value offering. For instance, Amex offers merchants best-in-class fraud protection. Furthermore, Amex offers merchants the opportunity to benefit from marketing campaigns targeted at Amex cardholders, who (based on RBA data for the last five years) spend 37-44% more on average per

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<sup>23</sup> RBA, 'Reform of Credit Card Schemes in Australia – A Consultation Document', December 2001, p. 117.

transaction than Visa or MasterCard.<sup>24</sup> Given the additional revenue this provides to stores, it is unsurprising that stores are willing to pay higher merchant fees in order to attract these higher-spending customers into their stores rather than simply rely on customers using Visa, MasterCard, debit cards or even cash.

- **Merchant buyer groups are not required to constrain Amex MSFs.** This Policy Option is designed to redress the balance between weak retailers and powerful payment systems. However, because Amex lacks market power, there is no need for this policy to apply in the case of Amex cards.

Amex has been a pro-competitive force in the Australian payment card market and therefore applying the IF regulations to Amex is likely to harm competition in the payment card market, which would be contrary to the RBA's objective of "promoting competition in the market for payment services."

### 3.1.5. Identical regulatory treatment does not equal "competitive neutrality" or a "level playing field"

Visa and MasterCard have called for Amex to be regulated to create "a level playing field"; we consider that such concerns are misplaced.<sup>25</sup> It is important to emphasise that "competitive neutrality" does not necessarily mean identical regulatory treatment. Indeed, the Reserve Bank Act 1959 charges the RBA with "promoting competition in the market for payment services"; it does not require the RBA to treat all competitors the same regardless of their market power.

It is important not to confuse treating payment system operators the same with "competitive neutrality"; from a competition perspective, the two concepts are by no means equivalent. Competitive neutrality implies no adverse impact on competition. To illustrate, suppose that two competing firms are told by a regulator to compete less aggressively and that this results in a 10 dollar price rise. In that case, both firms are treated the same and are equally impacted; however, this intervention is not competitively neutral, since its effect is anticompetitive.

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<sup>24</sup> Based on RBA, 'Statistical Table: Market Shares of Credit and Charge Card Schemes – C3', 13 April 2015, available at <http://www.rba.gov.au/statistics/tables/#payments-system>. The figures rely on a rolling 12-month average of the ratio of Amex/Diners value per transaction to MasterCard/Visa value per transaction for the 12 months up to and including March 2010 to the 12 months up to and including February 2015.

<sup>25</sup> See Visa, 'Visa Inc. Response to the Financial System Inquiry (FSI) Interim Report', 26 August 2014, which states at page 2: "at a minimum, American Express must be included in the scope of any regulation, particularly because it no longer operates under only a three-party model, but instead operates under a four party model. This will have positive effects on the economy and create more competition and stability in Australia's payments landscape. To date, competition in the Australian payments system has not been operating equitably or freely. Evidence tells us that this has created unintended and undesirable negative consequences for the market." It further states that "[t]hree party schemes operating as four party schemes, such as American Express and Diners Club, can set any fees they like (i.e. and can offer more incentives as a result) as they are not subject to interchange fee caps. The current state of play creates an unfair and distorted market". See also Deloitte Access Economics (prepared on behalf of Visa), 'Competitive neutrality in payments', August 2014, which states at page 8 that "RBA regulations are distorting the competitive landscape. They are neither technology neutral nor competitively neutral; regulations are applied to some modes of payment but not others, and even payments which have the same economic substance are not covered by the same regulations". Similarly, MasterCard's comments in response to the Inquiry, from 31 March 2014, recommend on page 5 that "a level playing field be introduced, so that any regulation affecting MasterCard and Visa also apply to other providers, including American Express".

In some cases, it is better for competition to have different regulatory treatment of different types of firms, leaving firms without market power freer to constrain their rivals. The relevant question is not whether three-party systems benefit from four-party systems being regulated but what outcome best delivers stronger competition and hence a better outcome for consumers (not simply in terms of price but greater quality and innovation over time). If excluding three-party systems (including the licensing model) delivers *greater competition*, then it is irrelevant whether that policy imposes more restraints on four-party systems than on three-party systems.<sup>26</sup>

- **The playing field is currently tilted in favour of Visa and MasterCard.** The playing field can hardly be described as “level” at present given the respective sizes of Visa and MasterCard versus Amex and, notably, the absence of market power held by Amex.
- **Regulating Amex would not make the playing field more level but tilt it further in favour of Visa and MasterCard.** In particular, it would weaken Amex’s ability to increase competition in the payment systems market and is therefore liable to harm consumers (as explained above). This outcome would be contrary to the objective of “competitive neutrality”.
- **The regulation of IFs paid in the four-party schemes is sufficient to constrain the merchant fees charged by Amex.** If the cap on the IFs of four-party schemes is lowered, three-party schemes will be subject to even greater pressure to lower their own charges since (from a merchant’s perspective) their charges relative to Visa and MasterCard will be higher than before. The merchant’s threat to drop three-party schemes would become stronger because its option of relying only on four-party systems becomes even more credible than before.
- **Indeed, since IF caps were first imposed on four-party schemes in 2003, the average MSFs of both Amex and Diners Club have decreased.** Amex’s average merchant fee in September 2003 – the last time the RBA recorded average merchant fees before the IF caps came into effect – was 2.48%. Eleven years later, in December 2014, this figure was down 79 basis points to 1.68%. By comparison, the average merchant fee charged by Visa and MasterCard decreased by 62 basis points over the same period.<sup>27</sup> This strongly suggests that the capping of IFs has constrained Amex’s pricing ability, as well as Diners Club’s. The Issues Paper acknowledges this point when it states that “[d]espite there being no direct regulation of the ‘three-party’ schemes, merchant service fees in these systems have also fallen, with the decline in American Express’ fees slightly larger than that of MasterCard and Visa.”<sup>28</sup>
- **Amex growth as a share of debit, credit and charge cards has been limited since 2003.** Consumers have a wide choice of card payment options, whether credit, debit or

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<sup>26</sup> As is explained below, three-party schemes are indirectly constrained by regulation.

<sup>27</sup> RBA, ‘Statistical Table: Average Merchant Fees for Debit, Credit and Charge Cards – C3’, 13 April 2015. Note that these figures are based on the *total* fees charged to merchants and that therefore not only have Amex’s MSFs fallen since 2003 but its *overall* fees have fallen too.

<sup>28</sup> Issues Paper, p. 22.

charge cards. In volume terms, Amex's share of this segment has not grown at all. In the 12-month period, running from November 2002 to October 2003, that immediately preceded the imposition of the IF caps, Amex and Diners Club combined share averaged 5.12%; in the recent 12-month period, running from November 2013 to October 2014, their combined share averaged 5.09%. In terms of purchase value, also, Amex and Diners Club's share has hardly grown at all. From November 2002 to October 2003 their combined share of the total value of card purchases was an average of 10.33%; that average was up just 0.72 of a percentage point to 11.09% in the period November 2013-October 2014.<sup>29</sup>

- **Even excluding debit cards, Amex's growth since 2003 has been limited, while Visa and MasterCard have lost at most 4.6 percentage points of value share in over a decade of being regulated.** According to the RBA's figures, the value share of four-party schemes decreased from 85.4% in October 2003 to a 2014 average of 80.8%. Even taken on face value this decrease is not significant; three-party schemes have not even gained 5 percentage points of share despite having had more than a decade to "benefit" from four-party schemes being regulated. Moreover, there are two reasons to believe that these figures overstate the decrease in Visa and MasterCard's combined share of credit card transactions, both of which are acknowledged by the RBA in its latest Issues Paper.<sup>30</sup> Firstly, before January 2007, when the Bankcard association ceased to exist, the share figures for four-party schemes included Bankcard's share. The actual combined share of Visa and MasterCard before the introduction of the IF caps must therefore have been lower than 85.4%. Secondly, until March 2008, Visa and MasterCard's shares included debit card transactions processed through either network meaning, again, that the actual combined share of Visa and MasterCard credit card transactions before the introduction of the IF caps must have been lower than 85.4%. In other words, Visa and MasterCard would have lost *at most* 4.6 percentage points of share in the credit card segment in over a decade.<sup>31</sup>
- **Moreover, Amex's growth is most likely due to issuer innovation.** In general, Amex has not grown materially in countries where IF caps apply. For example, in Spain Amex has realised no share growth despite a regulator-induced reduction in Visa and MasterCard's IFs between 2005 and 2010. Similarly in France, where the IFs of the dominant schemes for domestic transactions were reduced to 0.28% by agreement with the French competition authority in 2013, Amex has gained no share. The difference between these two countries and Australia, where Amex *has* enjoyed modest growth in the recent past, is that, in Australia, Amex has helped its issuing partners roll out an innovative two-card product that pairs Amex with either a MasterCard or Visa card.

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<sup>29</sup> Calculated using a combination of the following RBA primary data sources: RBA, 'Credit and Charge Card Statistics - C1', 2014; RBA, 'Statistical Table: Market Shares of Credit and Charge Card Schemes - C2', 13 April 2015; and RBA, 'Debit Card Statistics - C5', 13 April 2015. These sources are available at <http://www.rba.gov.au/statistics/tables/#payments-system>.

<sup>30</sup> Issues Paper, p. 16.

<sup>31</sup> RBA, 'Statistical Table: Market Shares of Credit and Charge Card Schemes - C2', 13 April 2015. See, in particular, in the RBA's Notes: "[t]he figures for 'Bankcard, MasterCard and Visa' for months up to and including January 2007 include Bankcard data" and "[t]he 'Bankcard, MasterCard and Visa' market shares include debit card transactions processed through the MasterCard or Visa networks before March 2008."

This allows consumers to benefit from the greater rewards, premium services and innovative marketing offers available from Amex, while providing the reach of Visa/MasterCard. Merchants, in turn, benefit from the greater purchasing power of Amex holders. This indicates that product innovation was the likely driving force behind Amex's (limited) growth, *not* the IF caps.<sup>32</sup>

- **There is no basis to seek a restoration of the 2003 position.** This was a position endorsed in June 2006 by the House of Representatives' Standing Committee on Economics, Finance and Public Administration. As it pointed out, the RBA had concluded, before imposing the IF caps in 2003, that "the operation of a centrally set, unregulated interchange fee is inappropriate" from a competition law perspective and that any advantage Amex has enjoyed since the IF caps is only an advantage "when compared to the pre-reform situation" – a situation which the RBA has subsequently found to be "inappropriate".<sup>33</sup>

In summary, Amex is a procompetitive force and should be left free to exert an important competitive constraint on the four-party schemes which collectively have a share of credit/charge card transactions in excess of 80%. Subjecting Amex to IF regulation would weaken Amex's ability to increase competition in the broader payment systems sector and is therefore liable to harm consumers; this outcome would be contrary to the RBA's objective of promoting competition in the payments system.

## 3.2. Impact of the Policy Options on efficiency

This section addresses two forms of claimed cross-subsidisation. First we consider the extent to which it is better for efficiency to attempt to rebalance terms away from cardholders in favour of merchants. We consider this as a general proposition and also, specifically, in relation to the regulation of Amex. Second we address claims that consumers who use cards with lower MSFs cross-subsidise those who use cards with higher MSFs.

### 3.2.1. The impact of IF regulation on cardholders, consumers and merchants

The Issues Paper states that "*as suggested in the recent Financial System Inquiry... it is possible that existing caps are still inefficiently high.*"<sup>34</sup> The Inquiry states:

*"Payments system efficiency could be increased by lowering interchange fee caps. The Inquiry acknowledges that lowering interchange fee caps would disrupt business models and involve transitional costs. Lower interchange fee flows may cause some service providers to reduce customer rewards. The Inquiry considers that these costs would be outweighed by*

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<sup>32</sup> Amex, 'Submission to the Financial System Inquiry', May 2014, p.p. 6-7.

<sup>33</sup> House of Representatives' Standing Committee on Economics, Finance and Public Administration, 'Review of the Reserve Bank of Australia and Payments System Board Annual Reports 2005 (First Report)', June 2006, paras. 4.56-4.58.

<sup>34</sup> Issues Paper, p. 29.



lower product prices for all consumers, resulting from lower fees charged to merchants, and reduced cross-subsidisation” (emphasis added).<sup>35</sup>

In other words, the Inquiry presumes that lowering IFs further would remove an inefficient transfer from merchants (by way of MSFs) to cardholders (by way of customer rewards). However, such a presumption is unwarranted both as a matter of theory and empirical evidence.

It is important to take a step back and understand the fundamental “two-sided” nature of payment systems. The price mechanisms adopted in three- or four-party payment schemes must balance the need to attract consumers to the card scheme (for example, with rewards) with the need to attract merchants. As such, the “efficient” price may involve charging the merchant side relatively more than the consumer side. This is inherent in the two-sided nature of such systems and, thus, should not be termed a “cross-subsidy”, and however the pricing structure is described, it should not be presumed to be inefficient.

Turning to the academic literature, there is no theoretical justification for *assuming* that the lower the IF the better from a consumer welfare perspective.

- A privately-set IF (even one set by a scheme only concerned with maximising volume, as opposed to maximising consumer welfare) may actually be *lower* than the consumer welfare-maximising level.<sup>36</sup>
- An IF cap for credit cards determined by the issuers’ costs methodology (ICM), as is the case for IF caps in Australia at present, may be *below* the welfare maximising level.<sup>37</sup> Indeed, there is not a strong theoretical basis for using the ICM to set IFs. This is because the ICM fails to account for the benefits associated with different payment methods.<sup>38</sup>

Given the above, the implication is that a further lowering of IFs, which would reduce the use of regulated cards, may not be optimal even for four-party systems and thus even less likely to be optimal for three-party schemes without market power. That lower credit card usage is not necessarily pro consumer even if it is the most economically costly is a sentiment echoed by Stewart et al. (2014) which states that *“increased use of the lowest-cost payment system or less use of the higher-cost system does not necessarily imply better outcomes.”*<sup>39</sup>

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<sup>35</sup> The Inquiry, Final Report, November 2014, p. 173.

<sup>36</sup> Rochet, J-C and Tirole, J., ‘Must-take cards: merchant discounts and avoided costs,’ *Journal of the European Economic Association*, 2011, Volume 9, Issue 3, p.p. 462-495. Interestingly, the authors arrive at this result while all the time assuming that merchant cost pass-through is 100%. As explained below, imperfect cost pass-through is another reason to believe that lower IFs are not necessarily beneficial from the point of view of consumers.

<sup>37</sup> Rochet, J.-C., Wright, J., ‘Credit card interchange fees’, *Journal of Banking & Finance*, 2010, Volume 34, Issue 8, p.p. 1788-1797.

<sup>38</sup> Rochet, J-C and Tirole, J., ‘Must-take cards: merchant discounts and avoided costs,’ *Journal of the European Economic Association*, 2011, Volume 9, Issue 3, p.p. 462-495.

<sup>39</sup> Stewart, C., Chan, I., Ossolinski, C., Halperin, D. and Ryan, P., ‘The Evolution of Payment Costs in Australia’, Research Discussion Paper, December 2014.

Moreover, in seeking to devise optimal IF rules, the academic literature makes simplifying assumptions which have important implications for the level of the optimum IF. One critical assumption employed by leading authors is that the cost pass-through rate in the retail sector is 100%. In other words, a dollar reduction in MSFs gives rise to a dollar reduction in price.<sup>40</sup> This, of course, may very well not be the case. Indeed, the theoretical literature is, at best, agnostic about the likely degree of cost pass-through.<sup>41</sup> Ultimately, it is an empirical matter.

The degree of pass-through is important because merchants are not consumers; raising merchant profitability is not the same as increasing consumer welfare. Reducing card-holder benefits so as to reduce MSFs paid by merchants does not make consumers better off if merchants fail to pass-through lower MSFs to consumers. Indeed, **the available evidence for Australia indicates that the impact of IF regulation has led to substantial windfalls for merchants without any benefit to consumers.** In short, merchant fees have fallen but surcharging has risen, with no convincing evidence that consumers overall have benefitted from lower prices.

First, there exists powerful evidence that **merchant fees are lower now than they were before the current regulations took effect in 2003:**

- Average merchant fees for Visa and MasterCard have decreased since the introduction of the current IF regulation. Amex's average merchant fee in September 2003 – the last time the RBA recorded average merchant fees before the IF caps came into effect – was 2.48%. Eleven years later, in December 2014, this figure was down 79 basis points to 1.68%. By comparison, the average merchant fee charged by Visa and MasterCard decreased by 62 basis points over the same period.<sup>42</sup> The Issues Paper states that these fee reductions may have benefited merchants by as much as \$13 billion relative to the amount they would have paid since November 2013 had MSFs remained at the rates existing prior to IF regulations.<sup>43</sup>
- The recent introduction of cards issued by banks on the Amex network has not led to any increase in average merchant fees for Amex cards.<sup>44</sup>

On the other hand, **there is no compelling evidence of merchants passing through any of this reduction in merchant fees to consumers:**

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<sup>40</sup> For instance, see: Rochet, J-C and Tirole, J., 'Must-take cards: merchant discounts and avoided costs,' *Journal of the European Economic Association*, 2011, Volume 9, Issue 3, p.p. 462-495. The authors assume (p. 469) that "the retail price moves one for one with retail cost."

<sup>41</sup> For example, see RBB (prepared on behalf of the UK's Office of Fair Trading, 'Cost pass-through: theory, measurement, and potential policy implications', February 2014, available at <https://www.gov.uk/government/publications/cost-pass-through-theory-measurement-and-policy-implications>.

<sup>42</sup> RBA, 'Statistical Table: Average Merchant Fees for Debit, Credit and Charge Cards – C3', 13 April 2015. Note that these figures are based on the *total* fees charged to merchants and that therefore not only have Amex's MSFs fallen since 2003 but its *overall* fees have fallen too.

<sup>43</sup> Issues paper, p. 23.

<sup>44</sup> Chan, I., Chong, S. and Mitchell, S., 'The Personal Credit Card Market in Australia: Pricing over the Past Decade', March 2012.

- The RBA concedes that there is no convincing evidence of merchants passing on any fraction of (let alone the entirety of) the reductions in merchant fees. In 2008, when reviewing the current IF regulation, the RBA admitted that “[n]o concrete evidence has been presented to the [Payments System] Board regarding the pass-through of [merchant] savings.”<sup>45</sup> It appears that no such evidence has been produced since then either as the Issues Paper relies on an unsubstantiated assumption: “just as with reductions in any other business costs – such as wages, taxes, the cost of energy, etc – that influence the prices charged by business in any industry, it seems reasonable to assume that they have mostly flowed through to lower retail prices for consumers, just as it is reasonable to assume that increases in merchant costs are similarly passed on to consumers over time”<sup>46</sup> (emphasis added).
- We note that as a matter of theory, where markets are subject to industry-wide cost reductions (which is in essence what the Policy Options seek to achieve by lowering IFs), pass-through is more likely where competition is strong (all else equal).<sup>47</sup> That is to say, even if competition among acquirers on four-party systems causes lower IFs to be passed-through substantially as lower MSFs, merchants themselves (in markets where they are subject to relatively limited competition) are less likely to pass-through these gains to consumers. In other words, market power among merchants may be one of the reasons that much of the gain from any IF reduction stays with merchants.<sup>48</sup>

However, the evidence does indicate that **cardholders have suffered from greater surcharging**:

- **Since the prohibition of the “no surcharge” rules in 2003, there has been a “steady increase in the number of merchants that levy a surcharge.”**<sup>49</sup> RBA data indicate that in December 2006, 14% of very large merchants surcharged, while 5% of very small merchants did so.<sup>50</sup> By December 2010, more than three times as many large merchants were surcharging, while the number of small merchants doing so had increased dramatically (by 500%).<sup>51</sup>
- **Many merchants now surcharge.** According to a survey prepared for the RBA, almost 30% of all merchants imposed a surcharge on at least one of the credit cards they accepted in December 2010. Furthermore, the majority of those that did not were

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<sup>45</sup> RBA, ‘Reform of Australia’s Payments System: Preliminary conclusions of the 2007/08 Review’, April 2008.

<sup>46</sup> Issues Paper, p. 23.

<sup>47</sup> See RBB, ‘Brief 48: The price effect of cost changes: passing through and here to stay’, 18 December 2014, p.2, available at <http://www.rbbecon.com/publications/brief-48-the-price-effect-of-cost-changes-passing-through-and-here-to-stay/>.

<sup>48</sup> For example, the Productivity Commission, ‘Economic Structure and Performance of the Australian Retail Industry’, November 2011, states at page 36 that “[c]oncerns have been raised in Australia about the level of market concentration in various parts of the retail industry”.

<sup>49</sup> RBA, ‘Reform of Australia’s Payments System: Issues for the 2007/08 Review’, May 2007, p. 18.

<sup>50</sup> RBA, ‘Reform of Australia’s Payments System: Issues for the 2007/08 Review’, May 2007.

<sup>51</sup> RBA, ‘Review of Card Surcharging: A Consultation Document’, June 2011.

considering doing so, with only around 20% of merchants stating that they did not plan to surcharge.<sup>52</sup>

- **Surcharge levels have increased in recent years.** According to an RBA-commissioned survey published in 2007, the average surcharge on Visa and MasterCard cards was around 1%, while the average surcharge on Amex and Diners Club cards was around 2%. By December 2010, the average surcharge had risen to 1.9% on Visa, 1.8% on MasterCard, 2.9% on Amex and 4% on Diners Club.<sup>53</sup>
- **Average surcharge levels exceed average merchant fees.** This is true of all card brands; average surcharge levels are around 1 percentage point higher than merchant fees for Visa, MasterCard and Amex cards, and around 1.8 percentage points higher for Diners Club cards.<sup>54</sup>

As well as being worse off because of the rise in surcharging, cardholders are worse off due to the lower rewards and higher interest rates that have followed the introduction of the current IF regulations:

- **Cardholder rewards have decreased in value since 2003.** Based on a sample of cards analysed by the RBA, the effective average rebate in a “standard” rewards program – as calculated from the spending on a Visa/MasterCard required for a shopping voucher of a given amount – has fallen from around 0.81 per cent in June 2003 to 0.49 per cent in December 2013.<sup>55</sup> We understand that the value of Amex rewards has also decreased since the current IF regulations first came into force.
- **Interest on credit card debt has increased since 2003.** Interest on standard and low-rate cards appears to have increased since the introduction of the IF regulations while fees have been steady.<sup>56</sup>

In summary, the available evidence suggests that the current IF regulation has made cardholding consumers worse off, without any clear evidence of lower retail prices for non-cardholders. Indeed, given the prevalence of cardholders, this indicates a plausible reduction in consumer welfare caused by IF regulation.<sup>57</sup>

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<sup>52</sup> RBA, ‘Review of Card Surcharging: A Consultation Document’, June 2011.

<sup>53</sup> RBA, ‘Review of Card Surcharging: A Consultation Document’, June 2011.

<sup>54</sup> RBA, ‘Review of Card Surcharging: A Consultation Document’, June 2011.

<sup>55</sup> RBA, ‘Submission to the Financial System Inquiry’, March 2014. See, also Chan, I., Chong, S. and Mitchell, S., ‘The Personal Credit Card Market in Australia: Pricing over the Past Decade’, RBA Bulletin, 2012, p. 57 (“in 2003 the average spending required to earn a \$100 shopping voucher was \$12,400, whereas by 2004 this had risen to \$14,400, and has gradually increased since then, to \$18,400 in 2011”).

<sup>56</sup> Issues Paper, March 2015, p. 18.

<sup>57</sup> Graph 7 on page 21 of the Issues Paper shows that, according to the 2013 Consumer Use Survey, roughly 40% of those respondents in the lowest income quartile held credit cards, while nearly 80% of those in the highest quartile held credit cards. Corresponding percentages with respect to the second and third quartiles were between these two figures.

### 3.2.2. The impact of IF regulation on MSFs for Amex cards

The RBA itself has cast doubt on the merit of regulating Amex payments to its issuers, stating that in three-party schemes the MSFs fund the payments to issuers (as opposed to the reverse):

*“In the MasterCard and Visa systems, interchange fees are an important determinant of merchant service fees, while in the American Express arrangement with its partner banks, the causation runs the other way – merchant service fees are an important determinant of interchange fees. This reflects differences in the nature of competition for acquiring services. In the MasterCard and Visa systems there are many banks competing for merchant acquiring business, with the interchange fee effectively putting a floor under merchant service fees. In contrast, in the American Express and Diners Club schemes, there is no competition in acquiring; merchants that wish to accept American Express cards, for example, must strike a deal with American Express. In these circumstances, the merchant service fee is determined by the ability of a merchant to bargain with the scheme. Interchange fees paid by these schemes to issuers are, in turn, not fixed but depend upon by the amount of revenue that can be earned through merchant service fees.”<sup>58</sup>*

That issuing fees are not an important determinant of Amex’s MSFs is attested by the growth in cards issued on the Amex network by bank issuers. Under the Amex Global Network Services model, Amex licenses issuers and pays them issuer fees. When bank-issued Amex cards were introduced in the 2000s, the MSFs that applied were based on pre-existing agreements with merchants. Further, there was no renegotiation with merchants when such cards proved to be popular with consumers.

The two-sided nature of payment systems means that there are several inter-related influences on MSFs. On the one hand, as the RBA indicates above, the MSF funds how much Amex can pay its issuers. On the other hand, a merchant’s willingness to pay MSFs is determined by the extent to which Amex can differentiate itself from MasterCard and Visa by offering an attractive cardholder base and valuable services to merchants. Intervention that harms Amex’s ability to attract consumers weakens the appeal of the Amex scheme, *lowering its quality* and weakening its ability to compete with Visa and MasterCard.

This raises an important point. Where lowering the MSF that Amex negotiates with merchants arises primarily as a result of intervention forcing Amex to operate at a lower quality level, this is not a genuine MSF reduction (because the level of quality is not held constant).

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<sup>58</sup> RBA, ‘Reform of Australia’s Payments System: Issues for the 2007/08 Review’, May 2007, p.p. 12-13.

### 3.2.3. Alleged transfer from consumers using lower MSF cards to those using higher MSF cards

The Issues Paper raises the concern that “cardholders may not face the correct price signals associated with their choices, which is likely to result in cross-subsidisation and less pressure to reduce the cost of payments”.<sup>59</sup> The Issues Paper also notes the concern in the Inquiry that there is cross-subsidisation in the payments system.<sup>60</sup>

The Inquiry claims that IF caps prevent cardholders who use cards with low MSFs and low rewards (non-premium cardholders) from cross-subsidising premium cardholders (i.e. those who use cards with higher benefits and high MSFs). The assertion is as follows:

- premium and non-premium cardholders pay the same retail price even though premium customers impose a greater cost per dollar spent on retailers;
- as a result, consumption decisions are distorted; and
- the distortion is *inefficient*.

The preceding concern does not provide a sound basis for imposing regulation on Amex.

It cannot be presumed that attempting to redistribute funds from premium cardholders to non-premium cardholders is beneficial for efficiency. For example, if the impact of the IF cap is to substantially reduce expenditure by premium cardholders (for example, because their available rewards fall dramatically) while non-premium consumers hardly benefit (for example, because retail prices hardly fall), then overall consumption may fall. Such an outcome would be consistent with an overall consumer welfare reduction.

To the extent that the objective of the Policy Options is to use price regulation to achieve income distribution, this would be inefficient and largely ineffective. Tackling income inequality can be addressed directly through fiscal measures as opposed to seeking to regulate the extent to which Amex is able to make payments to issuers of Amex cards. The former tackles the concern directly, while the latter would, at best, impact on income inequality indirectly and is liable to have unintended consequences, such as limiting the competition provided by Amex in the payments sector. Moreover, as explained in section 3.2.1 above, there is no convincing evidence to suggest that IF (and associated surcharging) regulation has led to lower prices for any consumers.

Finally, we emphasise that it is important not to muddle efficiency and “fairness”. It might be argued that it is “unfair” that premium cardholders pay the same as non-premium cardholders. However, that argument would be weak for a number of reasons. First, the RBA’s objective is efficiency and not fairness (and, as explained, it is unlikely that the IF Policy Options would increase efficiency).

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<sup>59</sup> Issues Paper, p. 25.

<sup>60</sup> Issues Paper, p. 36.

Second, the notion of “fairness” is subjective; it is commonplace that consumers impose different costs on retailers but are nonetheless charged the same price without that necessarily seeming (at least for most people) “unfair”. For example:

- consumers who prefer to shop in supermarkets at times when the store must pay premium wages (for example, due to weekend work or late shifts) but who nonetheless pay the same price as consumers who shop during other times (when wages are lower);
- consumers who make use of free-parking services for accessing a store but who pay the same as those who arrive by another mode of transport;
- consumers who take greater advantage of the in-store pre-sales service offered by some specialist stores to educate them about the store’s products (such as in some consumer electronic and hardware stores);
- consumers who return clothes or other products to a department store to exchange them for different items; and
- a group of consumers who purchase the same set menu in a busy restaurant as another group of the same size but who take three times as long to finish their meal (thereby preventing the restaurant from serving other customers at that table).

### **3.3. Conclusion on the IF Policy Options**

In summary, Amex lacks market power; its share of credit card transactions is low and it is not a must-take card. The implication is that its MSFs are not excessive; higher fees must be matched by higher merchant benefits. Intervention to disrupt its differentiated business model would force Amex to operate at a less efficient scale and a lower level of quality.

In turn, the Policy Options are likely to harm Amex’s ability to compete with Visa and MasterCard. Including Amex in the IF Policy Options, therefore, is contrary to the RBA’s objective of promoting competition.

Further, we find that the available evidence suggests that the current IF regulation has made cardholding consumers worse off, without any clear evidence of lower retail prices for non-cardholders. Indeed, given the prevalence of cardholders, this indicates a plausible reduction in consumer welfare caused by the current IF regulation.

The claim that efficiency would be improved by shifting funds from premium cardholders to non-premium cardholders is not convincing. Evidence has not been presented to demonstrate that different MSFs on premium and non-premium cards reduces consumption and it seems particularly unlikely that IF caps applied to Amex would give rise to a substantial increase in consumption.

Importantly, we note that to the extent that the aim is to force Amex to lower MSFs, it is sufficient to regulate the IFs of four-party systems; the evidence to date shows clearly how IF regulation of four-party systems has induced Amex to lower its MSFs.



## 4. Summary of the current regulations and the Policy Options regarding surcharging

This section describes both the current laws regulating surcharges and the Policy Options regarding surcharging, and their implications for whether the Amex card scheme may be subject to new or additional regulation.

### 4.1. Current surcharging regulations

The key aspects of the current surcharging regulations are as follows:

- **Visa, MasterCard and Amex are prohibited from imposing “no surcharge” rules on merchants.** Taking effect in January 2003, the Merchant Pricing Standard removed the “no surcharge” rules of Visa and MasterCard. Amex agreed to comply with the merchant pricing standard through an undertaking.
- **Merchants’ surcharges must be reasonable and reflect the cost of accepting payment by card.** This regulation came into effect in 2013, following the RBA’s decision in May 2012 to amend the Merchant Pricing Standard. We understand that this amendment was strongly advocated by Visa and MasterCard.<sup>61</sup>

### 4.2. Surcharging Policy Options

We understand that the surcharging Policy Options contemplate the following measures, which draw on the Inquiry’s recommendations:

- **Different caps on surcharges depending on the category of payment.** The three-tiered surcharging proposal suggests that the amount a merchant can surcharge should depend on which of the following three categories the payment method falls into:
  - **low-cost**, i.e. below the debit IF cap, in which case surcharging is banned.
  - **medium-cost**, i.e. below the credit IF cap, in which case set surcharge limits apply. If the IF regulation is extended to bank-issued Amex cards then they may be classified as “medium-cost”, in addition to all cards of Visa and MasterCard.
  - **higher-cost**, in which case the merchant can surcharge as much as it chooses to up to the “reasonable cost” of accepting that form of payment. Presuming that Amex-issued cards will not be subject to the new IF regulation, they may be classified as “higher-cost”. The consequence of this is that Amex cards issued

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<sup>61</sup> MasterCard Worldwide, ‘Response to Reserve Bank of Australia Review of Card Surcharging.’ 20 July 2011, p. 16, available at <http://www.rba.gov.au/payments-system/reforms/submissions-card-surcharging/mastercard.pdf>. Visa, ‘Reserve Bank of Australia Review of Card Surcharging,’ July 2011, p. 4, available at <http://www.rba.gov.au/payments-system/reforms/submissions-card-surcharging/visa.pdf>.

directly by Amex may be subject to much higher surcharges than the cards of Visa and MasterCard. Furthermore, there is a risk that some merchants will mistake bank-issued Amex cards for Amex-issued Amex cards and surcharge the former at the “higher-cost” level.

- **Targeted changes to reduce particular cases of excessive surcharging.** The Merchant Pricing Standard or Guidance Note could be amended to allow schemes to cap any surcharges that are not percentage-based at some low fixed-dollar amount.
- **Further easing of “honour-all-cards” rules to allow merchants to decline to accept cards with high IFs.** The restrictions which allow merchants to make separate decisions on credit and debit cards could be extended to allow merchants to decline high-cost cards within a particular scheme.
- **Facilitation of differential surcharging by merchants.** To the extent that the acquirers do not provide the ability to merchants to surcharge differently based on the nature of the cards, card schemes and acquirers could be required to provide merchants with this ability. This might be supplemented with controls on scheme rules or contractual terms that prevent merchants from informing consumers about the cost of IFs or MSFs.

## 5. Assessment of the impact of the surcharging Policy Options on competition and consumer welfare

This section comments on the Policy Options relating to surcharging. In particular, it assesses the competitive merits of firms without market power being permitted to ban surcharging; it then goes on to assess the potential impact on consumer welfare of the surcharging Policy Options.

### 5.1. Banning surcharging can benefit competition and consumers

By way of background, it is helpful to set out why “no surcharge” rules may benefit competition and consumers and hence why, as a matter of principle, Amex is opposed to surcharging.

Competition law permits firms without market power contractual freedoms in how they manage their business to allow such firms to put in place pro-competitive investments that facilitate their ability to compete with rivals. A rule that prohibits surcharging is an example of a vertical restraint. In general, vertical restraints between firms without market power are benign or pro-competitive.<sup>62</sup> **Amex lacks market power and so, in the event that it sought to limit surcharging, this would be expected to be pro-competitive.**<sup>63</sup> For example:

- **By prohibiting surcharging (as well as other forms of steering), merchants are prevented from *free-riding*** for example, using the Amex brand to attract premium customers into their outlets only then to steer them to a rival payment scheme (for example, by verbally urging the use of another card, imposing a surcharge on Amex cards, or refusing certain Amex cards entirely). Similarly, a merchant may free-ride by taking the greater benefits of being on the Amex system (such as valuable high-spending customers, business insights, marketing, relationship management and superior fraud services) while seeking to avoid contributing fully to the costs of that system by steering Amex cardholders to pay with cards of rival schemes.
- Ex post steering risks sending the message to Amex cardholders that their chosen method of payment is somehow unwelcome despite the fact that the merchant has chosen freely to accept Amex cards and typically states that it accepts Amex cards wherever payment options are disclosed. This must also be seen in the context of Amex being a differentiated brand which is associated with superior benefits and services. In other words, **steering away from Amex cards would create a customer experience that directly undermines that differentiated product, thereby harming the ability of Amex to constrain four-party schemes.**
- **Some cardholders will pay the surcharge; they are therefore made worse off, reflecting a transfer from the cardholder to the merchant.** As has been explained in Section 3.2 above, the available evidence suggests that the current IF regulation has

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<sup>62</sup> See Section 3.1.2, above, for references.

<sup>63</sup> More generally, any vertical restraint, such as an “honour-all cards rule” would be expected to be benign or pro-competitive when carried out by a firm without market power.

made cardholding consumers worse off. There is no convincing evidence that retail prices have fallen in line with the reduction in MSFs; however, there is evidence of reduced cardholder benefits and increased surcharging. In the latter case, for example:

- Surcharge levels have increased in recent years. According to an RBA-commissioned survey published in 2007, the average surcharge on Visa and MasterCard cards was around 1%, while the average surcharge on Amex and Diners Club cards was around 2%. By December 2010, the average surcharge had risen to 1.9% on Visa, 1.8% on MasterCard, 2.9% on Amex and 4% on Diners Club.<sup>64</sup> These surcharge levels are higher than the average merchant fees for these cards, which as of December 2014 were 0.83% for MasterCard and Visa, 1.68% for Amex and 2.10% for Diners.<sup>65</sup>
- Further, Amex cards are surcharged more often than either Visa or MasterCard cards.<sup>66</sup>

## 5.2. The 2013 regulation should be given time to take effect

The 2002 surcharging regulations have only just been updated. Specifically, on 18 March 2013, following concerns that surcharges were too *high* (as opposed to too low, which was the concern underpinning the banning of previous “no surcharge” rules), the RBA introduced additional regulation allowing credit card companies to impose rules to restrict the surcharge imposed by merchants to the reasonable cost of acceptance.<sup>67</sup>

In other words, having intervened to *permit* surcharging in 2002, the RBA intervened again in 2013 to *limit* surcharging. It is now contemplating a further – more complex – intervention on the basis (as set out in the Inquiry’s Final Report) that “*current rules may be difficult for schemes to enforce, potentially complex for merchants to comply with and can cause frustration for consumers.*”<sup>68</sup>

However, the fact that these regulations are difficult for payment systems providers to enforce does not justify a dramatic escalation of regulatory intervention in surcharging.

- **The surcharging Policy Options risk *encouraging surcharging* for medium and higher cost cards, by creating a clear focal point/price floor for retailers to adopt.** Creating the three-tier system for surcharging risks the following unintended consequences. By defining an “acceptable” level of surcharging, merchants with surcharges below that level may simply price up to it. Put another way, the legislation

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<sup>64</sup> RBA, ‘Review of Card Surcharging: A Consultation Document’, June 2011.

<sup>65</sup> RBA, ‘Statistical Table: Average Merchant Fees for Debit, Credit and Charge Cards – C3’, 13 April 2015. Note that these figures are based on the *total* fees charged to merchants and that therefore not only have Amex’s MSFs fallen since 2003 but its *overall* fees have fallen too.

<sup>66</sup> RBA, ‘Submission to the Financial System Inquiry’, March 2014.

<sup>67</sup> RBA, ‘Reforms to Payment Card Surcharging’, March 2013, available at <http://www.rba.gov.au/payments-system/surcharging/index.html>.

<sup>68</sup> Issues Paper, p. 31.

would potentially create a *focal point* for merchants when surcharging medium cost cards and a *floor* for surcharging higher cost cards. This could give rise to a shift upwards in price levels.<sup>69</sup>

- **The proposed surcharging Policy Option is likely to be even more complex and singles out Amex for greatest harm.** There would be three levels of surcharging and, at least for Amex, there would likely be some cards of the same brand which would be subject to different levels of surcharges. This could harm Amex as potentially cards which would fall under the “medium cost” category may be inadvertently treated as “high cost” by merchants.
- **As recognized by the Issues paper, concerns over excessive surcharging are focused on specific sectors, such as the airline and taxi industry.** Excessive surcharging by taxi drivers can and is being dealt with by individual states. In Australia, taxis are regulated on a state-by-state basis. Individual states are therefore well placed to deal with the problem themselves of excessive surcharging by taxis. Indeed, as the Issues Paper points out, certain states have already dealt with the problem by introducing a 5% surcharge cap.<sup>70</sup> **The regulation has only just been implemented and needs time to bed down.** The fact that some credit card companies have had difficulty in enforcing these rules does not justify dramatically changing the regulation, not least because many of those same difficulties would still arise in relation to higher-cost schemes.<sup>71</sup> Three- and four-party schemes do not have the incentive to allow excess surcharging of their cards and so over time should be well placed to discourage unreasonable surcharging by merchants.<sup>72</sup>

### 5.3. Conclusion on surcharging Policy Options

As a matter of principle, Amex is opposed to rules that prevent surcharging. Where payment schemes (such as Amex) lack market power, preventing merchants from surcharging can reduce merchant free-riding and allow smaller three-party schemes to compete more effectively with larger, four-party ones.

Even if the Merchant Pricing Standard were not removed, there is not a strong case for amending it. The amendments to the Merchant Pricing Standard (introduced in 2013) have had limited time to bed down. Card schemes have both the incentive and ability to educate merchants as regards what surcharge would exceed the reasonable cost of acceptance. To

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<sup>69</sup> In line with a concern that merchants have a strong desire to surcharge, the Inquiry's Final Report suggests that “[t]he PSB should also consider whether mechanisms are required to prevent merchants from only accepting payment methods they can surcharge.” Inquiry, ‘Final Report’, November 2014, p. 206.

<sup>70</sup> Issues Paper, pp. 20 and 31-31. The Issues Paper also suggests (p. 32) that “online commerce is likely to be more susceptible to excessive surcharging than ‘bricks and mortar’ retailers.”

<sup>71</sup> Amex considers that four-party schemes argued vociferously for the 2013 regulation and have now backtracked. Amex further considers that instead of investing in educating merchants to make the current regulation work, four-party schemes have in effect asked the regulators to use public resources to achieve their aims. See, for instance: Amex, ‘Submission to the Financial System Inquiry’, May 2014, p. 3.

<sup>72</sup> For example, Amex communicated to the entire merchant base, its updated terms and conditions when the changes to the surcharging rules were introduced.

impose yet another change in the Merchant Pricing Standard seems excessive at this point in time.

Moreover, the three-tiered surcharging option risks the unintended consequence of *greater surcharging* on medium and higher cost cards, thereby raising the price level and, in the process, harming consumers.

Additionally, the complexity of the proposed three-tiered system risks causing disproportionate harm to Amex. Under the proposed system there may be some Amex cards subject to “medium-cost” surcharging and others subject to “higher-cost” surcharging. This may harm Amex as potentially cards which would fall under the “medium cost” category may be inadvertently treated as “high cost” by merchants.

For the reasons above, and given that the RBA appears unwilling to allow card schemes with no market power to ban surcharging on their cards, there is a strong case for leaving the Merchant Pricing Standard unchanged.