

Eddie Grobler
Executive Vice President, Australasia

MasterCard Worldwide
Asia/Pacific, Middle East & Africa
Level 8, 100 Arthur Street
North Sydney NSW 2060
Australia

tel +61 2 9466 3722
fax +61 2 9954 4716
mob 0423 825 098
eddie_grobler@mastercard.com
www.mastercard.com.au



10 February, 2012

Dr Chris Kent
Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

Dear Dr Kent

Surcharging Consultation

MasterCard has reviewed the Reserve Bank of Australia's paper "A Variation to the Surcharging Standards: A Consultation Document" and, consistent with our ongoing engagement with the RBA on this and other important issues affecting payments in Australia, we offer our observations below.

From the outset, we wish to emphasise MasterCard's belief that it is consumers who are the most disadvantaged by surcharging and it is with them firmly in mind that we make this submission.

Our position on surcharging of card transactions in Australia has remained consistent throughout the various regulatory discussions. The unique nature of the Australian market, where a limited number of retailers dominate market-share in major merchant categories (grocery, airlines, taxis to name just three) meant that surcharging, once commenced, would quickly become prevalent in concentrated merchant segments where competitive, geographic and or channel forces were not sufficiently strong enough to impact the frequency of surcharging.

We reiterate our observations in Australia, compounded by the competitive dynamics of the retail industry, that surcharging actively discourages the most beneficial form of payment to merchants and consumers and as such, merchants should not be allowed to discriminate against payment cards by surcharging consumers for their use. In passing on the costs of accepting cards to consumers, merchants are failing to recognise the numerous benefits of card acceptance which in most cases far exceed the costs. These benefits include protection from fraud and defaults in the form of MasterCard's payment guarantee, virtually instant payment into their account and incremental sales.

The RBA itself noted some of the problems with surcharging in the consultation document. It set forth three alternatives that in some way restrict a merchant's ability to surcharge consumers paying with cards without reference to the cost of accepting those cards. While the first two options would effectively create a regulatory cap imposed by the RBA directly, the third option leaves some discretion to the networks to manage the impact that surcharging has on consumers. It is important to note that measures to manage or mitigate surcharging practices (in contrast to measures that would

ban surcharging) add additional costs to the various stakeholders and, ultimately to the payment system – not least in the clear additional administrative burden for banks, merchants and networks. Of course, surcharging of card transactions also assumes the cost of alternative forms of payment are free. Something we, and numerous economic studies around the world, reject absolutely.

We note the RBA's intention to continue to allow surcharging and as such, provide the following comments on how best to amend the regulatory regime to allow merchants the ability to pass on to consumers their costs of accepting cards while also ensuring consumers are protected from gouging. To that end, we welcome the acknowledgement by the Reserve Bank of Australia (RBA) of the growing and concerning trend by some Australian merchants to levy excessive and/or blended surcharges. This is something that was clearly not consistent with the original intent of the RBA's decision to allow surcharging in 2003. In announcing the reforms in 2002, the Governor of the Reserve Bank, Ian Macfarlane said:

“The Payments System Board has endorsed a balanced set of reforms which will ensure that normal market mechanisms work in a more transparent and effective way in the Australian payments system, to the benefit of the Australian community as a whole.”¹

MasterCard welcomes the RBA's preference for Option 3

In the absence of a complete ban on surcharging, MasterCard supports Option 3, as we believe that allowing the schemes to place reasonable restrictions on a merchant's ability to surcharge will provide welcome relief for consumers. MasterCard welcomes this option but we do seek some clarification in the implementation in order to fully protect consumers. This is covered in more detail below.

There must be an explicit ban on blended surcharges across payment brands

As stated in our submission to the first round of consultation, the increasing trend toward blended surcharging (*i.e.* the assessment of the same surcharge for use of multiple payment card brands, regardless of the relative costs of those brands) by merchants has been of great concern to MasterCard as it has meant that MasterCard cardholders are subsidizing customers who choose to pay with the more expensive American Express product.

Among the RBA's goals in establishing the Standards was to enable merchants to provide an incentive to consumers to use a lower-cost payment card brand instead of a more expensive one, or to use another form of payment altogether. Where a merchant applies the same surcharge to all card schemes, this ability to provide 'price signals' is eliminated. A consumer is not being given an incentive to use the card of one brand instead of another; rather, the merchant is simply recovering its costs of the higher-cost scheme while deriving additional revenue from users of lower-cost payment cards. We are aware that the increased prevalence in blended surcharging has been actively encouraged by the higher cost and unregulated schemes through financial incentives and/or contractual obligations with merchants.²

As indicated in the RBA's latest Consultation Document the Payment Systems Board's preferred Option 3 is intended to discourage blended surcharging, but does not ban it explicitly.

¹ RBA Media Release, 27 August 2002 “Reform of Credit Card Schemes in Australia”

² MasterCard Worldwide, “Response to RBA Review of Card Surcharging”, 20 July 2011 (<http://www.rba.gov.au/payments-system/reforms/submissions-card-surcharging/mastercard.pdf>)

The Board also recognises that this variation does not explicitly prohibit the practice of blended surcharging across card schemes. However, given that the variation allows scheme rules to limit surcharges to the cost of acceptance, under such rules any blended surcharge would be limited to the lowest cost of card acceptance, ensuring that blended surcharging is not also associated with excessive surcharging for lower-cost schemes. Further, to the extent that blended surcharges are set at the cost of acceptance of the lower-cost scheme, the variation is likely to discourage the practice of blended surcharging because the merchant will not be recovering its acceptance costs overall.³

We believe it would be best to explicitly prohibit the practice of blending surcharges. To allow it in the context of regulation of the four party schemes and no regulation of three party schemes – the major beneficiary of blended surcharges – creates an obviously unbalanced market.

Whether a merchant sets a blended surcharge for all cards it accepts at the level of the highest cost branded card or a lower cost branded card, the RBA's stated rationale for permitting surcharging is undermined. A blended surcharge across all card schemes set at the acceptance cost of American Express provides an inaccurate signal to the consumer concerning the merchant's lower cost of accepting MasterCard cards. A blended surcharge for all brands set at the merchant's cost of accepting MasterCard cards provides an inaccurate signal to the consumer concerning the merchant's higher cost of accepting American Express. And, in either scenario, MasterCard cardholders are effectively subsidising the merchant's costs of accepting American Express cards. This allows American Express to continue to reinvest these higher costs charged to merchants back to their own cardholders in the form of higher reward points. Indeed, the RBA in their latest document highlight blended surcharging ("often at a rate above the cost of the lower cost card") as a specific area of concern:

These practices are inefficient because they can cause consumers to underutilise a particular payment method. For instance, when the costs of card acceptance differ across card schemes and the merchant applies a blended surcharge, the consumer may have an incentive to use the higher-cost card more intensively than would be the case if the surcharges reflected the cost of acceptance for each card product. This is particularly the case if higher merchant fees are being used to fund more generous reward schemes. If the blended surcharge is at a level above the cost of acceptance of the lower-cost card, the lower-cost card is also likely to be underutilised relative to other payment methods, not just the higher-cost card. A potential flow-on effect from this is that such practices dull the incentive for the card schemes to compete down their effective costs to merchants.⁴

At least one merchant who today blends their surcharge is on the record as stating that the acceptance of Option 3 would allow them to continue this practice. Speaking in *The Australian Financial Review* on 20th December 2011, Qantas spokesperson Thomas Woodard said the \$7.70 that his organisation charges for the card purchase of a domestic fare did not reap a profit for the airline.

"We do not use surcharges to recover more than the costs of accepting credit cards. We welcome the RBA's statement that merchants must continue to have the ability to fully recover these costs."

³ Reserve Bank of Australia, "A Variation to the Surcharging Standards: A Consultation Document", December 2011 (<http://www.rba.gov.au/publications/consultations/201112-variation-surcharging-standards/pdf/201112-variation-surcharging-standards.pdf>)

⁴ Ibid

While Qantas may state they do not profit from surcharging, it is clear given the differential in costs of accepting (unregulated) American Express and (regulated) MasterCard products – currently 1.02 per cent according to the RBA’s own data collection⁵ – that surcharges on payments by MasterCard products are used to subsidise the acceptance of payments made on American Express products. The suggestion that were the RBA to move ahead with Option 3, merchants could continue to blend surcharge as they do today, should sound an alarm for consumers and the RBA. We believe this to be an unacceptable position for a regulator to knowingly allow and we must insist on the RBA specifically prohibiting the practice of blending surcharges.

This is vitally important if, as the RBA has previously and regularly stated, the intention of surcharging is to offer transparency of costs to consumers and that this subsequently applies downward pressure on merchant costs. Today, there is no downward pressure on the Merchant Service Fee (MSF) of the three party schemes where blended surcharging exists.

Technically, this can be done with a very simple addition to the current draft Standard immediately after section 10 in the section Merchant Pricing:

(11.) Merchants may not surcharge the same across different schemes where there is a differential in the specific costs of accepting different scheme products.

Should the RBA wish to quantify the size of the differential, this can also be done within this minor amendment.

We are aware of other organisations that do not strictly oppose blended surcharges. Indeed, one bank has suggested that it would allow a weighting of a surcharges between MasterCard and the higher cost three party schemes. In this arrangement, in a theoretical situation where transactions are equally divided among the four party systems and American Express, then a fair surcharge would be the difference between the two Merchant Service Fees. So, assuming MasterCard attracts an ad valorem fee of 1% and American Express 2%, then a surcharge of 1.5% would be considered by this bank to be an appropriate surcharge rate.

MasterCard absolutely rejects this – as will consumers for whom it is very, very far from fair. We reject it because it assumes something that is not the case in reality – a theoretical market splitting across networks of volumes and transactions. It continues the current situation where some merchants use MasterCard’s lower Merchant Service Fee to subsidise the higher fees of American Express, it continues to mask the transparency that the RBA was seeking to achieve and it penalises uses of the lower cost four party schemes to the sole benefit of the higher cost three party schemes.

“Fixed Fee” Surcharges should not be allowed

While MasterCard is not privy to all Acquirer pricing arrangements, we are not aware of any Merchant Service Fee charged in anything other than an ad valorem form, so it is clear that any surcharge to consumers that is set as a fixed rate would not be reflective of the transaction costs to that merchant. Indeed we would further argue that fixed fee surcharges are sometimes used to obfuscate and mislead. It most certainly makes the task of policing excessive surcharges very difficult and, as such, we ask the Reserve Bank to explicitly ban this practice.

⁵ RBA Chart C3 - Merchant Fees for Credit and Charge Cards (www.rba.gov.au/statistics/tables/xls/c03hist.xls)

MasterCard Enforcement

MasterCard has previously held concerns around the difficulty of policing excessive surcharging in Australia and we have expressed these to the RBA. However, we believe many of these concerns can be overcome with the proposed direction we intend to take.

MasterCard would seek to enforce its rules regarding surcharging in Australia in a similar fashion as it does in enforcing its rules generally. That is to say that we hold the participants in our system to account for compliance with our rules. In this regard, it would mean that MasterCard would sanction Acquirers (in the form of fines) who do not protect consumers by monitoring and policing their merchant customers who surcharge excessively.

However in Australia, where no caps have previously existed, we are aware of views among some merchants that they will not amend the way they levy a surcharge on cardholders (see references above), unless compelled by regulation or legislation. To that end, MasterCard is preparing to amend our local rules to ensure we are able to act with speed and to establish a precedent.

MasterCard's Rule 5.11.2 (in Europe) states:

"If a Merchant applies a surcharge for payment by Card, the amount or method of calculation of the surcharge must be clearly indicated to the Cardholder at the POI [point of interaction] location and must bear a reasonable relationship to the Merchant's cost of accepting Cards."

MasterCard enforces this rule as follows:

1. MasterCard receives a complaint or observes in the marketplace that a merchant is surcharging at levels that appear to be above the merchant's cost of accepting MasterCard cards.
2. We identify the differential and indicate to the Acquirer that they must act to require the merchant to bring their surcharging levels down to the actual Merchant Service Fee or a reasonable proportion of costs paid to that Acquirer, or risk sanction.
3. In the case of merchant continuing to surcharge, a fine is levied against the Acquirer.
4. In the case where the surcharge is not reduced and it remains at the excessive level, MasterCard requires that the Acquirer no longer provide MasterCard acceptance facility for that merchant.

As indicated above, where we believe merchants to be in breach of our rules, we are able to sanction Acquirers (under our contracts with them). While we are sometimes loathe to do so, it is the only option available to us, as MasterCard does not have a direct contractual arrangement with merchants; subsequently our penalties for non-compliance with our rules are levied against our principal members.

In the above arrangement, there have been some issues related to confidentiality of commercial arrangements between merchants and Acquirers. MasterCard has considered this and, in order to provide a level of comfort in this regard, is in the process of defining a further rule change that asks each Acquirer in this market to notify MasterCard when a merchant customer of theirs surcharges for MasterCard transactions (in effect, this will mean Acquirers and MasterCard will maintain a register

of surcharging merchants). We will additionally require an Officer of that Financial Institution to certify that the surcharge reasonably reflects the Merchant Service Fee paid.

This obligates the Acquirer to satisfy MasterCard that the surcharging merchant is doing so fairly, and with due reference to fees paid to that Acquirer without requiring them to provide detailed – and they would argue, confidential – commercial arrangements to MasterCard. It removes much of the investigative burden on merchants, Acquirers and MasterCard, while also providing some recourse, should there be an indication that the cost of acceptance is substantially lower than the surcharge applied. This additional benefit of confidentiality has been a key requirement of Acquirers in various discussions and submissions. It means in Australia, enforcement would be amended to the following:

1. MasterCard will require agreements between merchants and Acquirers to include a clause on surcharging for payment by MasterCard cards. The clause will address the following:
 - a. Any surcharge should bear a reasonable resemblance to the cost of accepting that particular Scheme's transactions;
 - b. The surcharge shall not be excessive;
 - c. Continued excessive surcharging may lead to cancellation of this merchant agreement.
2. All Acquirers would provide MasterCard with a written statement, endorsed by an Officer of that Financial Institution, for each of their merchant customers who surcharge MasterCard transactions. This statement would indicate the level of the surcharge and whether that surcharge was reflective of the Merchant Service Fee paid by that merchant to the Acquirer.
3. In the case where either MasterCard receives a complaint or observes in the marketplace that the Merchant is surcharging at a level different to that provided by the Acquirer, where the surcharge is blended or where it is reasonable to suspect it was higher than the Merchant Service Fee costs, MasterCard reserves the right to investigate in the following manner.
4. Identify the differential and indicate to the Acquirer that they must act to require the merchant to bring their surcharging levels down to the actual Merchant Service Fee or a reasonable proportion of costs paid to the Acquirer, or risk a fine.
5. In the case of merchant continuing to surcharge, a sanction would be levied against the Acquirer.
6. In the case where the surcharge is not reduced and it remains at the excessive level, MasterCard would require the relevant Acquirer to no longer provide MasterCard acceptance facilities for that merchant.

While we believe there are opportunities to further protect consumers from merchants looking to use surcharging as a way of increasing margins, MasterCard welcomes the move toward a fairer surcharging regime for consumers. We thank the Reserve Bank for the consideration of this important issue and will, of course, make ourselves available to further discuss the details in the coming weeks as the RBA fine tunes its intentions and the relevant amended Standards.

Sincerely,



Eddie Grobler
Divisional President