

A Variation to the Surcharging Standards: Final Reforms and Regulation Impact Statement

JUNE 2012

Contents

1. Introduction	1
2. Background and the Current Issue	2
3. Objectives	8
4. The Draft Variation to the Standards	9
5. The Consultation Process	10
6. The Options	13
7. Evaluation and Impact Analysis	14
8. Recommended Option	19
9. Implementation and Review	21
Attachment 1: Standard No. 2, Merchant Pricing for Credit Card Purchases	24
Attachment 2: Standard, The 'Honour All Cards' Rule in the Visa Debit and Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System	26
Attachment 3: Guidance Note	29

Reserve Bank

© Reserve Bank of Australia 2012. All rights reserved.

The contents of this publication shall not be reproduced, sold or distributed without the prior consent of the Reserve Bank of Australia.

ISBN 978-0-9872589-5-3 (Online)

1. Introduction

In 2003, the Reserve Bank (the Bank) imposed surcharging standards on the MasterCard and Visa credit card systems, which required the removal of no-surcharge rules that had been imposed by these card schemes. A similar standard was imposed on the Visa Debit system in 2007 and other international card schemes have provided voluntary undertakings to remove their equivalent rules.¹ The removal of these rules has allowed merchants to pass on the cost of credit and scheme debit card transactions to their customers via a surcharge, should they choose to do so. The Bank's assessment is that these Standards have contributed to the efficiency of the payments system; surcharging has improved price signals to cardholders about the relative costs of different payment methods and the ability to surcharge has been used as a negotiating tool by some merchants to put downward pressure on their costs of accepting credit cards.

In recent years, however, some surcharging practices that potentially distort price signals – such as surcharging in excess of card acceptance costs – have become more widespread, thereby reducing the effectiveness of the reforms. In light of these developments, the Reserve Bank's Payments System Board (the Board) decided at its May 2012 meeting that there is a case for relaxing the current surcharging Standards to provide card schemes the capacity to limit surcharges. In line with this decision, the Bank will vary the surcharging Standards to allow card scheme rules to limit surcharges to the reasonable cost of card acceptance. The Standards will still ensure that merchants cannot be prevented from fully recovering their costs. The Bank believes that the variation is in the public interest and will improve the efficiency of the payments system by ensuring that the surcharging Standards continue to support their original objectives.

This rest of this paper is structured as follows.² Section 2 discusses the original surcharging reforms and the surcharging practices that have developed in recent years that have the potential to undermine the effectiveness of the original Standards. Section 3 details the objectives of the Bank in varying the Standards and its mandate to do so. Section 4 then discusses the draft variation to the Standards, which were released for public consultation in December 2011, while Section 5 summarises the views expressed by various parties during consultation. Section 6 outlines the range of options the Bank has considered in varying the surcharging Standards and Section 7 evaluates and discusses these options. In light of the evaluation, Section 8 states the preferred option to be implemented by the Bank. Finally, Section 9 outlines the variation to the Standards and its implementation.³

1 These surcharge standards are collectively referred to in this paper as 'Standards'.

2 This paper should be read in conjunction with the earlier consultation documents: Reserve Bank of Australia (2011), *Review of Card Surcharging: A Consultation Document*, June, available at <<http://www.rba.gov.au/publications/consultations/201106-review-card-surcharging/index.html>>; and Reserve Bank of Australia (2011), *A Variation to the Surcharging Standards: A Consultation Document*, December, available at <<http://www.rba.gov.au/publications/consultations/201112-variation-surcharging-standards/pdf/201112-variation-surcharging-standards.pdf>>.

3 This document relates to the Bank's Standards under the *Payment Systems (Regulation) Act 1998*. Merchants also face obligations under the consumer protection framework, including under the Australian Consumer Law, which prevents the levying of a surcharge where there is no alternative surcharge-free payment method.

2. Background and the Current Issue

The Removal of No-surcharge Rules

In 2003, the Bank began implementing reforms to the credit and debit card systems in Australia. These reforms were intended to improve the efficiency of the payments system and to promote competition. As part of these reforms, the Payments System Board required the removal of a number of restrictions that had been placed on merchants by the international card schemes, including the no-surcharge rule that had prevented merchants from surcharging for credit card and scheme debit card transactions. Accordingly, the Bank imposed standards requiring the removal of no-surcharge rules from 1 January 2003 in the MasterCard and Visa credit card systems and from 1 January 2007 in the Visa Debit card system.⁴ American Express, Diners Club and MasterCard (for the Debit MasterCard system) provided voluntary undertakings to remove their equivalent rules.⁵

Paragraph 8 of the surcharging Standards for the MasterCard and Visa credit card systems specifically provides that:

Neither the rules of the Scheme nor any participant in the Scheme shall prohibit a merchant from charging a credit cardholder any fee or surcharge for a credit card transaction.⁶

This wording of the Standards is quite open-ended, providing merchants with the freedom to set surcharges without constraint. At the time the Standards were put in place, the Bank was of the view that this level of discretion for merchants was appropriate – the environment was one where surcharging was likely to develop slowly, given the expectation by cardholders, built up over many years, that surcharges would not apply. It was therefore unlikely that merchants would use surcharging to recover significantly more than the cost of acceptance.

Nonetheless, paragraph 9 of each of the Standards expressly provides that agreements between merchants and acquirers to limit the size of any surcharge to the fees incurred by the merchant would not be inconsistent with the Standards:

Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a credit cardholder will be limited to the fees incurred by the merchant in respect of a credit card transaction.⁷

4 The applicable standards are titled: *Standard No. 2, Merchant Pricing for Credit Card Purchases*; and *The 'Honour All Cards' Rule in the Visa Debit and the Visa Credit Card Systems and the 'No Surcharge Rule' in the Visa Debit System*.

5 It is important to note that the Bank has not had to address this issue in most other payment systems to date, such as the designated eftpos system, because there have not been any rules imposed in these systems that prevent merchants from surcharging. In 2008 and 2009, the Bank investigated the no-surcharge rules in the PayPal system, but decided at that time that the benefit of regulation would not outweigh the costs: see Reserve Bank of Australia, 'Payments Systems Issues', Media Release No 2009-03, available at <<http://www.rba.gov.au/media-releases/2009/mr-09-03.html>>.

6 The wording of the Standard for the Visa Debit system is similar.

7 The wording of the Standard for the Visa Debit system is similar.

Together, these elements of the Standards imply an expectation that surcharges would generally be in line with acceptance costs, but that it would be open to the merchant to apply higher surcharges and equally open to acquirers to attempt to bargain surcharges down to the fees incurred. It has become apparent over time, however, that paragraph 9 – the provision allowing agreement to limit surcharges to the fees incurred – has had limited use, and has therefore been ineffective. This is because acquirers for the four-party card schemes (as opposed to the schemes themselves) do not have an incentive to limit merchant surcharges in exchange for reducing merchant service fees.⁸ In fact, the opposite can be true since a surcharge may increase the merchant fee the acquirer receives.

Overall, the purpose of the Standards was to introduce more market discipline into negotiations between merchants and acquirers over merchant service fees and, to the extent that merchants surcharge, improve price signals facing consumers choosing between different payment methods.⁹ This would lead to a more efficient allocation of resources in the payments system, which is in the public interest. In particular, to the extent that there are payment methods that are more costly for merchants to accept, the merchant would have the power to surcharge for transactions using those payment methods. The consumer, in turn, would have the incentive to avoid using the more expensive payment method if they did not consider that they were receiving sufficient benefit from that payment method.

Indeed, there is evidence to suggest that consumers are responding to price signals brought about by the original reforms by avoiding surcharges where possible. According to the Bank's 2010 Consumer Payments Use Study, consumers paid a surcharge on just 5 per cent of their credit card transactions over the one-week period that the study was conducted, and this proportion was little changed from a similar study conducted in 2007, despite the greater prevalence in surcharging at the time of the later study.¹⁰ In addition, the study specifically asked consumers how they would react when faced with various surcharging scenarios. Across the scenarios, the results suggest that around half of consumers that hold a credit card would seek to avoid paying a surcharge by either using a different payment method that does not typically attract a surcharge (debit card or cash) or going to another store.

Past Review of Surcharging Arrangements

The Bank reviewed the no-surcharge Standards as part of its broader review of the card payment reforms in 2007/08.¹¹ During consultations for the Review, some industry participants expressed concerns about surcharging being exploited by merchants with market power. Reflecting these concerns, the Board considered whether there was a case for allowing a cap on surcharge levels.

8 The MasterCard and Visa schemes are often referred to as four-party schemes because there are four parties involved in the transaction: the acquirer, the cardholder, the issuer, and the merchant. By contrast, American Express and Diners Club are often referred to as three-party schemes because the transaction has traditionally involved three parties: the cardholder, the merchant, and the scheme, which is both the acquirer and the issuer.

9 Merchant service fees are the fees (typically a percentage of the value of transactions) that the merchant pays to the financial institution (known as the acquirer or acquiring bank) that provides them with card acceptance facilities.

10 As part of the Payments System Board's Strategic Review of Innovation in the Payments System, the Bank commissioned Roy Morgan Research to conduct a study of payment patterns. The 1 241 individuals participating in the study were asked to record details of every payment they made during one week, including whether they paid a card surcharge on the payment. See Bagnall J, S Chong and K Smith (2011), 'Strategic Review of Innovation in the Payments System: Results of the Reserve Bank of Australia's 2010 Consumer Payments Use Study', June. Available at <<http://www.rba.gov.au/publications/consultations/201106-strategic-review-innovation/results/>>.

11 Reserve Bank of Australia (2008), 'Reform of Australia's Payments System: Conclusions of the 2007/08 Review', September. Available at <<http://www.rba.gov.au/payments-system/reforms/review-card-reforms/pdf/review-0708-conclusions.pdf>>.

The arguments for and against capping surcharges were finely balanced, with the Payments System Board deciding at the time that the instances of high surcharges were isolated and did not provide sufficient grounds to allow the card schemes to impose restrictions on all merchants. Specifically, the Board was of the view that the imposition of a cap could limit merchant flexibility and potentially remove a negotiating tool for merchants who might agree to limit the amount of their surcharge in exchange for a lower merchant service fee. The Board also assessed that the isolated cases of considerably higher surcharges were more likely a reflection of the market power of the merchants concerned. Further, a confidential submission by one of the card schemes to the 2007/08 review provided the results of a survey that indicated that, at the time, surcharges tended to be set with reference to merchant service fees.

Recent Concerns about Surcharging Practices

Although the Bank believes that the surcharging reforms have been successful and provide significant public benefits, over the years since the 2007/08 review of the payments system reforms, it has become concerned that in some instances surcharging has developed in a way that potentially distorts price signals, thereby reducing the effectiveness of the reforms. In particular, the Bank has been concerned about cases where surcharges appear to be well in excess of acceptance costs – referred to hereafter as ‘excessive’ surcharging – and an apparent tendency for surcharges to be ‘blended’ across card schemes (often at a rate that is higher than the cost of acceptance for the lower-cost card scheme). Both these practices are inefficient because they can cause consumers to underutilise a particular payment method. These practices, which were also discussed in the earlier papers *Review of Card Surcharging: A Consultation Document* (June 2011 Consultation Document) and *A Variation to the Surcharging Standards: A Consultation Document* (December 2011 Consultation Document), are discussed in more detail below.

The importance of ensuring that the regulatory framework delivers efficient outcomes is underscored by the size of this part of the payments system, with the value of purchase transactions on scheme credit and debit cards amounting to around \$280 billion in 2011.

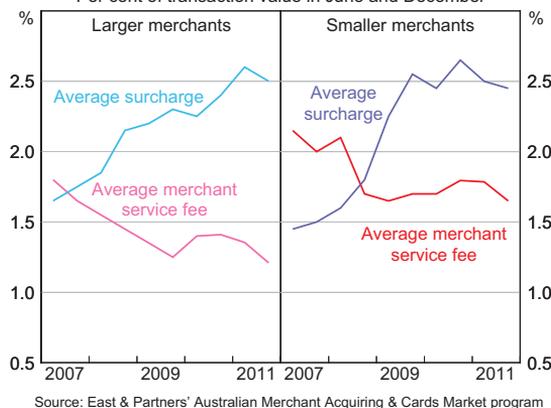
Excessive surcharging

In recent years, concern has been expressed to the Bank that some merchants may be using surcharging as an additional means of generating revenue, rather than simply covering the costs of card acceptance. A similar conclusion was reached in a report published by CHOICE in November 2010, commissioned by the New South Wales Department of Fair Trading.¹² Survey data by East & Partners also suggest that, for merchants that surcharge, the margin by which the average surcharge exceeds the average merchant service fee has been increasing in recent years; currently the margin is around 1 percentage point for American Express, MasterCard and Visa credit and charge cards, and around 1.9 percentage points for Diners Club cards (Graph 1).

As part of its analysis for the December 2011 Consultation Document, the Bank sought its own data on the distribution of merchant service fees and surcharges to assist in its understanding of the prevalence of excessive surcharging. Specifically, the Bank obtained detailed confidential data from several acquirers on the distribution of merchant service fees for credit cards across their entire merchant books. It also collected a sample of published surcharges from merchants across a range of industries. These data are broadly consistent with the East & Partners survey; for example, the average surcharge on MasterCard and Visa cards was 1.9 per cent, comparable with that of the East & Partners sample. Importantly, the Bank’s own data collection

¹² CHOICE (2010), *CHOICE Report: Credit Card Surcharging in Australia*, November.

Graph 1
Surcharges and Merchant Fees by Merchant
 Per cent of transaction value in June and December



also suggests that the observed distribution of surcharges is not entirely consistent with the data on merchant service fees. In particular, even allowing some amount for the other costs of card acceptance discussed below, the proportion of merchants imposing high *ad valorem* (i.e. percentage) surcharges appears surprisingly high given the distribution of merchant service fees.¹³ For example, around 10 per cent of those merchants identified as surcharging Visa and MasterCard credit cards had surcharges of 3 per cent or more; the average merchant service fee for these cards (across all transactions) is around 0.8 per cent.

There is also evidence to suggest that there are certain industries or payment channels where surcharging well in excess of merchant service fees is quite common. These industries and channels also tend to be those where the proportion of merchants that surcharge is quite high. The Bank identified a range of industries where it is common for merchants to impose high *ad valorem* surcharges, including: accommodation and travel; entertainment, leisure and recreation; hospitality; professional services; rental, hiring and transport; restaurants, dining and takeaway; retail; taxis; and telecommunications and internet. In addition, data from a survey conducted by the Bank in 2010 suggest that the incidence of surcharging is much higher for online purchases than those made in person; respondents paid a credit card surcharge on around 18 per cent of transactions made online compared with 4 per cent of those made in person.¹⁴ A related concern is that often these surcharging industries or merchants are ones for which there are few genuine alternatives to payment by a credit or scheme debit card.

Blended surcharging

The second of the Board's concerns is based on the evidence in the Bank's survey showing the relatively common use of blended surcharging; that is, where cards *across* different card schemes are surcharged at the same rate despite the fact that there may be significant differences in acceptance costs. For instance, a merchant may apply the same surcharge for American Express, Diners Club, MasterCard and Visa cards even though the merchant's acceptance costs are likely to be higher for some cards than others. In the Bank's survey

¹³ The distribution of the Bank's cross-section of surcharges is consistent with distributional data on surcharges provided to the Bank confidentially by East & Partners. The average surcharge for MasterCard and Visa credit card transactions was also in line with the average surcharge from the East & Partners research.

¹⁴ Bagnall J, S Chong and K Smith (2011), 'Strategic Review of Innovation in the Payments System: Results of the Reserve Bank of Australia's 2010 Consumer Payments Use Study', June. Available at <<http://www.rba.gov.au/publications/consultations/201106-strategic-review-innovation/results/>>.

of merchants, among those merchants for which surcharge rates for American Express, MasterCard and Visa could be identified, nearly 30 per cent charged the same rate across the three schemes. While some merchants may prefer the simplicity of applying only one blended surcharge across card schemes, this practice dulls price signals to consumers about the relative costs of different card payment systems. Specifically, cardholders have an incentive to use a higher-cost card system (which is able to fund more generous rewards than a lower-cost system) more intensively if surcharges do not reflect relative costs.

A related issue is that there appear to be few, if any, instances where merchants apply different surcharges for different cards *within* a card scheme (i.e. 'differential' surcharging). For instance, given that platinum/premium cards can be more costly for some merchants to accept than standard or gold cards – either immediately or subsequently as merchant service fees are adjusted over time to reflect the mix of card transactions – it might be expected that differential surcharging within a scheme would be more common than is currently the case.

The structure of pricing of card acquiring services to merchants may, in part, be contributing to the lack of take-up of differential surcharging. Discussions with merchants and acquirers suggest that many merchants pay a single blended merchant service fee to their acquirer. This single rate often covers all MasterCard and Visa credit and scheme debit card transactions; hence, merchants receive little information about how their card transaction mix influences their blended merchant service fee. In some cases, merchant acquirers also offer 'interchange-plus' pricing where each card transaction is priced at the interchange fee plus the acquirer's margin. In contrast to blended pricing, interchange-plus pricing is more transparent, but merchants and acquirers have indicated that, up to now, only a small number of merchants receive interchange-plus pricing.¹⁵

The Board's assessment of surcharging practices

Based on available data, views expressed in the Bank's extensive consultation rounds on surcharging and research undertaken for government agencies (i.e. the CHOICE report commissioned by the New South Wales Department of Fair Trading), the cases of excessive surcharging are more widespread than at the time the Board last considered the case for limiting surcharges at its 2007/08 review. The existence of excessive surcharging though, is inconsistent with the original intention of the surcharging reforms, which was that '... the price signals facing consumers choosing between different payment instruments would lead to a more efficient allocation of resources in the payments system ...'.¹⁶ The effectiveness of the price mechanism, as intended by the original surcharging reforms, is crucial to efficiency in the payments system and the broader reforms to card payments that have been undertaken by the Bank over the past decade. Specifically, the transmission of accurate price signals to consumers is expected to be an effective discipline on acceptance costs over the long run. However, the effectiveness of this price mechanism in this context depends on the extent to which surcharging practices reflect the cost of acceptance of alternative payment instruments; surcharges in excess of the cost of acceptance are inefficient since they can cause consumers to underutilise a particular payment mechanism. In a highly competitive environment, merchants would not be able to surcharge excessively, and so this source of inefficiency would not arise.

As discussed below, the Bank has a legislative mandate for efficiency and competition in the payments system. Although there are other regulations relevant to surcharging, these alone are not sufficient to address the

¹⁵ Some acquirers have also indicated that they offer a third type of pricing to merchants – 'semi-blended'. This is where card transactions are grouped into a few categories. For example, the merchant might pay two different merchant service fees: a higher rate for 'premium' transactions; and a lower rate for 'standard' transactions.

¹⁶ As set out in the Gazette notice dated 26 August 2002, in the summary of the purpose and effect of Standard No. 2. Available at <<http://www.rba.gov.au/payments-system/legal-framework/standards/pricing-cc-visa.pdf>>.

Board's concerns about efficiency in the payments system; instead, their focus is on consumer protection issues and increasing transparency of surcharging. For example, the Australian Competition and Consumer Commission (ACCC) and the Australian Securities and Investments Commission (ASIC) have published a guide on the disclosure of surcharges for merchants that choose to surcharge: 'Merchant Pricing for Credit Card Payments'.¹⁷ The guide provides that any surcharge should be clearly disclosed before the customer enters into the transaction and that the merchant should not mislead customers about the surcharge (e.g. by claiming it is recovering the merchant fee when in fact the surcharge is higher than the merchant fee). Similarly, the Australian Consumer Law requires that any fee or charge (including a card surcharge) that is unavoidable be incorporated into the advertised price.

While the Board supports measures to increase transparency of surcharges, it is unlikely that these regulations will, on their own, ensure the transmission of accurate price signals. It is in this regard that the Board undertook a review of its original surcharging Standards and decided to relax its current regulations.

¹⁷ See <[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/news_for_business.pdf/\\$file/news_for_business.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/news_for_business.pdf/$file/news_for_business.pdf)>.

3. Objectives

The Payments System Board's Mandate and Objectives

The Payments System Board's responsibilities stem from the Financial System Inquiry, whose findings and recommendations were released in 1997.¹⁸ The Inquiry found that, while earlier deregulation had improved competition and efficiency in Australia's payments system, further gains were possible. To that end, it recommended the establishment of the Payments System Board at the Reserve Bank with the responsibility and powers to promote greater competition, efficiency and stability in the payments system. The government accepted those recommendations and established the Payments System Board in 1998. The Board's responsibilities are set out in the *Reserve Bank Act 1959*. The Act requires the Board to determine the Bank's payments system policy so as to best contribute to: controlling risk in the financial system; promoting the efficiency of the payments system; and promoting competition in the market for payment services, consistent with the overall stability of the financial system.

At the time the Board was established, the government also provided the Bank with specific powers to regulate payment systems in order to implement the Board's policies. The most relevant powers in the context of the card payment reforms are those set out in the Payment Systems (Regulation) Act. Under this Act, the Bank has the power to designate payment systems and to set standards and access regimes in designated systems. The Act also sets out the matters that the Bank must take into account when using these powers, including the desirability of payment systems: being financially safe for use by participants, efficient and competitive; and not materially causing or contributing to increased risk to the financial system.

Objectives for the Surcharging Standards and Variations

In line with its specific powers, the Bank has three specific objectives for its surcharging Standards. First, the Standards aim to improve the efficiency of the payments system by providing better price signals to cardholders about the relative costs of different payment methods. Second, the ability to surcharge provides a negotiating tool for merchants, which may help place downward pressure on merchant service fees. Third, removing restrictions on merchant surcharging also reduces the subsidisation of credit card users by customers choosing less costly payment methods; instead of building the cost of card acceptance into the overall price of their goods and services, merchants can charge the customer if they choose to use a high-cost payment method. Any variations to be put in place would be intended to help ensure that the Standards continue to meet these objectives in light of the recent developments in surcharging practices that have been outlined above.

¹⁸ Financial System Inquiry (Wallis Committee) (1997), *Financial System Inquiry Final Report*, Australian Government Publishing Service, Canberra.

4. The Draft Variation to the Standards

The Payment Systems (Regulation) Act requires the Bank to publish any proposed variations to standards for public consultation. Accordingly, the Bank published a consultation document setting out its reasoning for its proposal and draft variations to the surcharging Standards on 16 December 2011 – *A Variation to the Surcharging Standards: A Consultation Document*. This document followed an earlier consultation document, *Review of Card Surcharging: A Consultation Document*, published on 8 June 2011, that set out the Board’s preliminary proposals for addressing concerns regarding surcharging practices.

The main element of the draft variation was to allow card scheme rules to impose a limit on surcharge levels. Specifically, the draft variation provided that neither the rules of a designated card scheme nor any participant in the scheme could prohibit a merchant from recovering part or all of the reasonable cost of acceptance by charging fees or surcharges to credit cardholders. The practical effect of this provision of the draft variation would be that scheme rules would be able to impose some limit on surcharge levels, but they could not prevent merchants from fully recovering their costs. The provision also clarified that card scheme rules could not prevent a merchant from differentially surcharging different card products either within a card scheme or across card schemes.

The reasonable cost of acceptance was left largely undefined; the merchant’s cost of acceptance includes, but is not necessarily limited to, the applicable merchant service fee. This approach was deliberate, to recognise the difficulty in capturing the difference in the types of acceptance costs faced by merchants in different industries. To define these costs prescriptively would risk including costs that could not always be attributed to a particular card’s acceptance or excluding some legitimate costs of card acceptance. Nonetheless, the draft Standards clarified that the merchant could determine the cost of acceptance by reference to:

- (i) the cost to the merchant of the card transaction in relation to which the fee or surcharge is to be levied (i.e. a different surcharge for each different card type);
- (ii) the average cost to the merchant of acceptance of all credit cards of all types issued under the scheme (i.e. a single surcharge for all credit cards for a particular scheme. The same would be true of all Visa Debit cards under the Visa Debit Standard); or
- (iii) the average cost to the merchant of acceptance of a subset of credit cards issued under the scheme that includes the type of credit card in relation to which the fee or surcharge is to be levied (e.g. one rate for ‘standard’ card transactions and another rate for ‘premium’ card transactions. The same would be true of a subset of Visa Debit cards under the Visa Debit Standard).

Under the draft Standards, merchants would also be able to apply a surcharge on either an *ad valorem* or a flat-fee basis, though schemes could ensure that merchants following either approach could recover no more than their reasonable acceptance costs, measured by one of the approaches outlined in (i) to (iii) above.

5. The Consultation Process

Under section 28(2) of the Payment Systems (Regulation) Act, the Bank must invite submissions on a proposed variation and consider those submissions in making a variation. Accordingly, the review of card surcharging has involved extensive consultation with interested parties. As noted above, the Bank invited submissions on two consultation documents: the first seeking views on the case to vary the surcharging Standards; and the second seeking views on the draft variation to the Standards. The views expressed on the first consultation paper have been summarised in detail in the December 2011 Consultation Document. Hence, this Section focuses on the views expressed in the recent round of consultation on the draft variation.

Views Expressed in Consultation

The December 2011 Consultation Document requested submissions from interested parties by 10 February. The Bank received 17 submissions in total from financial institutions, a merchant, merchant bodies, card schemes, a consumer group, an online payment system, a payment service provider and a private citizen. Bank staff met with the majority of those making submissions.

A number of submissions reiterated previously stated positions. This included submissions that questioned the quality of some of the surcharging data cited by the Bank. A few submissions argued that merchants' surcharging behaviour should not be restricted, while the schemes reiterated their view that they should be permitted to have 'no-surcharging' provisions in their rules. However, if there were to be a variation to the Standards, the majority of submissions were supportive of the Bank's preferred option for doing so – allowing a limit based on the reasonable cost of card acceptance. A notable exception to this view was that one of the four-party card schemes expressed support for allowing a limit based on what it called the *actual* cost of card acceptance. It argued that the actual cost should be defined to be a proportion of the merchant service fee to account for benefits the merchant attains by accepting card payments.

Despite general support for the Bank's proposed approach to varying the Standards, three broad concerns were raised in submissions from a number of parties. These concerns related to: the definition of the reasonable cost of acceptance, the treatment of blended and differential surcharging, and compliance and monitoring. These are discussed in turn below.

Reasonable cost of acceptance

There were mixed views about whether the reasonable cost of acceptance should be defined more prescriptively in the Standards. One merchant association and a card scheme supported the wording of the draft variation of the Standards; that is, leaving reasonable cost loosely defined, including specific reference only to the merchant service fee. These two submissions suggested that cost structures and commercial negotiations should determine what elements could be included.

By contrast, the majority of submissions suggested that the Bank should provide clarification as to the types of costs that constitute the reasonable cost of acceptance. These submissions argued that a loosely defined definition may lead to frequent disputes about reasonable surcharge levels, which may impose high administrative and compliance costs on the parties involved. For example, one financial institution suggested that the Bank develop a list of acceptable cost headings that are broad enough to encompass differing merchant circumstances. Likewise, two other submissions recommended that the Bank publish a 'guidance note', giving parties involved in negotiations, as well as consumers, a guide as to what costs might be considered by merchants as part of the reasonable cost of card acceptance.

One of the four-party card schemes suggested that the draft Standards were unnecessarily complex in terms of the options for the merchant's cost of acceptance. Given that a large proportion of merchants pay a blended merchant service fee, the scheme proposed that a merchant's cost of card acceptance should be solely tied to the average cost to the merchant of acceptance of all credit cards of all types issued under a particular card scheme. For definitional clarity, the scheme argued that the reasonable cost of acceptance should be the merchant service fee.

Blended surcharging

There was a range of views regarding the issue of blended surcharging across card schemes.

A number of parties indicated that merchants should be able to apply a blended surcharge across schemes. Several submissions expressed concern that, because the draft variations of the Standards allowed each card scheme to impose a limit on surcharges, applying a blended surcharge across card schemes would imply limiting the surcharge to the level of the lowest cost card. That is, for a merchant to comply with scheme rules for all the cards it accepted (as set out in its acquirer-merchant agreements) it would need to set any blended surcharge equal to, or less than, the lowest surcharge limit under the different card schemes. This would be the card with the lowest cost of acceptance to the merchant, which would mean that the merchant was not covering all of its costs of card acceptance. One financial institution and one three-party scheme suggested that blended surcharges across card schemes should be weighted by the scheme transaction mix incurred by the merchant. These parties argued that this would be more reflective of actual merchant costs in total.

However, the four-party card schemes reiterated their opposition to the practice of blended surcharging across card schemes. One recommended that the Bank specify in the Standards that it would not be reasonable for merchants to apply the same credit card surcharge across schemes where a price differential exists between those schemes' products. One also called on the Bank to prohibit blending of surcharges across credit and debit cards – or to ban surcharging on debit cards entirely – due to the differential in costs across credit and debit cards.

There was little discussion related to differential surcharging *within* a card scheme during this consultation round. In the first consultation round, some parties had commented that the terminal software of many merchants does not have the capability to distinguish card types within a card scheme. In addition, these submissions had noted the potential confusion to cardholders of displaying several different surcharges depending on the card type within a card scheme. The Bank had recognised these practical constraints in its December 2011 Consultation Document on the draft variations to the Standards, but nonetheless viewed it as important to clarify that merchants should not be prevented by schemes or acquirers from differentially surcharging within a scheme, should they choose to do so.

Compliance and monitoring

A number of submissions from merchants, merchant associations and acquirers raised concerns about the compliance and monitoring of any changes that are made to the Standards. Many of these submissions were concerned that a significant amount of power would reside in the card schemes' rules, and that the schemes may take a heavy-handed approach to implementation that would be costly for merchants and acquirers. During the consultation process, many participants referred to the proposed process for implementation outlined by the four-party card schemes in their submissions. Specifically, both the four-party card schemes indicated that a limit on surcharging could be implemented through scheme rules and that these changes would be implemented and enforced through acquiring institutions, which have the merchant relationship in a four-party card scheme. Under this framework, acquirers would be responsible for ensuring their merchants are compliant with card scheme rules, with the schemes imposing escalating sanctions on the acquirer (which could be passed on in some form to the merchant) if the schemes perceived that surcharging was excessive. Both schemes suggested that in the event of continued non-compliance with scheme rules, the merchant agreement could potentially be cancelled. MasterCard further indicated in its submission that it intended to require financial institution acquirers to report surcharge levels for each merchant and to certify that the surcharge was reflective of the merchant service fee paid by that merchant to the acquirer. It clarified in consultation that it is considering only imposing this kind of monitoring for merchants it suspects are surcharging excessively.

A number of submissions from merchants and merchant bodies raised concerns about the process for determining reasonable surcharge levels, and what recourse merchants would have if negotiations could not reach a satisfactory outcome. These merchants expressed concern that the draft Standards were silent as to the appeals mechanism. A number of submissions recommended that an independent body – such as the Bank, the ACCC or ASIC – be tasked with hearing appeals and determining merchant and scheme compliance with the Standards.

The Australian Payments Clearing Association (APCA) and several acquirers expressed concern about the potential costs of implementation of the variation to the Standards and ongoing compliance. One submission argued that merchant monitoring should be on an exceptions basis; that is, only those merchants suspected of surcharging in excess of reasonable costs should be required to demonstrate that they are compliant with their merchant agreement.

In addition to cost, a number of acquirers suggested that there would need to be reasonable time allowed for implementation. One three-party scheme noted that merchant acquirers, including itself, would have to renegotiate and amend contracts with merchants, and notify their merchant base of any changes to the Standards. It suggested that the Bank should give acquirers and merchants sufficient time to comply with any contractual changes that may be needed. APCA likewise suggested that large acquirers would need an appropriate amount of time to communicate any changes to their merchant base.¹⁹

¹⁹ A separate issue raised concerning implementation related to the types of transactions the Standards are intended to cover. In particular, it was suggested that the varied Standards should modify the definition of 'credit card transaction', 'MasterCard transaction', 'Visa credit card transaction' and 'Visa Debit card transaction' to ensure that the Standards are limited to transactions processed as MasterCard and Visa transactions, rather than all transactions made on a MasterCard- or Visa-branded card. The Bank acknowledges the views expressed in this regard, and notes, in particular, that there is no intention to capture programs that are not payments related. Issues related to the definition of card transactions will be considered separately by the Bank.

6. The Options

Four main options were considered during the Bank's consultation process. The first option retains the Standards unchanged, while the other three options canvass different approaches to varying the Standards for the designated MasterCard and Visa credit card systems, and the Visa Debit system. For the three options involving a modification of the Standards, the American Express, Diners Club and Debit MasterCard systems would be expected to modify their relevant voluntary undertakings accordingly. The four options are:

- *Option 1: No modification to the Standards*

Under this option, the existing Standards on surcharging would remain unchanged. The Bank would, however, make a public statement clarifying that the intent of the Standards is to allow merchants to pass through an amount to consumers that reflects the cost of acceptance. The Bank's statement could also provide a possible guide as to the level of surcharges that the Bank considers to be acceptable.

- *Option 2: Specific permissible surcharge limit*

This option would be a prescriptive approach: setting a fixed cap on surcharges. Under this option, the Board would determine a specific permissible surcharge limit – possibly expressed as a percentage of the transaction value – for the designated systems, with card schemes' rules permitted to limit the surcharge to the permissible level.

- *Option 3: Limit surcharges to a merchant's cost of card acceptance, which would be defined clearly as part of the Standards*

Another prescriptive option would be to relax the Standards to allow card scheme rules to limit surcharges to the merchant's cost of card acceptance, and for this cost to be defined clearly as part of the Standards (e.g. the Standards might specify that the cost of acceptance is the merchant service fee).

- *Option 4: Limit surcharges to the reasonable cost of acceptance of cards*

Under this option, the Standards would be modified to allow the schemes to set surcharging limits that are less prescriptive than under Options 2 and 3. Specifically, card scheme rules could limit surcharges to the reasonable cost of acceptance of the cards of that scheme. While the modified Standards would not define the reasonable cost of acceptance, they would specify that the merchant service fee would be included at a minimum. To provide some clarification, the Bank could publish a non-legally binding guidance note on the types of costs that the Bank considers might be included in the reasonable cost of acceptance.

7. Evaluation and Impact Analysis

In making a determination on whether to vary the surcharging Standards under section 18 of the Payment Systems (Regulation) Act, the Bank must consider whether the variation is in the public interest. Section 8 of the Act sets out that in determining whether a particular action is in the public interest, the Bank is to have regard to the desirability of payment systems:

- (a) being (in its opinion):
 - (i) financially safe for use by participants; and
 - (ii) efficient; and
 - (iii) competitive; and
- (b) not (in its opinion) materially causing or contributing to increased risk to the financial system.

The Reserve Bank may have regard to other matters that it considers are relevant, but is not required to do so.

The Bank has considered the public interest in its evaluation of the various options, as well as the potential effects each of these options may have on individual users and providers of payment services, including:

- the institutions that are participants in the credit card and scheme debit systems
- merchants that accept credit and scheme debit cards
- credit and scheme debit cardholders
- consumers and the community as a whole.

The Bank has also taken into account the views expressed by the various parties during the consultation process. The following discussion sets out the Bank's evaluation of the four main options considered.

The Options

Option 1: No modification to the Standards

The Board considers that the removal of card schemes' no-surcharge rules has had substantial benefits, particularly in improving price signals faced by cardholders about the relative costs of different payment instruments. The transmission of more accurate price signals to consumers is also an effective discipline on acceptance costs, which should, over the longer term, place downward pressure on merchant service fees, and potentially interchange fees.

Leaving the Standards unchanged would ensure that merchants continue to have the flexibility to surcharge without any regulatory constraint on the level of surcharges and to therefore continue to use surcharging to aid negotiations over pricing, which may help to place downward pressure on their merchant service fees.

Having an unconstrained capacity to surcharge was important when the Standards were first introduced because it encouraged the take-up of surcharging by merchants. However, this unconstrained capacity may arguably be less relevant in an environment where around one-third of merchants surcharge and the practice is well recognised by the public.²⁰

Another related argument for leaving the Standards unchanged is that any modification might be applied by the schemes in a way that makes it more difficult for merchants to surcharge. The Bank is of the view that an appropriately worded Standard would avoid such an outcome and would help to reinforce the rights of merchants to recover their card acceptance costs.

These potential benefits of leaving the Standards unchanged in their current form, however, need to be weighed against the potential costs. In particular, a significant cost is the potential detriment to the overall efficiency of the payments system in terms of total costs and the allocation of resources if the practices of excessive surcharging and of blended surcharging across card schemes are left unaddressed.

In addition to these effects, the Standards in their current form provide no capacity for consumers to assess, or be confident, that the surcharge they face is reasonable. This potentially limits the ability of consumers to question high surcharges and to place pressure on merchants that are excessively surcharging. While the Bank regularly publishes data on average merchant service fees for the different credit card schemes, it remains very difficult for consumers to assess whether surcharges being imposed by a *particular* merchant are excessive. As part of the initial consultation on surcharging in June 2011, the Board sought views from the industry on whether such concerns might be addressed by promoting the disclosure of merchant service fees by merchants. This could be one way to provide consumers with information about the cost of card acceptance, against which the reasonableness of any surcharge could be assessed. As reported in the December 2011 Consultation Document, nearly all submissions were strongly opposed to any requirements for disclosure of merchant service fees at the point of sale, citing the fact that merchant-acquirer agreements are subject to commercial confidentiality. A related argument was that the merchant service fee forms only part of a wider set of the costs of card acceptance, so disclosing only one price might not provide an accurate picture. On balance, the Bank is of the view that there would be significant costs to leaving the current surcharging Standards unchanged, with data suggesting that excessive and blended surcharging are now relatively common, while the cost of relaxing the Standards – mainly related to compliance – could be reduced with guidance from the Bank (see below).

Option 1, however, should be further considered in the context of whether the Board's concerns can be addressed by means other than varying the Standards. On this issue, the Bank has considered the possibility of using moral suasion to address inefficient surcharging practices; this was raised in the December 2011 Consultation Document. Under this approach, rather than a variation to the Standards, the Bank would make a public statement clarifying the intent of the Standards (in their current form) – for merchants to pass through an amount to consumers that reflects the cost of card acceptance. The Bank might also provide some specific guidance in its public statement that outlined its expectations for card surcharges to be no more than a certain percentage of the transaction value. By setting expectations about acceptable surcharge levels for merchants and consumers, moral suasion might potentially act as a constraint on inefficient surcharging practices, without the cost of regulatory action. However, moral suasion alone may not be sufficient to change the behaviour of some merchants, particularly those with some market power. In addition, if this were to be

²⁰ East & Partners (2011), *Australian Merchant Acquiring and Cards Markets: Special Question Placement Report prepared for the Reserve Bank of Australia*, December.

done by identifying a specific surcharge level that might be considered reasonable, it could lead to that level becoming the ‘acceptable’ level to which surcharges gravitated, and would not account for the differences in acceptance costs among merchants (see discussion of Option 2). Combined, these possible responses create a risk that moral suasion of this kind might distort price signals, albeit in a different way to the practices of excessive surcharging and blended surcharging across card schemes.

After considering this alternative approach, the Bank remains of the view that varying the Standards is in the public interest and that a relaxation of the Standards would improve efficiency and competition for the payments system as a whole, without contributing to increased risk in the system. Options 2 to 4, below, discuss the various options for doing so.

Option 2: Specific permissible surcharge limit

As discussed above, modification of the surcharging Standards is expected to ensure that the Standards continue to deliver substantial public benefits, particularly in terms of efficient price signals to cardholders and the efficient use of different payment methods. These benefits, however, need to be considered against the costs that are associated with each of the options for varying the Standards, including those that would result if the variation were implemented in a heavy-handed way such that it imposes a costly compliance burden on acquirers and merchants. There would also be costs resulting from the need to renegotiate merchant agreements and notify merchants of the change in card scheme rules.

Option 2 – the Bank setting a fixed permissible cap for surcharges – would provide some benefits over the other approaches to varying the Standards. Specifically, a fixed cap would be transparent for all affected parties, and monitoring compliance with such a fixed cap would be fairly inexpensive and straightforward.

However, this option also has a number of drawbacks flowing from its simplicity. First, the Board would be required to determine an appropriate level for the surcharge limit that would apply for all merchant types and sizes. This level would inevitably be higher than the cost of acceptance for some merchants and might encourage some of these merchants to simply set surcharges at the ‘acceptable’ and apparently ‘endorsed’ fixed limit. For other merchants, however, this level might be set lower than their costs of acceptance meaning that they would be unable to fully recover their costs. Accordingly, this option would lead to inappropriate price signals being provided to cardholders. The second drawback is that if the fixed limit was not adjusted over time, it would be unresponsive to competitive forces that might influence the costs of payments services. Third, if the fixed cap were set to reflect the average cost of card acceptance, it would not allow merchants to differentially surcharge for higher cost cards, and may therefore have the effect of limiting competitive pressure on card costs.

On balance, the Board is of the view that Option 2 is not flexible enough to enable price signals to cardholders to appropriately reflect the relative cost to merchants of accepting different payment instruments. This option may introduce distortions to price signals, separate to those arising from current surcharging practices. The Board therefore favours an approach that is more closely tied to acceptance costs for each merchant, as provided for in either Option 3 or 4.

Option 3: Limit surcharges to a merchant’s cost of card acceptance, which would be defined clearly as part of the Standards

Allowing for surcharges to be limited to the merchant’s actual costs of card acceptance is, in theory, a relatively clear and straightforward way of achieving the desired outcomes of the variation to the surcharging Standards

– to address surcharging practices that distort price signals to cardholders, while still ensuring that merchants can fully recover their costs of card acceptance. The challenge, however, is that in practice there is difficulty in adequately defining the cost of acceptance.²¹

A simple approach under Option 3 would be to define the cost of acceptance as being equal to the merchant service fee. However, the consultation process highlighted a wide range of other costs that may be associated with card acceptance. Some examples that were suggested by acquirers and merchants during the consultation process were the costs of chargebacks, ‘gateway’ fees, terminal rental, staff training, and communications networks. These costs vary substantially across merchants depending on their size, industry and channel (e.g. point of sale, online). In addition, these suggested costs of acceptance include many that are paid to other providers rather than to the acquirer. For example, some merchants have invested in their own terminals instead of renting them from their acquirer, while some online merchants use a payment gateway separate from their acquirer. In both these cases, defining the costs of acceptance as those charged by an acquirer would limit the ability of the merchant to recover the costs of acceptance on an equivalent basis to other merchants.

Another drawback of this simple approach is that limiting surcharges to the merchant service fee could prompt merchants to ask acquirers to include a wider range of fees in the merchant service fee to allow merchants a higher cap. Alternatively, schemes might put pressure on acquirers to lower merchant service fees (with a corresponding increase in other fees) to try to keep surcharges low.

As an alternative to the merchant service fee, one submission suggested allowing card scheme rules to set a surcharge limit as a specified function of the interchange fee that would apply to the transaction (e.g. a multiple of the interchange fee). This would reduce the incentive for acquirers to manipulate their merchant service fees in order to attract merchants. Additionally, this approach may be more effective in placing downward pressure on interchange fees by creating a direct link between these fees and surcharges; schemes would need to balance the desire to set higher interchange fees with the likelihood of facing higher surcharges for their cards. However, interchange fees are not a particularly good guide to costs faced by individual merchants. In addition, this approach would be difficult for merchants to implement practically (other than those for which a single interchange fee rate applies, such as ‘strategic’ merchants and utilities), because the applicable surcharge limit would depend on each merchant’s specific transaction mix.

On balance, the outcomes in terms of price signals and efficiency of the payments system as a whole are likely to be better under Option 3 than under Options 1 or 2 because surcharge limits would vary with the main component of the costs of card acceptance for each particular merchant. However, Option 3 is difficult to practically implement in the Standards because what constitutes the cost of acceptance varies considerably across merchants.

Option 4: Limit surcharges to the reasonable cost of acceptance of cards

Option 4 is a less prescriptive way of tying surcharges to a merchant’s cost of acceptance; it would allow card scheme rules to limit surcharges to ‘the reasonable cost of acceptance’ of cards of that scheme. Under this option, the reasonable cost of acceptance would be left largely undefined, though – at a minimum – it would

²¹ The approach of imposing a limit on surcharges equal to the actual cost of card acceptance is one that has been adopted in the European Union. Specifically, the Consumer Rights Directive prohibits merchants from charging fees that exceed the costs borne for acceptance of a particular payment method, in countries that allow surcharges. However, this Directive will take effect from 2014; hence, there is yet to be an announcement from individual countries on how the limit to actual costs of card acceptance will be implemented. In addition, the European Commission is in the early stages of consultation on the harmonisation of payments regulation in the European Union, including the possibility of limiting surcharges to actual costs.

be specified to include the merchant service fee (along the lines provided for in the draft variation to the Standards).²²

A key advantage of Option 4 is that it provides the flexibility to allow for different costs to be considered in the reasonable cost of acceptance across different merchants and industries, thereby addressing the concerns mentioned under Option 3 regarding the different types of costs beyond the merchant service fee. This enables surcharges to better reflect the costs of acceptance because the Standards are not prescriptive in what those costs might be. As discussed in the evaluation of Option 3, above, the costs of card acceptance vary widely across merchants of different sizes, different industries and for different channels of payment, which makes it difficult to precisely define these costs for the purpose of the surcharging Standards. For example, as discussed above, some online merchants may have higher costs in processing card payments because they outsource processing to a payment gateway that is separate from their acquirer; under Option 4, this could be reflected under 'the reasonable cost of acceptance' while it would be precluded from the other options.

The flexibility of Option 4, however, necessarily affords less certainty for participants. This drawback of Option 4 was noted by a number of participants during consultation. In particular, acquirers, merchants and card schemes expressed concern that there may be lengthy and potentially costly discussions on what are 'reasonable' costs to pass on to cardholders. Moreover, some concerns were also expressed during consultation about the possibility of the schemes imposing onerous compliance costs on acquirers and merchants, possibly as a means of discouraging surcharging altogether.

The costs and any uncertainty associated with this option would be largely dependent on how the card schemes adopt surcharging limits in their scheme rules. The Bank's intention is that card schemes do this in a way that imposes minimal burden on all parties concerned. The risk that the schemes might enforce any new surcharge limits more aggressively than intended nonetheless remains. However, the nature of the market may help minimise this risk. In particular, in a four-party card scheme, it is the acquirer that has the relationship with the merchant and negotiates merchant service fees with the merchant. Accordingly, the scheme is not privy to the exact merchant service fee paid or the magnitude of the other costs of card acceptance faced by the merchant. Therefore, the four-party card schemes will have to rely on the assessment of acquirers as to whether or not the surcharge of a particular merchant is excessive. Hence, competition in the acquiring market may assist in keeping the intensity of enforcement in check, as the primary incentive of acquirers is to maintain their merchant relationships, particularly with their larger merchant clients. Furthermore, the schemes will be conscious that the Board is likely to respond if any new freedoms are not being used in the way intended. Indeed, the Bank will be liaising with the card schemes prior to the Standards coming into effect to ensure that they do not impose *de facto* no-surcharge rules. Both of the four-party card schemes have also indicated that implementation would occur in a way that takes into account the costs and other effects on acquirers and merchants.

As discussed, some submissions noted that the Bank could also help other parties' interpretation of the 'reasonable cost of acceptance' by clarifying the costs it considers reasonable. This might be achieved through a guidance note, for example, and would be one way to provide greater confidence that the benefits of the flexibility offered by Option 4 are not outweighed by compliance costs. It would be important that merchant associations were made aware of such a guidance note so that they could broaden its distribution among smaller merchants to ensure that these merchants are aware that they retain the right to surcharge to recoup their costs of acceptance.

²² A similar flexible approach has been adopted in some other jurisdictions, such as New Zealand and parts of Europe, though the introduction of surcharging has only been relatively recent in these jurisdictions, making it difficult to appropriately evaluate the effect on surcharging practices.

8. Recommended Option

After considering the various options in light of recent surcharging practices, the Board is of the view that a variation to the surcharging Standards would be in the public interest.²³ It would allow the schemes to address cases where merchants are clearly surcharging at a higher level than is justified for card acceptance, which is a practice that may distort price signals and result in inefficiencies in the relative use of payment methods. At the same time, any modification of the Standards should continue to allow merchants to fully pass on the legitimate costs of accepting cards, thereby ensuring that appropriate price signals can be given to consumers and that proper market disciplines are enabled in negotiations over card acceptance costs between acquirers and merchants. These outcomes are likely to lead to more efficient use of payment instruments, an effect that will be ongoing.

In line with this, the Bank is of the view that allowing a limit based on the reasonable cost of card acceptance (Option 4) would be the most effective way to relax the Standards. Of the options considered, this is the least prescriptive and, as a result, is the option likely to achieve the most efficient outcomes by enabling surcharges to best reflect the costs of card acceptance faced by each individual merchant. In the Bank's view, it is the option that also best balances the interests of users and providers of payment services; indeed, the majority of submissions made to the Bank in the second stage of the consultation process also supported this approach.

In forming these views, the Bank has carefully considered evidence on the extent of excessive and blended surcharging. It recognises the mixed views expressed about the extent of excessive and blended surcharging during its extensive rounds of consultation and that there are insufficient data available to quantify the effect of these practices. However, based on available data, views expressed in consultation and recent similar research undertaken for government agencies (i.e. the CHOICE report commissioned by the New South Wales Department of Fair Trading), the Bank believes that there is sufficient evidence to suggest that such practices are now relatively widespread and that the use of the freedoms provided to merchants by the surcharging reforms is no longer entirely in line with the original intent of the reforms.

The Bank has also considered possible implementation and compliance costs related to the relaxation of the Standards. It recognises that these costs are also difficult to quantify, but it expects these to be quite small in the absence of disputes over the level of surcharging. Initially, acquirers would be obliged to notify merchants of the change in the Standards and any changes in scheme rules or contract terms, and merchants that are surcharging above their costs of card acceptance would be required to adjust their surcharges. There is no reason to expect that these costs would be higher for smaller merchants than for larger merchants and, in fact, the proportion of smaller merchants that impose a surcharge is lower than the proportion of larger merchants,

²³ As previously discussed, the meaning of the public interest, as set out in section 8 of the Payment Systems (Regulation) Act, involves the Bank having regard to the desirability of payment systems being: financially safe for use by participants, efficient and competitive; and not materially causing or contributing to increased risk to the financial system. The Bank may also have regard to other matters that it considers are relevant.

according to East & Partners' data. Indeed, to the extent that the merchant is already appropriately recovering the reasonable cost of card acceptance (or is not surcharging at all) there is likely to be little cost of compliance for the merchant.

The Bank recognises, however, that there are likely to be additional costs where disputes arise. The extent of these costs, though, is difficult to measure. In particular, it will depend on the approaches adopted by the card schemes (in establishing their rules), as well as how actively the merchant and the acquirer pursue the dispute; they will presumably weigh their own costs and benefits of doing so. At a minimum, there would be costs involved in the time taken for merchants and acquirers to negotiate over the pricing to the merchant and the level of the surcharge. It is recognised that such negotiations may have a greater effect on smaller merchants because they tend to have fewer resources or specialist personnel to deal with such negotiations. At the same time, the Bank's understanding is that acquirer pricing to smaller merchants, in general, tends to be simpler than that of larger merchants, suggesting that disputes may be less likely.

As noted previously, the Bank believes that publication of a guidance note that clarifies the constituents of reasonable costs may assist in keeping both compliance costs and the costs of disputes in check. As mentioned above, the Bank will also be monitoring the implementation closely for any indication that the approach is imposing unnecessary costs on merchants and acquirers.

While the Bank recognises that it cannot precisely measure the benefits and costs involved with varying the surcharging Standards, it notes that most of the compliance costs are likely to occur in the early stages of the variations coming into effect as merchants and acquirers adapt to any changes in scheme rules. However, the benefits that flow from improved price signals and thereby more efficient payment choices are likely to be ongoing. The Bank is, therefore, satisfied that, over the longer term, the variations will benefit society as a whole.

9. Implementation and Review

The Variation to the Standards

The varied Standards are largely similar to the draft varied Standards that were proposed in the December 2011 Consultation Document. Paragraph 9 of the varied Standards provides that neither the rules of a designated card scheme nor any participant in the scheme may prohibit a merchant from charging fees or surcharges to card users so as to recover part or all of the reasonable cost of acceptance by the merchant. They also provide that the merchant cannot be prohibited from applying different surcharges for different card types, either across card schemes or within a card scheme.²⁴

The varied Standards do not explicitly prohibit the practice of blended surcharging across card schemes, a practice that distorts price signals to cardholders about the relative costs of different card payment methods. However, given that the Standards allow card scheme rules to limit surcharges to the reasonable cost of acceptance, merchants that choose to apply a blended surcharge across card schemes may in practice be limited by scheme rules to setting that surcharge at the cost of acceptance of the lowest cost scheme. To the extent that the merchant would not be recovering its total costs of card acceptance, blended surcharging is likely to be discouraged by the Standards.

Similarly, the Standards do not explicitly prohibit the practice of blended surcharging across debit and credit cards within a card scheme. The Bank notes that the schemes impose different interchange fee schedules for debit and credit, in line with the Bank's interchange fee Standards, and that, for most transactions, the interchange fee on a scheme debit card transaction will be less than for a credit card transaction. However, the Bank understands that this is not always reflected in acquirers' pricing to merchants; many merchants face a single merchant service fee for a particular card scheme, regardless of whether a credit or debit card is presented. The varied Standards will mean that the schemes may be able to enforce differential surcharges between debit and credit where the merchant faces a different price for each, but not where the merchant is charged the same merchant service fee and other charges for both. The Bank would like to see the differences in costs between credit and debit card transactions better reflected to merchants and encourages acquirers to move towards pricing models that would do so.

²⁴ The Bank recognises there are technical and practical difficulties that may limit a merchant's capability or willingness to differentially surcharge within a card scheme. Regardless, the Bank believes it is important to provide this flexibility for merchants in the Standards, given such difficulties may be overcome in the future, and that it is aware of a small number of merchants that currently impose differential surcharges for 'premium' and 'standard' cards. In general, the Bank is of the view that differential surcharging within a card scheme improves price signals to cardholders about the cost to merchants of accepting different card products. The Bank considers that it would be contrary to the intent of the Standards for schemes or issuing banks to take actions that prevent merchants from understanding the cost of acceptance of particular cards.

Paragraph 10 of each of the Standards defines the merchant's cost of acceptance to include, but not necessarily be limited to, the applicable merchant service fee. The cost can be determined by reference to:

- (i) the cost to the merchant of the card transaction in relation to which the fee or surcharge is to be levied;
- (ii) the average cost to the merchant of acceptance of all credit cards of all types issued under the scheme (the same would be true of all Visa Debit cards under the Visa Debit Standard); or
- (iii) the average cost to the merchant of acceptance of a subset of credit cards issued under the scheme that includes the type of credit card in relation to which the fee or surcharge is to be levied (the same would be true of a subset of Visa Debit cards under the Visa Debit Standard).

The effect of this paragraph is that merchants will have flexibility in the way that they recover their costs of card acceptance from cardholders. That is, merchants may choose to recover their costs of card acceptance by applying: a different surcharge for each different card type; a single surcharge rate for all credit cards for a particular scheme (or all Visa Debit cards for the Visa Debit Standard); or some combination, such as one rate for 'standard' card transactions and another rate for 'premium' card transactions. Merchants may also apply a surcharge on either an *ad valorem* or a flat-fee basis.

Finally, the varied Standards also remove the now-redundant provision that currently allows a merchant to voluntarily agree with its acquirer to limit the size of any surcharge to the fees incurred by the merchant.

The varied Standards are set out in Attachments 1 and 2.

To complement the Standards, the Bank is also giving consideration to publishing a guidance note to explain the Standards. The intention of the guidance note would be to help clarify the types of costs that the Bank considers to be part of the merchant's reasonable cost of card acceptance. The costs that would be listed in the guidance note, however, would not be exhaustive, and may not be applicable to all merchants in all industries. The guidance note would not impose legal obligations on the schemes and their participants, but would seek to guide expectations. In particular, the Bank would be looking to ensure that merchant associations received the guidance note so that they could distribute information to their members, especially smaller merchants, to ensure that merchants are aware that they continue to have the right to impose surcharges so as to recover their reasonable costs of card acceptance. A draft Guidance Note is set out in Attachment 3. The Bank is seeking views from interested parties on the form of the Guidance Note and the elements that it should include.

Along with the guidance note, the Bank will investigate the potential for enhancing transparency around costs of acceptance by the Bank publishing more detailed data on merchant service fees in the future, such as by merchant sector.

Implementation Timeframe and Review

After considering the views expressed in consultation, the Bank has decided to make the varied surcharging Standards effective from 1 January 2013. This will give acquirers time to notify merchants, and if necessary, renegotiate contracts, and for the card schemes to amend their rules. The Bank would expect any revised undertakings by the American Express, Diners Club and Debit MasterCard systems to come into force at that time. The Board will monitor the effect of the variation to the surcharging Standards on an ongoing basis and will act, consistent with its obligations under the Payment Systems (Regulation) Act, if it deems further action to be in the public interest.

As noted above, the Bank is seeking feedback from interested parties on the form of a guidance note to complement and clarify the surcharging Standards. Parties wishing to comment on the draft Guidance Note should contact the Head of Payments Policy Department by 20 July at:

Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

or

pysubmissions@rba.gov.au.

At this stage, the Bank anticipates that if it decides to publish a guidance note this will be done later in the year, prior to the Standards taking effect.

Attachment 1

Standard No. 2

Merchant Pricing for Credit Card Purchases

Objective

The objective of this Standard is to promote:

- (i) efficiency; and*
- (ii) competition*

in the Australian payments system by providing merchants the freedom to make a reasonable charge according to the means of payment.

Amended and restated Standard

1. This Standard is an amended and restated Standard of that gazetted on 27 August 2002.

Application

2. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.
3. This Standard applies to the credit card system operated within Australia known as [] designated on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, and referred to in this Standard as the Scheme.
4. In this Standard:
 - an ‘acquirer’ is a participant in the Scheme in Australia that provides services to a merchant to allow the merchant to accept a credit card;
 - ‘credit card’ means a card issued under the rules of the Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;
 - ‘credit card transaction’ or ‘transaction’ means a transaction in Australia between a credit card holder and a merchant involving the purchase of goods or services using a credit card;
 - ‘merchant’ means a merchant in Australia that accepts a credit card for payment for goods or services;
 - ‘merchant service fee’ means a transaction-based fee charged to a merchant for acquiring credit card transactions from that merchant whether collected on an *ad valorem* or flat-fee basis, or charged as a blended rate across all credit card types or on an interchange plus acquirer margin basis or any other basis;

'rules of the Scheme' mean the constitution, rules, by-laws, procedures and instruments of the Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in the Scheme in Australia consider themselves bound;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

5. Each participant in the Scheme must do all things necessary on its part to ensure compliance with this Standard.
6. If any part of this Standard is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.
7. This Standard is to be interpreted:
 - in accordance with its objective; and
 - by looking beyond form to substance.
8. This Standard originally came into force on 1 January 2003. This Standard as amended and restated comes into force on 1 January 2013.

Merchant pricing

9. Neither the rules of the Scheme nor any participant in the Scheme shall prohibit:
 - (i) a merchant from recovering part or all of the reasonable cost of acceptance of credit cards issued under the Scheme by the merchant charging fees or surcharges to credit card holders; or
 - (ii) a merchant, in recovering part or all of the reasonable cost of acceptance of credit cards issued under the Scheme, from applying different fees or surcharges to credit card holders for different card types either within the Scheme or across card schemes.
10. For the purposes of paragraph 9, the merchant's cost of acceptance of credit cards issued under the Scheme may, for the purpose of determination of a fee or surcharge, be determined by reference to:
 - (i) the cost to the merchant of the credit card transaction in relation to which the fee or surcharge is to be levied;
 - (ii) the average cost to the merchant of acceptance of all credit cards of all types issued under the Scheme; or
 - (iii) the average cost to the merchant of acceptance of a subset of credit cards issued under the Scheme that includes the type of credit card in relation to which the fee or surcharge is to be levied,and includes, but is not necessarily limited to, in the case of (i), the applicable merchant service fee and, in the case of (ii) and (iii), all applicable merchant service fees.

Transparency

11. Each acquirer must notify, in writing, each merchant to whom the acquirer provides services of the provisions of this Standard (as amended) either before, or as soon as practicable after, this Standard (as amended) comes into force.

Attachment 2

Standard

The ‘Honour All Cards’ Rule in the Visa Debit and Visa Credit Card Systems and the ‘No Surcharge’ Rule in the Visa Debit System

Objective

The objective of this Standard is to ensure that the rules of the Visa Debit system and the Visa credit card system promote:

- (i) efficiency; and
- (ii) competition

in the Australian payments system.

Amended and restated Standard

1. This Standard is an amended and restated Standard of that gazetted on 7 July 2006.

Application

2. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.
3. This Standard applies to the payment system operated within Australia known as Visa Debit, which was designated as a payment system on 23 February 2004, and to the Visa credit card system operated within Australia which was designated as a payment system on 12 April 2001 (together referred to as the ‘Scheme’).

4. In this Standard:

an ‘acquirer’ is a participant in the Visa Debit system in Australia that provides services to a merchant to allow that merchant to accept a Visa Debit card;

‘merchant’ means a merchant in Australia that accepts a Visa Debit card or Visa credit card for payment for goods or services;

‘merchant service fee’ means a transaction-based fee charged to a merchant for acquiring Visa Debit card transactions from that merchant whether collected on an *ad valorem* or flat-fee basis, or charged as a blended rate with Visa credit cards or on an interchange plus acquirer margin basis or any other basis;

'rules of the Scheme' means the constitution, rules, by-laws, procedures and instruments of the Visa Debit system and of the Visa credit card system as applied in Australia respectively, and any other arrangement relating to the Scheme by which participants consider themselves bound;

'Visa credit card' means a card issued by a participant in Australia in the Visa credit card system, under the rules of the Scheme, that allows the cardholder to make payments to merchants for goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

'Visa credit card transaction' means a transaction in Australia between a Visa credit card holder and a merchant involving the purchase of goods or services using a Visa credit card;

'Visa Debit card' means a card issued by a participant in Australia in the Visa Debit system, under the rules of the Scheme, that allows the cardholder to make payments to merchants for goods or services by accessing a deposit account held at an authorised deposit-taking institution;

'Visa Debit card transaction' means a transaction in Australia between a Visa Debit card holder and a merchant involving the purchase of goods or services using a Visa Debit card;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

5. Each participant in the Visa Debit system and the Visa credit card system must do all things necessary on its part to ensure compliance with this Standard.
6. If any part of this Standard is invalid, the Standard is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.
7. This Standard is to be interpreted:
 - in accordance with its objective; and
 - by looking beyond form to substance.
8. This Standard originally came into force on 1 January 2007. This Standard as amended and restated comes into force on 1 January 2013.

Merchant pricing

9. Neither the rules of the Scheme, nor any participant in the Visa Debit system, shall prohibit:
 - (i) a merchant from recovering part or all of the reasonable cost of acceptance of Visa Debit cards issued under the Scheme by the merchant charging fees or surcharges to Visa Debit card holders; or
 - (ii) a merchant, in recovering part or all of the reasonable cost of acceptance of Visa Debit cards issued under the Scheme, from applying different fees or surcharges to Visa Debit card holders for different card types either within the Scheme or across card schemes.
10. For the purposes of paragraph 9, the merchant's cost of acceptance of Visa Debit cards issued under the Scheme may, for the purpose of determination of a fee or surcharge, be determined by reference to:
 - (i) the cost to the merchant of the Visa Debit card transaction in relation to which the fee or surcharge is to be levied;

- (ii) the average cost to the merchant of acceptance of all Visa Debit cards of all types issued under the Scheme; or
- (iii) the average cost to the merchant of acceptance of a subset of Visa Debit cards issued under the Scheme that includes the type of debit card in relation to which the fee or surcharge is to be levied,

and includes, but is not necessarily limited to, in the case of (i), the applicable merchant service fee and, in the case of (ii) and (iii), all applicable merchant service fees.

Honouring cards

11. Neither the rules of the Scheme, nor any participant in the Visa Debit system, or the Visa credit card system, may require a merchant to accept Visa Debit cards as a condition of the merchant accepting Visa credit cards. Likewise, neither the rules of the Scheme, nor any participant in the Visa Debit system or the Visa credit card system, may require a merchant to accept Visa credit cards as a condition of the merchant accepting Visa Debit cards.

Transparency

12.
 - (i) All Visa Debit cards issued after 1 January 2007 must be visually identified as debit cards. By 31 December 2009, all Visa Debit cards on issue must be visually identified as Visa Debit cards.
 - (ii) From 1 January 2007, all Visa Debit cards issued in Australia must be issued with a Bank Identification Number (BIN) that allows them to be electronically identified as Visa Debit cards.
 - (iii) On request, acquirers must provide to merchants for which they acquire Visa Debit and credit card transactions, BINs that would permit the merchant to identify separately Visa Debit and Visa credit card transactions electronically.
 - (iv) Each acquirer must notify merchants to which it provides acquiring services of the provisions of this Standard (as amended) either before, or as soon as practicable after, this Standard (as amended) comes into force.

Attachment 3

Guidance Note

The Reserve Bank of Australia is providing this Guidance Note to assist the relevant schemes and any participant in the relevant schemes to implement and comply with:

- the Standards titled *Standard No. 2, Merchant Pricing for Credit Card Purchases*. These Standards apply to the MasterCard and Visa credit card systems; and
- the Standard titled *The 'Honour All Cards' Rule in the Visa Debit and Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System*.

These surcharging standards are collectively referred to as 'Standards' in this Guidance Note. These Standards come into force, as varied, on 1 January 2013.

This Guidance Note is intended to provide practical assistance to the MasterCard and Visa credit card schemes, and the Visa Debit scheme (as designated under the *Payment Systems (Regulation) Act 1998*), as well as the participants of those schemes. The Guidance Note does not vary the Standards. The Bank may update or vary the Guidance Note from time to time as necessary. Any updates or variations will be advised through a media release issued on the Bank's website.

Reasonable Costs of Card Acceptance

The purpose of paragraphs 9 and 10 of the Standards is to ensure that merchants are not prevented from using surcharges to fully recover their costs of card acceptance.

Accordingly, for each of the designated schemes mentioned above, the Standards prevent the scheme rules (or any participant in the scheme) from prohibiting merchants from recovering 'part or all of the reasonable cost of acceptance' of the scheme's cards through surcharges to the cardholder. The Standards state that for this purpose, the reasonable cost of acceptance includes, but is not necessarily limited to, the merchant service fee. However, the Standards do not specify the types of any additional costs that may be considered as part of the reasonable cost of acceptance and these costs may vary significantly across merchants and industries, including based on whether merchants own their own payments processing equipment.

These additional costs, which in addition to the merchant service fees might form part of the reasonable cost of acceptance, may include, but are not necessarily limited to:

- (a) Other costs payable to acquirers. These may include fees for the rental and maintenance of payment card terminals, scheme fees incurred in processing card payments and levied by the acquirer (e.g. international service assessments or cross-border transaction fees), and other fixed fees for providing payment acquiring equipment and services (e.g. access fees, minimum transaction fees and other monthly or annual fees).

- (b) Costs payable to other payment service providers. These may include gateway fees, switching fees and fees for the provision of equipment and/or services required to accept card payments.
- (c) Merchants' own costs related to card acceptance. These may include the cost of purchasing and maintaining their own card acceptance infrastructure, scheme fees levied on the merchant by the scheme, and line rental and communications charges related to the use of payment card terminals.
- (d) Any other costs that are incurred only for the acceptance of cards of the relevant schemes and not other payment methods.

The examples of costs outlined above (including the merchant service fee) should be calculated net of any rebates from either the acquirer or the issuer. Any costs applying to multiple payment methods should be apportioned, as far as possible, pro-rata based on the transaction volumes attributable to each payment method (e.g. the cost of card terminals should be apportioned between the card schemes that use those terminals) and to the extent the apportioned costs have not already been included in the cost of acceptance for another payment method.

Disclaimer

The information contained in this Guidance Note is only intended to provide a general overview in relation to certain matters concerning the Standards. It is not intended to be exhaustive.

The information does not constitute, nor should it be treated as, legal advice. It is the Reserve Bank of Australia's recommendation that independent professional advice be sought. The information contained herein is current as at the date of the Guidance Note and is based on the Standards and the designation of the schemes as at the applicable issue dates.