CHAPTER 3: RESTRICTIONS ON MERCHANT PRICING

3.1 Introduction

The MasterCard and Visa credit card schemes have regulations, enforced by their respective Australian members, that prevent merchants in Australia charging customers who use these credit cards more than they charge customers that use less costly payment instruments. These restrictions are absent in the Bankcard scheme but they are also imposed by the three party card schemes, American Express and Diners Club. The restrictions are so well entrenched that some merchants mistakenly believe they have been imposed under legislation; this is not so.

The restrictions are commonly known as the "no surcharge" rule. This is a misleading description because the use of the term "surcharge" implies that the restriction is against imposing a second or additional transaction charge on a person using a credit card, whereas it prevents charging any transaction fee at all. Thus, it prevents merchants recovering from cardholders, on a "fee for service" basis, the costs they incur when they accept credit cards for payments rather than lower-cost payment instruments. As a consequence, the merchant service fees charged to merchants by credit card acquirers are passed onto all consumers – not just those using credit cards – in the form of higher prices of goods and services. Prices paid for goods and services by users of lower-cost payment instruments are higher, and those paid by credit cardholders lower, than would otherwise be the case.

Earlier official inquiries into scheme restrictions on merchant pricing in Australia have unanimously agreed that the restrictions are anti-competitive and against the public interest. In 1980, the Trade Practices Commission (TPC), the predecessor of the ACCC, disallowed the restrictions when it granted authorisation for the Bankcard scheme; the TPC found that the restrictions prevented merchants from adopting variable pricing techniques as a method of competing with other merchants, and were therefore anti-competitive.[103] The same conclusions were reached by the Martin Committee in its 1991 report into banking and deregulation[104] and by the Prices Surveillance Authority in its 1992 report into credit card interest rates and in its subsequent reports into credit card pricing.[105] The Prices Surveillance Authority concluded that "[w]hile many retailers may choose

103 Bankcard Scheme: Interbank Agreement (1980) ATPR (Com.), 50-100, at 52, 169. Bankcard's authorisation was revoked by the Trade Practices Commission in 1990.

104 House of Representatives Standing Committee on Finance and Public Administration (1991), pp 365-366.

105 Prices Surveillance Authority (1992), (1994) and (1995).

not to dual price given the freedom to do so, an in principle case, nonetheless, exists for ensuring efficient pricing by giving merchants the freedom to set prices reflecting the costs involved in effecting transactions, including methods of payment."[106] In 1993, Australia's credit laws were amended, *inter alia*, to allow merchants to charge different prices for accepting different payment instruments, but the credit laws do not prevent credit card schemes imposing restrictions, which are enforced by card scheme members, which prevent merchants from exercising this freedom.

The Joint Study also concluded that restrictions on merchant pricing suppress important signals to end-users about the costs of the credit card network and that such restrictions are not desirable. Merchants "… should not be prevented by the credit card schemes from passing on some or all of the merchant service fee through surcharges …".[107] The credit card schemes and their members, however, have responded that there are benefits to the community flowing from these restrictions and that the restrictions should be allowed to stand.

This Chapter considers whether the restrictions imposed by the credit card (and charge card) schemes are in the public interest. After detailing the restrictions, it explains their impact on community welfare and the public interest concerns that are raised. It then analyses the main arguments made by the card schemes and their members against abolishing the restrictions. In the Reserve Bank's judgment, restrictions on merchant pricing are not consistent with the promotion of efficiency and competition in the Australian payments system. Accordingly, it has decided to determine a standard for merchant pricing to ensure that merchants are free to recover from cardholders the costs of accepting credit cards. The draft standard is discussed in the concluding section.

3.2 Restrictions in card schemes rules

The restrictions on merchant pricing imposed by MasterCard and Visa are set out in their respective international rules and apply in that form to Australia.

The MasterCard rules state that:

> "The merchant shall not directly or indirectly require any MasterCard cardholder to pay a surcharge, to pay any part of any merchant discount, whether through any increase in price or otherwise, or to pay any contemporaneous finance charge in connection with the transaction in which a MasterCard card is used. A surcharge is any

106 Prices Surveillance Authority (1992), p 123.

107 Reserve Bank of Australia and Australian Competition and Consumer Commission (2000), p 55.

> fee, charged directly or indirectly, deemed by this Corporation to be associated with the use of a MasterCard card that is not charged if another payment method is used … . The prohibitions of this subsection (14) do not prohibit discounts for payments in cash, or for charges … that are charged to the cardholder regardless of the form of payment."[108]

The Visa rules state that:

> "A Merchant must **not**:
>
> - Add any surcharges to Transactions, unless local law expressly requires that a Merchant be permitted to impose a surcharge. Any surcharge amount, if allowed, must be included in the Transaction amount and **not** collected separately."[109]

The rules of both schemes permit cash discounts in Australia, as they do in the United States. This is in contrast to many European countries where "no discrimination" rules imposed by the card schemes prevent cash discounts as well as surcharges for card use. Both schemes also acknowledge that their rules on merchant pricing are not valid if the laws of the relevant jurisdiction forbid it. Other countries have prohibited such rules on anti-competitive grounds. The rule has been prohibited in the United Kingdom since 1991, in the Netherlands since 1994 and in Sweden since 1995.

3.3 Merchant restrictions and community welfare

Scheme restrictions on merchants' ability to recover costs are *prima facie* a restraint on trade. They deny merchants the freedom to set prices that promote the competitiveness of their business. No other supplier of goods or services to merchants seeks – or is legally able – to restrain them from passing on the costs of these services to customers who use them. The anti-competitive nature of these restrictions was a major factor in the decisions of competition authorities to prohibit them in the three European countries noted above. In the Netherlands, for example, the authorities judged that merchant pricing freedom was essential for safeguarding effective price competition within and between payment systems.[110]

Scheme restrictions on merchant pricing inhibit the normal market mechanisms and have two important economic effects. The first is that the general level of prices is higher than it otherwise would be, and consumers who do not use credit cards

108 Under 9.04 b (14) of the MasterCard International Bylaws and Rules.

109 Under 5.2.C of the Visa International Operating Regulations, General Rules. Prohibitions.

110 Correspondence from NMa, the Netherlands' competition authority, 12 July 2001.

pay more than they would otherwise. The second is that by distorting the relative prices of payment services to consumers, the restrictions do not promote efficient resource allocation and maximum community welfare.

Consumers who do not use credit cards pay more, and credit cardholders less, than otherwise

Scheme restrictions on merchant pricing require merchants to charge the same price to consumers irrespective of the payment instrument used. Merchants therefore average their costs from different payment instruments to determine their prices. If customers switch from lower-cost alternatives to credit cards, which have been shown to be a higher-cost payment instrument for merchants to accept, merchants face an increase in total costs. As discussed in Chapter 2, there is no evidence to suggest that this increase in costs would be offset by higher sales for merchants as a whole. Merchants therefore pass the increase in their total costs into the prices of goods and services. As a consequence, scheme restrictions on merchant pricing mean that increases in credit card usage result in a higher general level of prices of goods and services. Consumers who use lower-cost payment instruments pay a higher price for goods and services than they would otherwise, and therefore contribute indirectly to the costs of credit card schemes.

The potential for consumers who do not use credit cards to be harmed by scheme restrictions on merchant pricing is recognised in the recent theoretical literature on credit card networks. The article by Rochet and Tirole demonstrates that the no surcharge rule gives the interchange fee its ability to affect the size of the credit card system: "[t]he no-surcharge rule leads, as one would expect, to a redistribution towards cardholders."[111] In Rochet and Tirole's model, if the privately and socially optimal interchange fees are equal – in a context of strong merchant resistance to credit cards – removing the no surcharge rule would lead to an underprovision of credit cards, reducing the community's welfare. However, if merchants have limited resistance to accepting credit cards – the more realistic assumption – the interchange fee set by an issuer-controlled credit card scheme will lead to the overprovision of credit card services; in this context, removing the no surcharge rule would reduce credit card usage and increase the community's welfare.

Gans and King also note the argument that "cash and cheque customers are implicitly cross-subsidising card customers" and conclude that "up to a point, by increasing the interchange fee a credit card association with market power is able to extract rents from cash customers."[112] However, Gans and King claim this effect

111 Rochet and Tirole (2000), p 18.

112 Gans and King (2001a), pp 106-107 and (2001d), p 18.

is overstated because merchants are able to offer cash discounts; to the extent they do so, rents extracted from cash customers and customers using other lower-cost payment methods, would be reduced. In their analysis of the welfare implications of the no surcharge rule, Schwartz and Vincent see the rule as the means by which a credit card scheme can indirectly "tax" purchases made by cash customers. The rule enables the card scheme to raise the merchant service fee which in turn increases prices to all consumers. However, when rebates (such as loyalty points) are offered to cardholders, the impact of the no surcharge rule on merchant pricing is magnified. Issuers can provide rebates to boost credit card use and raise fees to merchants through the interchange fee, knowing that any resulting increase in prices must apply equally to cash customers. "Rebates thus misallocate transactions towards cards, the opposite of what occurs absent an NSR [no surcharge rule]."[113] Schwartz and Vincent also note that it is not in the interest of credit card scheme members to set merchant service fees so high that cash customers, observing the high prices, choose not to shop at merchants that accept credit cards "since cross-subsidization of cash to card customers then disappears."[114]

As an empirical matter, the likely magnitude of the impact of the no surcharge rule on the general level of prices in Australia is not easy to determine. The impact is diffused over a wide range of markets, in which varying mixes of payment instruments may be used, and over millions of consumers undertaking a myriad of transactions. In total, however, the effect is likely to be significant. The Joint Study found that the average merchant service fee in Australia is around 1.8 per cent of the value of credit card transactions; it is this fee, generating revenue to card scheme members of around $1.5 billion a year, that is passed into price levels, depending on supply and demand conditions in each market.

In its study of the credit card system in the United States, the Board of Governors of the US Federal Reserve System found that US consumers did pay a higher price than would be paid in the absence of credit cards. "As a result it can be said that cash buyers, at least to some extent, subsidize credit card users by paying identical prices."[115] However, the Board concluded that the size of the price effect would be small – between $^1/_2$ per cent to perhaps $1^1/_2$ per cent of total sales – because of the relatively small share of sales transacted by credit cards at that time (1983). (The share of retail sales made using credit and charge cards in Australia, estimated at around 35 per cent,[116] is now substantially higher than the figure of 15 per

113 Schwartz and Vincent (2000), p 3.

114 *ibid*, p 21.

115 Board of Governors of the Federal Reserve System (1983), p 8.

116 Australian Retailers Association (2001b).

cent that was used by the Board in its study.) In its report on credit card services in the United Kingdom, the Monopolies and Mergers Commission also reached the conclusion that credit cardholders were subsidised by customers who do not use credit cards.[117]

A number of submissions have challenged the argument that restrictions on merchant pricing give rise to cross-subsidisation of credit cardholders by customers who do not use credit cards.[118] These submissions focus on a technical definition of cross-subsidy provided by Faulhaber.[119] On this definition, if the price paid by a group of consumers is greater than the incremental cost of selling to that group, there is no cross-subsidy from another group of consumers – prices are said to be subsidy-free.[120] Applied to credit card schemes, if the price paid by credit cardholders is greater than the incremental cost per unit associated with sales to these cardholders, there is no subsidy from customers who do not use credit cards. The conclusion follows that, since merchants are prepared to accept credit cards, the price must be above incremental cost per unit and there is no cross-subsidy.

In the Reserve Bank's opinion, the focus on this technical definition of cross-subsidy does not address the public interest concern that consumers who do not use credit cards are harmed by scheme restrictions on merchant pricing. That harm arises because those consumers pay higher retail prices because other consumers – facing distorted price signals – choose to use a relatively costly payment instrument. In reviewing this argument, Katz has concluded that:

> "… what matters for consumer welfare and efficiency is what actually happens, not what labels are attached to the effects … The cited economic test for cross-subsidies (*e.g.*, incremental cost floors) is neither a necessary nor sufficient test for economic efficiency. By distorting relative prices, the no-surcharge rule can harm economic efficiency even if all prices are above incremental costs. These effects

117 "We have considered whether the payment of MSCs [Merchant Service Charges] had caused price increases and whether there is a measure of subsidisation of credit card users by those shoppers who still do not use them. Clearly in principle this could be the case. But to the extent that traders give discounts to their customers who do not use credit cards (which could be a consequence of abolishing the No Discrimination rule) such subsidisation would be reduced." Monopolies and Mergers Commission (1989), p 161.

118 See, for example, Australian Bankers' Association (2001b), Commonwealth Bank (2000), Australia and New Zealand Banking Group (2001a) and Visa International (2001a).

119 Faulhaber (1975).

120 The incremental cost associated with a group of consumers is defined as the difference in total costs when the merchant serves that group and all other existing customers and total costs when the merchant serves only the other existing customers.

have two sources. One is from distortions in the use of alternative payment mechanisms. The other is from distortions in the retail purchases made by consumers not using the credit or charge card at issue."[121]

Price signals about the costs of different payment instruments are distorted

Scheme restrictions on merchant pricing suppress price signals to consumers about the costs of different types of payment instruments. Since they do not bear any of the costs imposed on merchants when they use their credit card, cardholders have no incentive to make an efficient choice between payment instruments. The price signals are further distorted for credit cardholders in loyalty programs, who are paid a rebate to use credit cards in preference to lower-cost payment instruments.

Table 3.1 compares the costs of various card-based payment instruments and the fees typically levied by Australian financial institutions, drawing on data from the Joint Study; in the case of credit cards, the costs refer only to the provision of payment services and not the revolving credit facility. Consumers using debit cards (EFTPOS) face a fee of around $0.50 for transactions beyond the fee-free threshold, broadly in line with the average costs of providing debit card services. The average

Table 3.1: ATM, debit card and credit card costs
$, per $100 transaction

	Acquirer	Issuer	Total cost	Costs passed to cardholder
Foreign ATM[a]	0.49	0.21[b]	0.70[b]	1.40
Own ATM[a]	0.49	0.21[b]	0.70[b]	0.65
Debit card[a]	0.26	0.21	0.47	0.50
Credit card	0.43	1.58	2.01	-0.42 to -1.04[c]

a For transactions beyond the fee-free threshold.
b Does not allow for a difference in switching costs between own ATM and foreign ATM withdrawals.
c Includes costs of interest-free period and loyalty points.
Source: Reserve Bank of Australia and Australian Competition and Consumer Commission (2000) and Reserve Bank of Australia, *Bulletin*, July 2001.

121 Katz (2001), pp 41-42.

cost of providing a $100 credit card transaction, in contrast, is around $2.00. Credit cardholders do not incur a cost, but instead receive a *benefit*: for those not in a loyalty program the benefit is equivalent to around $0.42 from use of the interest-free period, while those in loyalty programs receive an incentive of up to $1.04 (measured as the cost to the card issuer) for using their credit cards for an average size transaction.

Current price signals are therefore encouraging the use of a relatively high-cost payment instrument over lower-cost alternatives. This structure of incentives is not, in the Reserve Bank's opinion, conducive to allocative efficiency in the Australian payments system. As noted in Chapter 1, allocative efficiency focuses on the relationship between inputs and outputs; allocative efficiency is increased if a given level of output can be produced with fewer resources. Payment instruments are used so that the consumption of goods and services can take place, but the payment instruments themselves cannot, for the reasons discussed in Chapter 2, generate a permanent increase in consumption. If price signals direct resources into producing relatively high-cost payment instruments rather than lower-cost alternatives, average costs in the payments system are higher and the resources that can be directed into other productive uses are reduced. As a consequence, output and community welfare are lower than they would be if price signals were more efficient.

Although the credit card is a higher cost payment instrument, some submissions have argued that the credit card generates greater benefits than other instruments and therefore community welfare will be higher with increased use of credit cards. The claim is that "… it is clear that consumers much prefer credit cards to debit cards when there is no material difference in the price of these services."[122] No empirical support is provided for this claim, and it is impossible to verify since there *is* a material difference in the price of the two services. Before financial institutions changed incentives through the introduction of loyalty programs for credit cards, use of debit cards had been expanding more strongly than credit cards; moreover, despite the current incentives, debit cards are still a widely used payment instrument.

3.4 The justifications for merchant restrictions

Submissions to the Reserve Bank have claimed that scheme restrictions on merchants' ability to recover costs can be justified as being in the public interest and should be allowed to remain. The justifications take three main forms:

122 Visa International (2001a), p 17.

- the restrictions are needed to ensure that network externalities in credit card schemes are realised;
- abolishing the restrictions would have limited impact in any event because merchants will not choose to charge differential prices; and
- consumers will be confused by differential prices or may be exploited by merchants.

The first two of these arguments, although sometimes quoted in the same submissions, are largely contradictory.

Network externalities

As discussed in Chapter 2, the network externalities argument states that credit card schemes provide benefits to consumers and merchants that would not be realised if cardholders faced the full costs incurred by card issuers. On this argument, an interchange fee paid to issuers by acquirers (and passed onto merchants) ensures that these unrealised benefits are captured by allowing issuers to subsidise cardholders; in this way, growth of the scheme is encouraged. If there are no restrictions on their pricing behaviour, however, merchants will pass the cost of accepting credit cards onto cardholders, who will therefore face the full costs of the scheme. Some cardholders may choose not to join the scheme while others may reduce their usage. As a consequence, the credit card scheme will not reach its optimal size and the community's welfare will be lower than it could be.[123]

The Reserve Bank considered the network externalities argument in detail in Chapter 2, and found it unconvincing. Two of the reasons for that judgment are equally relevant to assessing this particular justification for scheme restrictions on merchant pricing.

First, the benefits of credit card use have been overstated. The claim made is that merchants benefit from lower transactions costs and higher sales. However, the evidence discussed in Chapter 2 suggests that credit card usage actually increases transactions costs for merchants. Moreover, no evidence was provided that credit card usage leads to a permanent increase in sales for merchants as a whole that would offset their higher transactions costs.

Secondly, even if there are potential network externalities in credit card schemes, the price mechanism may be able to internalise some of them. Chapter 2 showed that if merchants do face higher transactions costs from credit card use (after allowing for any merchant benefits), charging a higher price to credit cardholders

123 Visa International (2001a).

than for other consumers would ensure that consumers faced the social costs of different payment instruments. Where merchants have the freedom to charge differential prices for accepting different payment instruments, the market will internalise effects that would otherwise be externalities.[124] Moreover, by focusing only on the potential impact on credit cardholders, the submissions have failed to acknowledge that removal of scheme restrictions on merchant pricing might encourage more merchants to accept credit cards. Merchants that had previously refused to accept credit cards because they perceived the costs to be too high might be prepared to accept them if they could charge customers for their use.[125] Rather than facing an "all or nothing" choice in accepting credit cards, merchants would have the freedom to negotiate the terms on which they were prepared to accept these cards. Some merchants might still refuse to accept credit cards if the fixed costs of doing so were very high; however, annual costs of around $300 per year for a credit card terminal are unlikely to be a serious deterrent, particularly since the same terminal is typically used to process debit card transactions.[126]

Visa has offered two other perspectives on network benefits to justify scheme restrictions on merchant pricing. First, it quotes a theoretical model that shows that, under particular parameter values, removal of the no surcharge rule would generate a loss of at least $4.5 billion to the Australian economy.[127] This conclusion depends on certain stylised assumptions about consumer demand – that consumers purchase a fixed number of goods each period and place the same value on each purchase, and that consumers as a whole make a greater volume of purchases when credit cards are accepted (for which no evidence is provided). As a consequence, the no surcharge rule in this model does not create any efficiency losses for consumers that do not use credit cards, and removal of that rule leads to the collapse of the credit card system.

Katz has demonstrated that this result "… is an artifact of an extreme assumption made in the model."[128] The model's lack of plausibility is also obvious from the experience of countries where differential pricing by merchants is permitted. The credit card system has continued to expand in the United Kingdom, despite

124 "… in some circumstances, rather than simply undermining the use of interchange fees, merchant surcharges are a substitute for interchange fees that ensure the internalization of what would otherwise be externalities." Katz (2001), p 46.

125 Rochet and Tirole note that "When merchants are allowed to apply card surcharges, their accepting the card is no longer an issue." Rochet and Tirole (2000), p 18.

126 Australian Retailers Association (2001a).

127 Wright (2000).

128 Katz (2001), p 21 and pp 55-57.

prohibition of the no discrimination rule in 1991, in Australia despite amendments to credit laws in 1993 that allow discounts for cash, and in the Netherlands and Sweden despite prohibition of the no discrimination rule in the mid 1990s.

Visa's second argument to demonstrate the desirability of scheme restrictions on merchant pricing uses a car park in a shopping centre as an analogy for the credit card system.[129] In this analogy, the provision of free parking benefits merchants since it attracts customers to the shopping centre; merchants in the centre gain from the patronage and customers who do not use the car park still benefit from the establishment and ongoing viability of the shopping centre. Nonetheless, the provision of parking is costly, and this will be reflected in the rents charged to merchants by the shopping centre and passed onto all customers using the centre in higher retail prices. An individual merchant may not want to pay for the cost of the car park and, if it had the ability to do so, might attempt to recover this cost from customers that use the parking facility. Merchants in the centre as a group, however, would not want this to occur since it would deter shoppers from coming to the shopping centre and defeat the purpose of the free parking. "To solve this free rider problem, the centre owner will require that all the merchants contribute to the cost, and if the technology to surcharge customers for car parking existed, the centre owner would put in place a no-surcharge rule."[130] The conclusion is that such a rule ensures both shoppers and merchants at the centre are better off.

In the Reserve Bank's view, the car park analogy is unconvincing and is subject to the same fallacy of composition as the claims that higher credit card sales for individual merchants mean higher sales for merchants as a whole. Free parking does not increase shopping for the community as a whole; it is used by shopping centres as a strategic device for attracting shoppers from other centres. If all shopping centres reacted by providing free parking, there would simply be a new equilibrium in the economy at the same level of sales, but with higher costs. Consumers who do not use parking facilities at any centre would, as a group, face higher retail prices.

Another misleading parallel concerns the extent of competition between shopping centres and within the credit card market in Australia. There is competition among shopping centre owners and customers can choose to shop in centres with free parking, higher rents and perhaps higher prices or in centres with no free parking, lower rents and perhaps lower prices. This competitive market is not analogous to the designated credit card schemes in Australia, which are characterised by overlapping governance arrangements and lack of effective competition. Credit

129 Visa International (2001a), pp 26-29.

130 *ibid*, p 28.

card acceptance is so widespread that, in reality, consumers have limited choice of "cash only" merchants.

Finally, if the analogy were credible, it would suggest that even if individual merchants wanted to recover the costs of accepting credit cards, merchants as a whole would support a no surcharge rule binding on individual merchants because they would expect it to boost aggregate sales. Merchant groups in Australia, however, do not support this view. The ARA and the Restaurant and Catering Association of Australia, both bodies representing large groups of merchants, have argued that merchants should be able, if they wish, to recover the costs of accepting credit cards from customers using those cards.[131] They do not agree that restrictions on merchant pricing benefit them as a group.

A more appropriate analogy for the no surcharge rule would be one based on trucking companies that provide home delivery on behalf of stores. Traditionally, many stores provided their own delivery service, often free of charge, but increasingly this service has been outsourced to trucking companies and explicitly charged for by the store (ie the service has been "unbundled"). The no surcharge rule is analogous to a situation in which all trucking companies throughout Australia collectively agreed to prevent individual companies from providing services to stores that passed explicit delivery charges onto customers using the service. Stores would therefore have to include delivery costs in prices to all customers, whether or not they used the service. The trucking companies would benefit from this prohibition because more customers might use a delivery service which appeared "free"; the trucking companies might even argue that merchants as a whole would also benefit by being able to sell a larger number of bulky goods. However, the distortions from such arrangements are obvious. Customers who have no need for the delivery service still pay part of the cost through higher prices. In addition, since customers do not face the cost of delivery, they may use the service for items they would otherwise choose to pick up or carry home themselves, leading to an inefficiently high use of resources in delivery services. One could even imagine that the trucking companies would like to promote use of their services by providing rebates or reward points to the final customers.

Differential pricing in practice

The justification for scheme restrictions on merchant pricing presented above argues that they are essential for the viability and expansion of credit card networks. The second justification is that abolishing the restrictions would have no effect in any

131 Australian Retailers Association (2001b) and Restaurant and Catering Association of Australia (2001).

event because merchants will not choose to charge differential prices to customers.[132] A variant on this view is that, since discounts for cash are already possible in Australia, there is no need to allow merchants to recover their credit card costs on a "fee for service" basis because such fees are economically equivalent to cash discounts.[133]

Set side by side, the two justifications are contradictory. If removal of scheme restrictions on merchant pricing would have little effect on credit card usage and network size, it follows that the restrictions are redundant and, like unnecessary regulation in any form, can safely be abolished.

No surcharge rules (or their equivalent) have been prohibited by competition authorities in at least three overseas countries: the United Kingdom, the Netherlands and Sweden. Studies for the European Commission have shown that a limited number of merchants in both the Netherlands and Sweden charge for credit card use. In the Netherlands, nine per cent of a sample of 310 merchants charged a higher price to credit cardholders and another 10 per cent offered discounts for cash. In some industries, price differentiation was more prevalent than in others: 25 per cent of petrol stations surveyed and 22 per cent of travel agencies surveyed indicated that they charged credit cardholders a fee to recover their costs. The level of that fee was around the level of merchant service fees and often lower.[134] In Sweden, only five per cent of a sample of 300 merchants charged credit cardholders a fee for using their credit card and around 1.5 per cent offered discounts for cash. Merchants that charged a higher price to credit cardholders cited cost recovery as the main reason; those that did not cited concerns about negative reactions from cardholders or claimed it was a matter of service or principle.[135]

On the basis of these studies, the European Commission has recently decided not to disallow Visa's no discrimination rule at the European level, though it had originally objected to it.[136] While submissions to the Reserve Bank have made much of this decision, arguing that it vindicates the *status quo* as far as Australia is concerned, the following points are significant:

- the Commission considered that the no discrimination rule did restrict the freedom of merchants to pass on a component of their costs to cardholders and may be restrictive of competition;

132 See, for example, Australian Bankers' Association (2001b) and Visa International (2001a).

133 Gans and King (2001b).

134 ITM Research (2000).

135 IMA Market Development AB (2000).

136 European Commission (2001a).

- however, the Commission is required under its powers to find that the restriction on competition is "appreciable" before it may disallow the rule; and
- the Commission's decision at the European level does not override the decisions of domestic competition authorities. Hence, prohibitions on the no discrimination rule in the United Kingdom, the Netherlands and Sweden stand.

The Reserve Bank's payments system powers do not contain any materiality tests comparable to the trigger of an "appreciable" restraint on competition applying to the Commission. More importantly, the Reserve Bank is required to act in the public interest to promote efficiency as well as competition.

A closer reading of the overseas evidence also suggests that merchant willingness to charge differential prices might not have been accurately captured in the surveys. Visa has claimed that, although the no discrimination rule has been prohibited in credit card schemes in Sweden, bilateral agreements between acquirers and merchants forbidding merchants from recovering credit card costs from cardholders are now commonplace.[137] If so, it is not surprising that the survey data revealed that price discrimination by merchants was uncommon, since the rule remains in place *de facto* despite the intent of the competition authorities that it be prohibited. In the Netherlands, the study showed that almost three-quarters of merchants surveyed were not aware that the no discrimination rule had been abolished, raising the question of whether merchants thought they were still bound by that rule. Looking at the two surveys together, a higher proportion of merchants impose a fee for credit card use in the Netherlands, which has the higher average merchant service fee, than in Sweden (Table 3.2). This illustrates a common-sense point that, for many merchants, the cost and trouble of recovering credit card costs from

Table 3.2: Merchant service fees and merchant price discrimination
per cent

	Merchant service fee	**Merchants who price discriminate**
Sweden	2.0	6.5
Netherlands	4.5	19.0

Source: Based on a presentation by Alan Frankel to the Econometric Society of Australia, July 2001. ITM Research (2000) and IMA Market Development AB (2000).

137 Visa International (2001a), p 36.

cardholders may not be worthwhile when merchant service fees are low but becomes worthwhile when merchant service fees are higher.

In the Reserve Bank's opinion, the argument that removal of scheme restrictions on merchant pricing will have little impact on merchants is an argument, in principle, against retaining these restrictions. In the absence of other public interest considerations, the starting point for an assessment of private-sector regulations imposed on merchants is that merchants should have the right – whether they use it or not – to follow pricing strategies that promote the competitiveness of their business. It may well be that supermarkets or other retailers with relatively small transaction sizes will find the costs of systems changes and checkout queues too high to justify a "fee for service" for credit cardholders. However, the fact that discounting for cash is not uncommon for higher value items suggests that other merchants – for example, those selling furniture, electrical equipment or other high-value items – may want to recover their credit card costs. Utility companies, schools or clubs that accept credit cards but clearly gain no additional revenues might also choose to follow that pricing strategy.

Finally, some submissions have questioned whether permitting merchants to recover their credit card costs would achieve anything that discounts for cash currently do not. If that is the case, it is hard to understand why card schemes would object to the removal of the restrictions. In principle, it should not matter whether merchants recover their costs by charging above the cash price for credit cardholders or charging below the credit card price for cash users. However, the two pricing practices appear to be perceived quite differently. The "framing hypothesis" argues that a consumer's decision can be affected by the way the issue is framed.[138] The labels "discount" and "surcharge" that are used by the credit card industry would appear to be framed to suggest that the former is good and the latter is bad. It is possible that discounts for cash have less impact on cardholders' decisions to use credit cards than facing a specific "fee for service" from merchants. In the United States, the staunch defence of the no surcharge rule by American Express, while allowing its merchants to offer cash discounts, would suggest that credit and charge card schemes think that consumers might react differently to the different labels and can be convinced that surcharges are unfair.

Merchant pricing and consumer issues

The third justification for scheme restrictions on merchant pricing relates to the possible effects on consumers if these restrictions were removed. There are two parts to the justification: consumers will be confused by facing differential pricing

138 Kitch (1990).

and/or merchants may exploit them. If the price a cardholder sees on the shelf differs from that charged at the till, the cardholder may be confused and may lose confidence in the credit card scheme. If individual merchants set different fees for different cards, and the fees vary from one merchant to another, the argument is that confusion will multiply.[139]

In the Reserve Bank's opinion, the argument about consumer confusion, which has not been raised by consumer representatives, is easy to overstate. Consumers have become increasingly accustomed to the unbundling and separate pricing of goods and services, whether it be packaging or delivery charges, options on a new motor vehicle or account services provided by financial institutions. Price variation according to the type of payment instrument used is not unusual; consumers understand that their choice of payment instrument can often provide leverage to bargain on prices, as in the case of cash discounts for high-value goods. Consumers also face other, albeit relatively inefficient, signals about the costs of payment instruments in the form of minimum purchase obligations which some merchants impose on customers who wish to use their credit cards; these minimum obligations often differ between merchants and between cards issued by members of the four party credit card schemes and by the three party schemes.

Over a decade ago, in reviewing the no discrimination rule in the United Kingdom, the Monopolies and Mergers Commission reviewed concerns about consumer confusion and concluded that such concerns were "… exaggerated because they underestimate the ability of consumers, particularly of domestic consumers, who make the great majority of credit card purchases, to look effectively after their own interests."[140]

Two pieces of evidence are cited in support of the argument about potential merchant exploitation of consumers. The first is theatre bookings in the United Kingdom, where credit card users are charged a fee on top of the ticket price for bookings over the phone. The second is taxis in Australia, where customers paying by credit card are charged a fee on top of the metered fare. Visa asserts that these are examples of "hold up" of credit card users.[141]

The Reserve Bank believes this evidence is unconvincing. Claims about theatre bookings in the United Kingdom fail to distinguish between credit card bookings and other bookings. Since credit cards are the only means of paying for tickets over the phone, the fee could be either a charge for credit card use or for a phone

139 Australian Bankers' Association (2001b), p 69.

140 Monopolies and Mergers Commission (1989), p 161.

141 Visa International (2001a), p 30, p 33 and pp 36-37.

booking. There is no evidence of a fee imposed on credit card use at the booking office, suggesting the latter interpretation is correct.[142] In the case of taxis in Australia, a "surcharge" is applied for *any* payment instrument aside from cash. Use of a credit card, charge card or debit card incurs a 10 per cent fee (plus GST) over the metered fare; use of the taxi industry's own payment system, Cabcharge, which was the first non-cash payment method to be offered in taxis in Australia, incurs a 10 per cent fee (including GST). The evidence does not indicate that credit card users are being exploited but that the taxi industry is protecting its own Cabcharge system from all other non-cash payment instruments.

A variant on the exploitation argument is that merchants will discriminate against wealthier customers by charging them more to use a credit card. The notion is that credit cardholders are typically wealthier than non-cardholders; if so, merchants might interpret a customer's desire to use a card as evidence of willingness to pay more and they will systematically charge cardholders higher prices to exploit this.[143]

This argument also does not stand up to scrutiny. In principle, it seems unlikely that such behaviour could be anything but a once-off effect – cardholders would not frequent such a merchant once its pricing behaviour became known. Customers could also easily avoid the merchant's attempt to discriminate by paying by other means. More importantly, however, such pricing behaviour would likely be in breach of the *Trade Practices Act 1974*. This legislation prohibits merchants from making false and misleading statements about the prices of goods and services. The ACCC has advised the Reserve Bank that charging a "fee for service" for credit card use is not a breach of the *Trade Practices Act 1974*, provided consumers are made aware of the existence and amount of the fee prior to a transaction being entered into. If a merchant were to add a fee for accepting a credit card, it would need to post that fee for all customers to see. The ACCC notes that this situation is not analogous to GST pricing where the GST component must be included in the price. Unlike the GST component, any fee charged by a merchant for accepting a credit card is not an integral part of the total price of a good; a consumer could choose to avoid paying that fee by using an alternative payment instrument.[144]

142 In a subsequent submission, Visa has conceded that it cannot demonstrate that the booking fee is a fee for credit card usage. Visa International (2001e).

143 Gans and King (2001d), p 49.

144 The ABA has argued that the ACCC stance on GST pricing – that the GST component must be included in the price - implies that a "fee for service" for credit card use would need to follow the same principle. See Australian Bankers' Association (2001b), p 69.

3.5 A draft standard on merchant pricing

In the Reserve Bank's opinion, restrictions imposed by credit card schemes on the freedom of merchants to set their own prices are not in the public interest. These restrictions harm consumers who do not use credit cards because they pay higher prices for goods and services than they would otherwise. By distorting the relative prices of payment instruments, the restrictions are not conducive to efficiency in the payments system. In addition, the restrictions undermine the competitive pressure which merchants might impose on interchange fees and merchant service fees by limiting them to an "all or nothing" choice about taking cards.[145]

The justifications for the restrictions do not, in the Reserve Bank's opinion, outweigh these consequences. Overseas evidence provides no support for assertions that credit card networks suffer a significant loss of network benefits where such restrictions are removed. If overseas experience is a guide, the removal of scheme restrictions may not have a large impact on the pricing strategies of merchants; many merchants may judge that it is not worth their while to charge a fee for accepting credit cards. However, that is not an argument for denying merchants the *right* to charge differential prices for different payment instruments, particularly given that credit card issuers themselves are able to achieve that outcome through the use of loyalty programs (which reduce the net price of goods and services for credit cardholders).

For these reasons, the Reserve Bank has concluded that a standard on merchant pricing is needed, in the public interest, to promote efficiency and competition in the payments system. The standard would apply to participants in the three designated credit card schemes, under the *Payment Systems (Regulation) Act 1998*.

The Reserve Bank's draft standard will ensure that a merchant accepting a credit card of a designated credit card scheme is free to recover from the cardholder the cost of accepting that card. The draft standard has two key provisions. First, it prohibits designated credit card schemes from having any rules in Australia that restrict merchants, if they so wish, from charging a "fee for service" for accepting credit cards. Secondly, to ensure that existing restrictions cannot continue in a *de facto* way, the draft standard requires that designated credit card schemes introduce a rule in Australia requiring that credit card acquirers, in their contractual agreements with merchants, must allow merchants the freedom to recover their credit card costs. The draft standard also requires that merchants be advised by

145 Gans and King note that "[t]he ability to cross-subsidise makes merchants more willing to bear higher merchant service charges as they derive an indirect benefit from this cross-subsidy." Gans and King (2001a), p 107.

their acquirers, or by the credit card schemes, that they have the freedom to recover their credit card costs.

The draft standard would not preclude contractual agreements between a credit card acquirer and a merchant that would limit the size of the "fee for service" for accepting credit cards to the cost of a merchant of accepting a credit card. Such agreements are permitted in the United Kingdom notwithstanding the prohibition of no discrimination rules in that country.[146]

The Reserve Bank will consult the three party card schemes, American Express and Diners Club, on why the standard on merchant pricing should not apply to them. Access Economics, consultants to American Express, has argued that American Express should be free to continue to impose restrictions on merchant pricing. Its argument is that the no surcharge rule in four party schemes allows their members to "exploit" the market power of these schemes through interchange fees, but that American Express has neither market power nor interchange fees. However, restrictions on merchants recovering from their customers the costs of accepting American Express cards have, in principle, the same types of effects on the prices of goods and services and on price signals to users of payment instruments as do those imposed by MasterCard and Visa.

146 *The Credit Cards (Price Discrimination) Order 1990*, Statutory Instrument 1990 No. 2159.

Standard No. 2

Draft Standard for Designated Credit Card Schemes

Merchant Pricing for Credit Card Purchases

Objective

The objective of this Standard is to promote:

(i) efficiency; and

(ii) competition

in the payments system by ensuring that a merchant accepting a credit card of a designated credit card scheme for the purchase of goods or services is free to recover from the credit cardholder the cost of accepting that card.

Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.

2. This Standard applies to the three credit card systems designated on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, being:

   (i) the credit card system operated within Australia known as the Bankcard Scheme;

   (ii) the credit card system operated within Australia known as the MasterCard System or MasterCard Network Card System; and

   (iii) the credit card system operated within Australia known as the Visa System or the Visa Network Card System,

   each referred to as follows as a Scheme.

3. This Standard applies to any rules of a Scheme that affect the rights and entitlements of a merchant to recover from a credit cardholder the cost of accepting a credit card issued by any of the participants in a Scheme.

4. In this Standard:

   an "acquirer" provides services to merchants to allow the merchant to accept a Scheme's credit cards;

"rules of a Scheme" or "rules" include the constitution of a Scheme, rules, by-laws, procedures or any arrangement in relation to a Scheme by which participants in the Scheme in Australia may consider themselves bound;

a "Scheme Administrator" is the administrator of the Scheme, if any;

a "Scheme's credit card" is a credit card issued in accordance with the rules of that Scheme.

5. This Standard is to be interpreted:
   - in accordance with its objective; and
   - by looking beyond form to substance.

6. This Standard comes into force on [ ].

Merchant pricing

7. The rules of a Scheme must not include any rule that requires a participant in the Scheme to prohibit, or that has the effect of prohibiting, a merchant in Australia from recovering from a credit cardholder the cost to the merchant of accepting a credit card issued by a participant in the Scheme.

8. The rules of a Scheme must include a rule that prohibits acquirers in the Scheme from imposing any term or condition in a contract, arrangement or understanding with a merchant in Australia which prevents, or has the effect of preventing, a merchant from recovering from a credit cardholder the cost to the merchant of accepting a credit card issued by a participant in the Scheme.

9. A participant in a Scheme must not prevent a merchant in Australia from recovering from a credit cardholder the cost to the merchant of accepting a credit card issued by a participant in the Scheme.

Transparency

10. The Scheme Administrator or, if none, each acquirer in the Scheme must ensure that each merchant in Australia that accepts a credit card issued by a participant in the Scheme is advised in writing of the provisions of this Standard.

Notification of Reserve Bank of Australia

11. The Scheme Administrator or, if none, each of the participants in the Scheme must notify the Reserve Bank of Australia of the changes made to the rules of the Scheme to give effect to this Standard.

Reserve Bank of Australia
SYDNEY