

## I. INTRODUCTION

1. This report analyses the economic effects of several practices of Australian credit and charge card systems. Specifically, it looks at the use of so-called *no-surcharge rules* and the setting of *interchange fees*.<sup>1</sup> Under no-surcharge rules imposed by MasterCard and Visa, a merchant accepting a given credit card agrees not to charge its customers any more for using that card than any other non-cash means of payment.<sup>2, 3</sup> The interchange fee is an amount collected from the relevant financial institution serving a merchant at which a payment card is used and transferred to the institution that issued the card.

2. These practices have been subject to an enquiry by the Reserve Bank of Australia and the Australian Competition and Consumer Commission. In October 2000, the Bank and

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<sup>1</sup> No-surcharge rules are sometimes referred to as “non-discrimination rules.” The latter is an economic misnomer. To the extent that different payment mechanisms have different costs, no-surcharge rules force retailers to engage in price discrimination because they require the same prices for products with different costs.

<sup>2</sup> According to the MasterCard rules,

**Charges to Cardholders.** 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 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. “Merchant discount,” as used in this subsection, means any charge for the acquisition of sales slips negotiated by the merchant and the member or affiliate with which the merchant has a merchant agreement. The prohibitions of this subsection (14) do not prohibit discounts for payments in cash, or for charges (such as bona fide commissions, fees for special handling or expedited service, postage and handling, and the like) that are charged to the cardholder regardless of the form of payment. (*MasterCard Bylaws and Rules*, May 1999, §9.04(b)(14).)

According to the Visa rules,

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. (*Visa ByLaws*, November 15, 1999, §5.2.c.)

<sup>3</sup> It is my understanding that Bankcard association regulations do not contain a no-surcharge rule, but that the agreements between merchants and their acquiring banks may well contain surcharge prohibitions.

Commission published a study (the *Joint Study*) stating their initial findings.<sup>4</sup> Industry participants were given the opportunity to comment on the study and offer support for, or objections to, its findings. The present report, commissioned by the Reserve Bank of Australia, analyses economic issues raised by the *Joint Study* and the responses to it.

3. The report is organized as follows. Sections II through IV set the stage for the later analysis. Section II provides an overview of the credit and charge card industry. Section III identifies benefits potentially enjoyed by consumers and merchants from the use of credit and charge cards. As discussed in Section IV, these benefits give rise to network effects. Moreover, because a card-based transaction affects both consumers and merchants, actions by one side of the transaction can affect the economic welfare of the other side. This fact raises the possibility of externalities, which also are defined in Section IV.

4. Sections V through VII analyse the effects of no-surcharge rules and interchange fees. Section V examines the market outcome when merchants can freely engage in surcharging. Section VI then examines the market outcome when merchants must set retail prices that are invariant with respect to the payment mechanism used. Section VII compares the market outcomes with and without surcharging to identify the net effects of no-surcharge rules on economic welfare.

5. After a brief concluding section, a technical appendix surveys several economic models that have been developed to shed light on interchange rate setting and no-surcharge rules. A second appendix discusses the definition of a relevant market and notes that there is no contradiction between the finding that credit and charge cards constitute a relevant market and the finding that distortions in credit and charge card prices can lead to excessive card use.

## II. INDUSTRY OVERVIEW

6. Figure *A* provides an illustrative schematic of the credit and charge card industry. As shown in the diagram, consumers obtain credit and charge cards from card issuers. A card-holding consumer—either a household member or business employee—can use a credit or charge card to make purchases at merchants who accept that brand of card. To do so, the merchant must have a relationship with an acquiring institution. Card issuers and acquiring institutions interact with each other through the credit or charge card system to which they both belong. At the outset, it is important to recognize that each of the Bankcard, MasterCard, and Visa systems is an association of independent corporate entities, the member banks. In contrast, American Express and Diners Club each is a single corporate entity. Bankcard, MasterCard, and Visa often are referred to as *open systems*, while American Express and Diners Club are referred to as *closed systems*.

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<sup>4</sup> Reserve Bank of Australia and Australian Competition and Consumer Commission, “Debit and Credit Card Schemes in Australia, A Study of Interchange Fees and Access,” October 2000.