DESIGNATION OF CREDIT CARD SCHEMES IN AUSTRALIA

Submission to Reserve Bank of Australia

By

COMMONWEALTH BANK OF AUSTRALIA

3 JULY 2001

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1.0 INTRODUCTION

This submission considers issues for guiding a best practice approach to regulatory management which we believe need to be borne in mind by the Reserve Bank of Australia (RBA) in developing the regulatory framework for the designated credit card schemes:

At the outset, the Commonwealth Bank of Australia (the Bank) re-states the views expressed in our letter to the Governor of the RBA of 20 December 2000 that, we believe, need to remain paramount in the consideration of any designation process, viz-

> *"The Bank is keen to ensure that Australia retains its world class electronic payments networks, providing long term benefits to all participants - consumers, merchants and financial institutions. To ensure on-going investment and development, financial institutions need to be able to generate appropriate long-term returns on investment after allowance for associated risks. Only through considerable long - term strategic investment, with ongoing enhancements, will Australia retain its enviable position in electronic payments and enable the deployment of infrastructure for new and emerging technologies.*
>
> *We are concerned, therefore, for the long-term implications for investment in electronic payments systems if reduced returns to financial institutions from electronic payments systems lessen the incentive for financial institutions to invest in the maintenance of existing facilities or the development of new technologies."*

2.0 PROPOSED CONSULTATION PROCESS

The Bank seeks clarity on the proposed consultation process.

The Bank notes that the RBA:

> *"envisages an extensive consultation process, leading to the publication of a consultation document which will explain the public interest issues and outline the (Reserve) Bank's proposed standards and access regime. Interested parties will have a further period for comment before the (Reserve) Bank's regulatory framework is finalised"* (RBA Media Release, 12 April 2001).

The Bank is fully supportive of a transparent process of consultation conducted within a framework that allows for due consideration and discussion of the relevant issues and looks forward to participating actively in this process.

RBA staff indicated on 7 June that the consultation document (including proposed standards and access regime) will not be released until after the 21 August 2001 meeting of the Payments System Board (PSB) and that a consultation period of 6 to 8 weeks is being considered but that no decision has been made. We understand that the publication of the consultation document commences the formal consultation process set out in Section 28 (2) of the Payments Systems (Regulation) Act 1998 (PSRA).

The consultation document is clearly necessary to guide the Bank's deliberations towards those issues the RBA regards as relevant and so provide us with fair opportunity to be heard on those issues. It will provide the Bank, for the first time, with an outline of the RBA's proposed regulatory framework, its purpose and its intended effect. It is also relevant for the consultation document to provide reasons for the designation and the PSB's policies in relation to payments systems.

Given the commercial implications of the RBA's actions to our credit card business, the Bank requests that the RBA's timetable allow adequate time for full and fair consultation even if this means that the RBA's regulatory framework is in place in early 2002 rather than the indicative date of the end of 2001.

The Bank will need time to assess the commercial implications of the matters contained in the consultation document, and consider them against the reasons for designation and the PSB's policies in relation to payments systems.

The Bank's consideration of, and further submission on, the proposed regulatory framework will require an appropriate period of time which will depend on the extent of regulation proposed. Each stage of consultation should be given its due weight, as discussion of issues is no substitute for consultation on concrete proposals and involves consideration of the distinct commercial interests of the Bank.

Accordingly, the Bank is of the view that the appropriate 'specified time' for submissions to the RBA is at least 3 months following the publication of the consultation document.

We would therefore appreciate confirmation that the formal consultation period will proceed with sufficient time to meet our concerns and so allow the Bank to properly consider its commercial interests and make further submissions to the RBA. Publication of a revised timetable, taking into account the necessary consultation periods, would thus be appreciated.

3.0 RBA / ACCC JOINT STUDY COMPRISES INSUFFICIENT JUSTIFICATION FOR REGULATORY INTERVENTION

In the light of significant concerns raised by leading economists about the RBA / ACCC Joint Study (Debit and Credit Card Schemes in Australia, A Study of Interchange Fees and Access, October 2000), the Bank is of the view that the Joint Study's conclusions do not constitute sufficient justification for regulatory intervention in the activities of credit card schemes. The Bank believes, therefore, that the RBA consultation document will need to argue the case for regulatory intervention from a zero base and where reference is made to conclusions in the Joint Study, the consultation document will need to address criticisms of the Joint Study's analysis and conclusions.

4.0 REGULATION OF INTERCHANGE FEES UNDER ACCESS POWERS NOT STANDARDS POWERS OF PAYMENT SYSTEMS (REGULATION) ACT 1998 (PSRA)

The Bank is of the view that any regulation of interchange fees setting should be under the RBA's powers under Section 12 (Imposition of Access Regime) of the PSRA rather than the RBA's powers under Section 18 (RBA may make Standards for Designated Systems). To support this view, the Bank provides a copy of advice from Jeffrey S Hilton S.C. dated 30 June 2001 (refer Attachment to the submission), that concludes that:

> *"the preferable construction of the PSRA, and the one more likely to be found by a Court if the RBA's exercise of its powers under sections 12 or 18 of the PSRA were the subject of an application for review under the Administrative Decisions (Judicial Review) Act 1977, is that:*
>
> - *if the RBA exercises its powers under the PSRA to impose pricing regulation on credit card systems, the regulation must be imposed under section 12 of the PSRA as part of an access regime, together with other conditions of access that have a commercial and financial impact; and*
>
> - *the RBA may not impose pricing rules and principles as a standard under section 18 of the PSRA. Such standards should be confined to standards of a technical or operational character or standards pertaining to financial security."*

In the event that the RBA proposes to take a contrary view of the way the PSRA operates, the Bank requests that discussions on this issue take place with the Bank prior to the publication of the consultation document.

5.0 KEY PRINCIPLES FOR BEST PRACTICE REGULATION

5.1 "Best practice" regulatory approach

The RBA's designation of credit card schemes in Australia is being made under the PSRA. A key requirement of the PSRA is that, before imposing an access regime or standards, the RBA must have formed the opinion that this imposition will be in the public interest. The PSRA further specifies that, in determining whether the imposition:

> *"would be in, or contrary to, the public interest, the RBA 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 in the financial system.

The Reserve Bank may have regard to other matters that it considers are relevant, but is not required to do so." (PSRA s.8)

This test needs to be considered against the background of general principles widely accepted as guiding good regulatory practice in market economies and against the general co-regulatory foundation of regulation in Australia. In the current context, this means that the RBA would only introduce regulation where:

- there is a clear divergence between private interests and the public interest – ie, there is a clear case of "market failure";
- that market failure is giving rise to, or is likely to give rise to, a significant loss of social welfare, materially greater than the cost of regulation;
- the precise nature of the factors giving rise to the market failure have been unambiguously identified;
- the regulation will directly address the causes of market failure or, if that is not possible, its immediate consequences (ie no attempt should be made to "offset" the problems in one market through regulation of another);
- the regulation complements, as far as possible, any mechanisms established by the private sector to address the identified market failure; and
- the regulation will, or is likely to, have in practice an impact which results in a material net increase in social welfare.

Therefore, the Bank considers that, in framing a consultation document setting out proposals for the regulation of the Bankcard, MasterCard and Visa credit card systems, it is incumbent on the RBA to:

- Identify and describe the precise nature of the problem(s) – ie the points of market failure and their causes – the proposed regulation is intended to address;

- Explain how the proposed regulations will address the problems – not only in terms of meeting the public interest test but also their impact on the points of market failure – and their likelihood of success;

- Explain why the proposed regulations are regarded as the most appropriate in the circumstances, having regard to the measures already in place and being put in place by the private sector to address the problem(s);

- Identify and explain any likely consequences of the proposed regulations, if any, beyond their intended targets, including on investment, innovation and the competitive dynamics of the market and related markets; and

- Invite comment from interested parties on any matters relating to the proposed regulations, including whether they are specified unambiguously and can be given a practical implementation (at a reasonable cost).

In addition, when imposing an access regime, the RBA is expressly required to have regard to the interests of existing participants. This express requirement is consistent with "best practice" regulation as it recognises that regulators should carefully consider the potential

impact of proposed interventions upon parties whose interests may be adversely affected by that intervention.

5.2 Best practice regulation

As already noted, "best practice" regulation aims at addressing the source of market failure. The types of situations of market failure that can be effectively addressed include the following examples:

(a) "Access Regime"

- Absence of a workable competition in a market due to artificial barriers to entry.
- Service not widely enough available due to restrictions on participants.
- Innovation is being inhibited by exclusion of those best able to drive it or by inability of participants to appropriate sufficient benefits to justify the investment required.
- Control of bottlenecks which limit market participation and penetration.

(b) "Imposed Standards"

- The system is unsafe or presents excessive risks.
- Technical inefficiencies are creating excessive costs.
- Technical constraints are inhibiting innovation.
- Technical constraints are limiting the ability of computer systems to interconnect thus limiting the "reach" of the network.

These examples illustrate the necessity of identifying the precise nature of the problem to be resolved if "best practice" regulation is to be achieved. For example, in framing regulations, it would not be sufficient simply to know a problem exists with innovation. Until the nature of the problem is clarified, the appropriate power under which the regulation should be formulated remains unclear.

Against this background, we provide our views as to the nature of the "problem" being addressed, along with principles relating to the setting of interchange fees and principles for the determination of other aspects of an access regime.

6.0 RBA's STATEMENT OF THE "PROBLEM" BEING ADDRESSED

In its 12 April 2001 Media Release, the RBA stated:

> *"The credit card systems designated by the (Reserve) Bank have two unique characteristics that raise public interest questions about efficiency and competition:*
>
> - *the systems have wholesale fees (known as interchange fees) set collectively by the financial institutions that are members of these systems, but that are otherwise competitors in providing credit card services to cardholders and merchants. Interchange fees are an important determinant of the fees facing cardholders and merchants in credit card systems; and*
>
> - *membership of the international card systems (MasterCard and VISA), either for credit issuing or acquiring, is restricted in Australia to authorised deposit-taking institutions. Such membership rules based on institutional status may be more*

restrictive than necessary to protect the safety and integrity of the systems. Bankcard is currently reviewing its membership rules."

The most recent account of the problems perceived by the regulators in relation to the open credit card schemes in Australia is contained in the RBA/ACCC Joint Study (Joint Study) published in October 2000. In the media release quoted above, the RBA summarised the main criticisms levelled at the credit card systems in the Joint Study as follows:

"In the case of the credit card systems, the study found:

- *interchange fees are not reviewed regularly by system members on the basis of any formal methodologies;*
- *interchange fees are higher than can be justified by costs, and system members lack clear incentives to bring these fees into line with costs;*
- *price signals are encouraging the growth of credit card usage at the expense of other payment instruments, particularly debit cards and direct debits, that consume fewer resources; and*
- *restrictions by credit card systems on which institutions can enter the acquiring business were unjustified and restrictions on access to card issuing needed to be reviewed."*

These criticisms may, to the extent they are valid, be indicative of problems within the designated systems that need to be addressed. They do not, however, represent a statement of problems in a form that can be regarded as a basis for regulation. For example, the points of market failure and its causes are not clearly identified. Accordingly, the Bank believes that the RBA has not yet identified and expressed problems with the designated credit card systems in a way that is sufficiently clear and unambiguous to guide the framing of "best practice" regulation.

It is not the intention of this submission to address what the Bank sees as shortcomings with the Joint Study. The Bank's views on that document were set out in our letter of 20 December 2000, wherein we stated:

"… the Bank disagrees with a number of the Study's conclusions, and is mindful of potential customer impacts …"

However, as a lead in to the discussion below on interchange setting and access regimes, it is pertinent to address a few key concepts, viz-

- One of the key features of credit card systems is the inherent "jointness" of production – the service to the payer represents a service to the payee and vice versa. From a merchant's perspective, a key service provided by credit cards (as well as by store cards and charge cards) is their role in attracting consumers to their store and in helping to close the sale. If the cards provided merchants with no assistance in achieving sales (ie if cardholders were equally willing to pay by some other means) there would be no incentive for merchants to agree to accept them. That many holders of credit cards prefer to use these cards to pay for their purchases is a strong driver of competition between merchants that, like other strong drivers of competition, has become a widespread feature of the market. The fundamental point is that this service provided to merchants – the service which induces merchants to accept the cards – cannot in any sense be produced separately from the services provided to cardholders.

The Bank believes that the Joint Study attempts to downplay its relevance.

- Cardholders receive benefits from using their cards. These take many forms including the provision of rewards which can be regarded as a discount on the price of the goods or services being purchased. The Joint Study erroneously regards such rewards as a negative price for the payment service, although no payment service is being separately supplied, independent of the purchase. Because of the range of alternatives available to consumers, they are relatively price sensitive and easily switch to another card or other payment instrument.

- The available evidence points strongly to the conclusion that card issuing is a highly competitive activity. The evidence also strongly favours the conclusion that card acquiring is highly competitive and there is strong competition between payment systems. The Bank believes that the RBA should undertake a full competition analysis aimed at identifying points of market failure and their causes before attempting to frame any regulations to address alleged problems in this area.

- For the operation of a credit card system to be economically efficient, the revenues it receives must cover its (economic) costs. Since it involves the joint production of services, costs can be recovered from two separate sources, namely cardholders and merchants. The question for the efficient recovery of costs is as follows: To what extent should the costs be split between these two classes of end-users of the system? The function of interchange fees is to balance cost recovery against the costs incurred by the different participants of the system to enable the efficient operation of the system to be sustained.

  These considerations have important consequences for the consideration of the efficient setting of interchange fees:

  - Cost-based considerations are relevant to the setting of efficient end-user prices for a credit card system. However, since the services to end-users of a credit card system are jointly produced, the key question to be resolved for efficient pricing is the extent to which different classes of end-users should contribute to the costs of the system.

  - Standard economic theory indicates that, for efficient pricing, cost recovery is most heavily weighted towards the end-users that have the least elasticity of demand. In the case of the designated systems, the evidence (including that presented in the Joint Study) indicates that elasticity of demand of merchants is far less than that of cardholders.

  - A system of interchange fees is efficient if it balances the costs incurred by the participants of the credit card system against the revenues that would be generated through efficient user charges.

Various studies published since the release of the Joint Study in October 2000 have addressed shortcomings with the Joint Study's conclusions. The Bank is of the view that:

1. There does not appear to be any problem with respect to the designated credit card systems in relation to competition:
   - from other payment systems (including from the other designated systems);
   - within the issuing function; or
   - within the acquiring function.

2. As participants in the setting of interchange fees, neither issuers nor acquirers have any incentive to increase the fees above their socially optimal level unless there is a failure in the market for retail goods and services. However, significant market failure in the retail market appears unlikely.

3. In the absence of market failure in retailing, the participants in the setting of interchange fees have an incentive to prevent interchange fees from rising above the level consistent with maximising the volume of transactions. This level may be below the socially optimal level.

7.0 PRINCIPLES FOR THE SETTING OF INTERCHANGE FEES

As stated in the RBA's 12 April 2001 Media Release, the key concerns of regulators regarding the setting of interchange fees are that:

- it is undertaken by parties who are otherwise competitors in the provision of credit card services; and
- the interchange fees set are an important determinant of the fees charged to cardholders and merchants.

The interchange fee is one of a number of cost components which together form the basis upon which an acquirer sets its merchant service fee. Further, the second point mentioned above is only relevant to the extent that interchange fees are set at an inappropriate level. Hence, the regulatory concern must centre on the potential for interchange fees to be set at a level designed to deliver higher profits to the industry at the expense of overall social welfare.

The joint production characteristics of credit card systems and other features of the market lead to different considerations from those relevant to price setting in other situations.

The Bank is strongly of the view that a prescriptive approach to interchange setting is inappropriate at this stage; rather, the RBA, should it elect to regulate, should remain at the "principles" level of regulation – ie, if regulation is to be imposed, it should set principles under which competing schemes can adopt potentially differing methodologies provided they comply with the endorsed principles.

8.0 PRINCIPLES FOR THE DETERMINATION OF AN ACCESS REGIME

The purpose of imposing restrictions on who can participate in a payment system (including in what capacity and under what conditions) is to ensure the prudent management of risks, minimise the inappropriate transfer of costs, and facilitate the good governance of the system. In reaching its conclusion that restrictions imposed by credit card systems on which institutions can enter the acquiring business were "unjustified", the Joint Study did not fully examine these issues.

The conclusion that restrictions on participation in acquiring are "unjustified" needs to be re-examined, taking full account of risk management, cost and system governance issues, before it becomes the basis for regulatory action.

The RBA should not intervene until the perceived "problem" with access has been specifically identified and analysed. In particular, any benefits that are considered likely to arise from more "liberalised" access must be weighed against the potential costs including

those associated with the potential increased risk to the safety of the payment system and the interference with the property rights of the existing members of the schemes.

In the event that a case for intervention can be made, the guiding principle should be that the intervention must not increase risk to the system and should be no more than necessary to address the problems identified.

The RBA will also need to consider carefully the nature of the "access rights" that are conferred by any access regime. Third parties may "participate" in credit card payment schemes in one or more of three ways:

- economic participation – through partnership with credit card issuers in the form of "co-branded" cards. This form of participant allows third parties to benefit from the attributes of existing schemes including brand reputation etc;
- participation as a user – through the right to obtain services and participate in interchange activities; and
- participation as a member.

Access to the economic participation in credit card payment schemes is already widespread with many non-financial institutions entering into co-branding commercial arrangements with card issuers.

The second form of participation must be distinguished from the third. It is not necessary or appropriate to mandate, through regulation, access to the rights of membership to achieve liberalisation of participation as a user. The definition of access in the PSRA makes it clear that the right of "access" that the RBA has power to mandate is the right "as a user of the system". Consequently, any access regime imposed by the RBA must be carefully tailored to provide an entitlement to "use" as distinct from purporting to grant ownership rights in the schemes as membership entails – particularly the right to participate in the corporate governance of the schemes. In considering this distinction it is critical that the RBA recognises that the schemes today are the product of investments and business decisions made by their members over many years. These members should continue to be the sole arbiters of the management of the business of the schemes and should continue to be free to decide who they will admit as co-venturers or partners.

The core function of any access regime imposed by the RBA is to lay out the principles under which a corporation seeking access to one of the designated payment systems could become a user.

The most vital principle for the RBA to apply, especially given its statutory responsibility to ensure the safety of payment systems, and to not, by its actions, increase risk in the financial system, is the prudential requirements for those users. This requires the balancing of interests envisaged in section 12 of the PSRA between financial security, the interests of the current participants in the commercial reliability and good standing of their scheme and the interests of access seekers. Consequently the prudential requirements should ensure – but do no more than ensure - that recognised security measures for financial institutions are adopted.

It is clear that there should be an important supervisory role here for the Australian Prudential Regulation Authority (APRA). Similarly it is well accepted that an Authorised Deposit – Taking Institution (ADI) would, prima facie, meet the necessary standards, but the question remains whether non-ADI corporations might be objectively considered sufficiently financially secure and stable. Issuers need to be financially sound so as to settle transactions promptly

and prior to receiving payment from cardholders. Acquirers must be financially sound in order to bear the risk of merchant fraud and failure.

Consequently, in order for the schemes to be financially safe and secure, certainty of payment by issuers and acquirers must be guaranteed. Where a prospective user is not an ADI this level of certainty can only be achieved when its liabilities are guaranteed by an entity of ADI status and that guarantee will survive the financial collapse of the user.

The rules recently adopted by Bankcard in its reforms of membership concur with this approach (although its rules obviously apply to membership and not just participation). However, this approach will not necessarily translate into the globally operating schemes where international considerations come into play.

There are a number of other important principles that an access regime imposed through the exercise of regulatory powers would also need to address:

- a user must agree to comply with any rules and procedures adopted by the governing body of the scheme in relation to the conduct of interchange (which would comply with any principles applicable to pricing of interchange which are comprised within the access regime);

- a user must agree to comply with any rules and procedures adopted by the governing body of the scheme in relation to technical and operational standards;

- a user must agree to the payment of reasonable fees and expenses; and

- the access regime must allow for a procedure for termination of participation rights.

It should always be borne in mind, and was noted by the recent Productivity Commission report on National Access Regimes, that a third party access regime constrains property rights. The imposed access regime must therefore be no more extensive than strictly necessary to achieve statutory objectives. The public interest objective means that the RBA should only act where the current membership requirements are clearly inefficient or unduly restrictive of competition and alternative criteria exist which would better deliver those economic objectives without materially adding to costs or the risk of the financial system.

9.0 NO SURCHARGE

The 12 April RBA Media Release stated:

> *"The RBA/ACCC study was also critical of "no surcharge" rules in card schemes that prevent merchants passing on to cardholders the cost of using their payment cards. In the study's view, such rules — which are imposed by the credit card systems as well as American Express and Diners' Club — suppress price signals that guide the efficient allocation of resources. The (Reserve) Bank will review whether the imposition of "no surcharge" rules by card schemes is in the public interest. Any decisions taken by the (Reserve) Bank in this area would, of course, apply to both credit card systems and "three party" systems.*

The Bank set out its views on the no surcharge rule in our submission to the RBA dated 6 April 2001. The Bank considers that the evidence of a public benefit resulting from the abolition of 'no surcharge' rules is weak, and is unlikely to outweigh the consumer detriment

involved in exposing cardholders to pricing uncertainty and the actions of unscrupulous merchants.

Since our 6 April submission, we have considered the market surveys carried out in Sweden and the Netherlands for the European Commission in relation to the "no discrimination" rule.

Merchant reasons for not surcharging in Sweden are set out on page 23 of the survey titled "Study Regarding the Effects of the Abolition of the Non-discrimination Rule in Sweden for European Commission Competition Directorate General" by IMA Market Development AB, 29 February 2000 as follows:

> *"Foreseen negative cardholder reactions leading to loss of customers is the dominating reason for not surcharging, closely followed by merchants' opinion that it simply is a matter of service or principle not to surcharge. About one tenth of the merchants are careful to point out that card payment is a well functioning system, allowing them to avoid handling of (large amounts) of cash."*

Merchant reasons for not discounting for customers paying by means other than with a credit card are set out on page 26 of the survey:

> *"The dominating reason for not discounting is that merchants do not wish to differentiate between customers due to means of payment (29%). In addition, card payment is regarded as a well functioning, safe system that one would rather like to encourage, thus avoiding cash handling as far as possible (23%)."*

In the Bank's 20 December 2000 submission, the Bank expressed the view, based on the work of Frontier Economics, that there is no basis for the proposition that cash paying consumers are cross-subsidising credit card paying consumers. In addition, if merchants were able to surcharge, it results in over-compensation of the merchant to the detriment of the cardholder as the merchant is not paying their fair share from participating in the credit card system and as a consequence the cardholder pays too much.

The Bank notes that any decisions the RBA takes in this area would apply to both credit card systems and "three party" systems. As the "three party" systems are not subject to the current designation, the consultation document would need to set out the proposed method of including "three party" systems within the scope of any decision.

10.0 COMPETITIVE NEUTRALITY WITH "THREE PARTY" CARD SCHEMES

The Bank notes that the operations of the closed "three party" card schemes in Australia were not brought under the RBA's regulatory oversight. The Bank notes also from the RBA 12 April Media Release that the PSB will take into account the competitive dynamics of the industry in any decisions it takes. In the Bank's submission to the RBA dated 6 April 2001, the Bank argued that regulatory action against the open card systems that would weaken the competitive constraints on the closed systems would not be in the interest of either competition or efficiency.

The Joint Study acknowledged, but did not examine, the competitive risk associated with action against the open card systems but not the closed systems:

> *"… the study is mindful that its findings on credit card schemes may have implications for the competitive position of credit cards vis-à-vis store cards and charge cards."*

The consultation document will need to examine the likely competitive outcomes in determining whether any proposed regulatory intervention is in the public interest.

11.0 BENEFITS FOR CONSUMERS

The Bank is of the view that any regulation of interchange fees needs to result in an outcome which ensures that any merchant savings are passed on to consumers. The Bank notes that the Governor of the RBA stated to the House of Representatives Standing Committee on Economics, Finance and Public Administration on 11 May 2001 that he is confident that the competitiveness of retail markets will mean that any savings will be passed on to consumers and not be held by retailers. The consultation document will need to set out the mechanisms by which the RBA will ensure that any savings are passed on to consumers.

12.0 REGULATORY CERTAINTY

The Bank notes that the 12 April RBA Media Release stated:

> *"As set out in their Memorandum of Understanding, the (Reserve) Bank and the ACCC will ensure that credit card systems and their members would not be at risk under the Trade Practices Act 1974 as a result of complying with the (Reserve) Bank's requirements."*

The consultation document will need to set out the mechanisms by which the interactions of the PSRA and the Trade Practices Act will give regulatory certainty to the credit card systems and their members.

13.0 VISA DEBIT

In the Bank's letter to the RBA dated 20 December 2000, the Bank indicated that it was reviewing the Visa debit card product that was acquired from Colonial Limited. As a consequence of that review, the Bank has discontinued the Visa debit product and has replaced all Colonial's Visa debit cards with standard Commonwealth Bank debit cards as part of the Bank's conversion of Colonial's products over the weekend 2 / 3 June 2001.

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Attachment

Advice from Jeffrey S Hilton S.C. dated 30 June 2001

COMMONWEALTH BANK OF AUSTRALIA

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DESIGNATION OF CREDIT CARD SYSTEMS

MEMORANDUM

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1. BACKGROUND

On 12 April 2001 the Reserve Bank of Australia ("**RBA"**) formally "designated" the credit card systems operated in Australia by Bankcard, MasterCard and VISA as payment systems subject to its regulation under the *Payment Systems (Regulation) Act* 1998 ("the **PSRA"**).

In its press release accompanying the designation, the RBA stated that designation is the first step in the RBA establishing an access regime under section 12 of the PSRA and/or standards for the operation of these credit card systems under section 18 of the PSRA. The RBA has also expressed a preliminary view that it considers standards as encompassing price regulation.

The Commonwealth Bank of Australia has requested my advice as to whether the principles or rules governing the pricing of credit card systems may be imposed under an access regime under section 12 of the PSRA or as a standard under section 18. I understand that the Commonwealth Bank of Australia intends to provide a copy of my advice to the RBA in connection with the Bank's own submission to the RBA on the designation of credit card schemes in Australia.

The following advice concludes that the preferable construction of the PSRA, and the one more likely to be found by a Court if the RBA's exercise of its powers under sections 12 or 18 of the PSRA were the subject of an application for review under the *Administrative Decisions (Judicial Review) Act* 1977, is that:

- if the RBA exercises its powers under the PSRA to impose pricing regulation on credit card systems, the regulation must be imposed under section 12 of the PSRA as part of an access regime, together with other conditions of access that have a commercial and financial impact; and

- the RBA may not impose pricing rules and principles as a standard under section 18 of the PSRA. Such standards should be confined to standards of a technical or operational character or standards pertaining to financial security.

I acknowledge that alternative constructions of these provisions of the PSRA are available as the express terms of the provisions are drafted in general terms only and the interplay between sections 12 and 18 is less than clear. Nevertheless, I am of the view that the interpretation detailed in this advice is to be preferred.

2. ACCESS POWERS UNDER THE PSRA

2.1 Division 3 of the PSRA

Section 12 of Division 3 of the PSRA grants the RBA power to impose the rules for an access regime on a designated payments system. Section 12 of the PSRA requires that in imposing an access regime the RBA should consider whether the access regime is appropriate having regard to:

> *(a) whether imposing the access regime would be in the public interest; and*
>
> *(b) the interests of the current participants in the system; and*
>
> *(c) the interests of people who, in the future, may want access to the system; and*
>
> *(d) any other matters the Reserve Bank considers relevant.*

Access is defined in section 7 of the PSRA to mean:

> *"in relation to a payment system…the entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable."*

Section 14 provides for the variation of access regimes and stipulates that the RBA may vary an access regime if it considers it appropriate to do so, again having regard to the matters listed in (a) – (d) above. In addition, the RBA is not to vary a regime (unless the variation is of a minor technical nature) unless it has consulted in accordance with section 28.

Lastly, section 17 grants a person who has been denied access to a designated payment system the right to apply to the Federal Court if that person considers that

the denial of access constitutes or is attributable to a breach of a provision of an access regime.

2.2 Interpretation of the RBA's powers under section 12

The PSRA is largely silent as to how the RBA is to form its opinion as to what is the most appropriate subject matter for an access regime or standard that it imposes on the participants in a designated payments system. However, in exercising its powers and making its determination under the PSRA, the RBA will be bound by a construction of the relevant provisions "that would promote the purpose or object underlying the Act (whether or not that purpose or object is expressly stated in the Act or not)": section 15AA of the *Acts Interpretation Act 1901* (Cth). Such a purpose is to be preferred to a construction that would not promote the purpose or object: Mills v Meeking (1990) 91 ALR 16, per Dawson J at 30-31; Saraswati v R (1991) 100 ALR 193 at 207-208 per McHugh J, with whose judgment Toohey J agreed; Corporate Affairs Commission (NSW) v Yuill (1991) 100 ALR 609 at 628-9 per McHugh J; R v Boucher (1994) 70 A Crim R 577 at 591.

To establish the purpose or object underlying the PSRA, regard may be had to extrinsic material in accordance with common law principles governing statutory interpretation, independently of section 15AB of the Acts Interpretation Act 1901 (Cth): Newcastle City Council v G10 General Ltd (1997) 191 CLR at 112 per Toohey, Gaudron and Gummow JJ at 99. As stated by McHugh J in Newcastle City Council v GIO General Ltd (1997) 191 CLR at 112:

> *"In construing a provision […] a court is permitted to have regard to the words used by the legislature in their legal and historical context and, in appropriate cases, to give them a meaning that will give effect to any purpose of the legislation that can be deducted from that context."*

McHugh J went on to cite Toohey and Gummow JJ in CIC Insurance Ltd v Bankstown Football Club Ltd (1997) 187 CLR 384 at 408:

> *"It is well settled that at common law, apart from any reliance upon s 15AB of the Acts Interpretation Act 1901 (Cth), the court may have regard to reports of law reform bodies to ascertain the mischief that a statute is intended to cure. Moreover, the modern approach to statutory interpretation (a) insists that the contexts be considered in the first instance, not merely at some later stage when ambiguity might be thought to arise, and (b) uses "context" in its wider sense to include such things as the existing state of the law and the mischief*

> *which, by legitimate means such as those just mentioned, one may discern the statute was intended to remedy."* (References omitted).

Section 15AB also provides that consideration may be given to extrinsic material to determine the meaning of the provision where the provision is ambiguous or obscure.

The Explanatory Memorandum to the Payment Systems (Regulation) Bill 1998 ("**EM"**) supports the interpretation that effective access under the PSRA encompasses both the identity of the parties able or entitled to access as well as the economic terms on which they have access. The EM states that:

> *"This Bill proposes a new regulatory framework for the system. … The Bill provides powers to the Reserve Bank to enable it to undertake more direct regulation of designated payment systems (which are sub-set of the payment system) where it is in the public interest. These powers include the imposition of rules of access for participants* ***on commercial terms****.*
>
> *…access is defined to mean an entitlement to become a participant in a designated payment system on a commercial basis that is fair and reasonable. This means that* ***access rights are not imposed on non-commercial terms*** *that do not take appropriate account of the costs and interests of current participants in a payment system."*

In addition the EM provides some context in which to view the RBA's power under the PSRA in stating two guiding principles for the RBA:

1. *Regulation of the payment system needs foremost to promote competition and efficiency while ensuring security, confidence and stability in the system.*

2. *The regulator is to ensure, in consultation with the existing participants, that conditions of access to designated payment systems are fair, transparent and contestable.*

This statement makes it clear that access rights are not to be imposed on non-commercial terms that do not take account of the costs and interests of the current participants. As pricing issues are fundamental to the interests of the current participants and to the question of their costs, section 12 of the PSRA, which expressly acknowledges the interests of current participants and provides for consultation is the applicable provision for their determination.

It is also relevant to have regard to the *Financial System Inquiry Final Report* (March 1997) ("**Wallis Report**"), to ascertain the purpose or object of the PSRA, as the PSRA formed part of the legislative reform package in response to the inquiry.

The Wallis Report addresses the issue of whether there is scope for increased competition and efficiency in the payments system in Chapter 9.

In relation to credit card payment systems, the Wallis Report identified two industry arrangements which it claimed had the potential to affect the efficiency of credit card payments system adversely, which it described as follows:

> *"First, ad valorem interchange fees on credit cards mean that the cost of providing this payment mechanism to consumers can be very high. Also, the cost to consumers is not transparent but is ultimately borne by consumers in the form of higher prices …. concerns have been raised about the size of the interchange fee on credit cards and whether the pricing of debit interchange is appropriate.*
>
> *Secondly, confidential information provided to the Inquiry demonstrates that the relative negotiating strength of major merchant acquirers and card issuers over interchange fees is uneven and that regional banks have been frustrated in their efforts to gain access to the EFTPOS network as acquirers. In addition, some participants have found that equipment certification by the four major banks (necessary for the security of the system) has been protracted, inconsistent and at the convenience of incumbents. Given the proprietary networks and current interchange arrangements, it appears that card issuers bear a disproportionate share of the cost of the EFTPOS network".*

The Wallis Report suggests that the PSRA was intended by Parliament to give the RBA the power in certain circumstances to remedy the "mischiefs" identified above, namely the interchange fees or the costs of providing credit card payments systems to consumers and the difficulties encountered by some parties, in part as a result of those costs, of obtaining access to the EFTPOS network.

However, the Wallis Report also commented on and made recommendations as to how these issues could be addressed by regulation, stating that:

> *"While interchange fees should continue to be a matter of bilateral negotiation, free and open competition for switching revenues will be the most appropriate means of ensuring efficient pricing. However, the evolution of the market must be monitored to ensure that access to electronic networks on*

appropriate commercial terms remains available to all industry participants. This should include appropriate oversight of technical standards by the PSB."

The Report suggests that effective access to the electronic payments systems is provided where "appropriate commercial terms" are available to all industry participants. The price which participants pay for such access is the core issue in determining whether appropriate commercial terms of access are available to participants. Standards, however, are distinguished as being relevant to "technical" matters, that also assist participants to access the electronic payments system. The use of the term "technical" indicates that standards were not intended to deal with commercial or pricing issues, but with obstacles to access that were identified, such as equipment certification procedures.

Lastly, regard must be had to the language of the relevant provisions of the PSRA, in the context of its legislative purpose, to confirm the proper construction of the section. The examination of extrinsic material above suggests that the purpose of the PSRA is to ensure that where an access regime is imposed, it must be on commercial terms, which take into account the costs and interests of current participants in a payment system. This is consistent with the terms of the PSRA, including the definition of the term "access", the requirement to consult with participants in the payments system, and the right of a participant to appeal to the Federal Court when such access is not made available. It is submitted that where the RBA seeks to regulate the price of use of the payment system, it is consistent with the purpose and object of the Act, and the "mischief" it seeks to address, to impose price regulation pursuant to an access regime.

3. STANDARDS POWERS UNDER THE PSRA

3.1 Section 18 of the PSRA

Section 18 of the PSRA provides for the RBA to make standards for designated systems. It simply provides:

the Reserve Bank may, in writing, determine standards to be complied with by participants in a designated payment system if it considers that determining the standards is in the public interest.

In imposing a standard, the RBA need not take into account the interests of the current participants, nor future access seekers. As well, section 18(3) of the PSRA provides that:

The Reserve Bank may, in writing, vary or revoke a standard.

Variation of standards is therefore not constrained by any of the matters set out in section 14, including the need to consult, which constrain the variation of an access regime.

Parties which are subject to standards do not have the right to appeal to the Federal Court if they consider that a breach of a standard has occurred. Standards are only enforceable by the RBA.

3.2 Interpretation of section 18

The term "standards" is not defined in the PSRA. Consistent with the principles of statutory interpretation outlined above in 2.2, the meaning of the term "standard" in the context of the PSRA must be derived from the natural meaning of the word, the purpose or object of the PSRA and the use of the term "standard" in the context of the PSRA itself.

The Macquarie Dictionary 3rd Edition defines standard as:

"a level of quality which is regarded as normal, adequate or acceptable"

This concept of a "standard" in a payment system referring to matters of an operational nature is supported by the EM. The EM, in describing the new regulatory framework in paragraph 1.6 describes the determination of standards as:

"the determination of standards for the operation of payment systems"

The Wallis Report also recommended that:

> *"the evolution of the market must be monitored to ensure that access to electronic networks on appropriate commercial terms remains available to all industry participants. This should include appropriate oversight of* ***technical standards*** *by the PSB."*

The statement that standards are "for the operation of payment systems" and the reference to "technical" standards indicate that the legislative purpose in empowering the RBA to impose standards was to enable it to address questions of reliability, safety and adequate capacity. Qualifications on a right of access to a payment system in addition to the access price are required to protect the integrity of the system. In the context of payment systems, it is submitted that these considerations

translate to questions of financial security (such as prudential requirements) and technical operation (such as the encryption specifications).

Importantly, the restriction of the RBA's standards making powers to technical or operational standards for the payment system is consistent with the principle of statutory interpretation in relation to the operation of specific and general powers within a statute. As Mason J stated in Leon Fink Holdings Pty Ltd v Australian Film Commission (1979) 141 CLR 672 at 678:

> *"It is accepted that when a statute confers both a general power, not subject to limitations and qualifications, and a special power, subject to limitations and qualifications, the general power cannot be exercised to do that which is the subject of the special power."*

This principle has been applied by McHugh J stated in Saraswati v The Queen (1991) 172 CLR 1 at 24, in Waters v Public Transport Corporation (1991) 173 at 349 and more recently in David Grant & Co Pty Ltd v Westpac Banking Corporation (1995) 184 CLR 265 where Gummow J at 276 cited Gavan Duffy CJ and Dixon J in Anthony Horden & Sons Ltd v Amalgamated Clothing and Allied Trades Union of Australia (1932) 47 CLR 1 at 7:

> *"When the Legislature explicitly gives a power by a particular provision which prescribes the mode in which it shall be exercised and the conditions and restrictions which must be observed, it excludes the operation of general expressions in the same instrument which might otherwise have been relied upon for the same power."*

The PSRA provides for specific powers in relation to the imposition of an access regime. Division 3 – 'Access to designated systems' sets out the RBA's powers for the imposition and variation of an access regime as well as when an access regime under the PSRA comes into and ceases to be in force. An important aspect of power conferred under this Division is that it prescribes the mode in which it must be exercised, and the matter which the RBA must take into account. Under section 14(2)(b) the RBA must have regard to the interests of the current participants when considering whether a proposed access regime is appropriate. This requirement is consistent with the concept of access to a service in that it recognises that commercial implications are implicit in the granting of a right of access.

In contrast, the standards making powers in section 18 of the PSRA are general. The RBA's standards making powers provide the RBA with greater discretion, as it is only restricted in the exercise of that power by the requirement to determine that

standards are in the public interest. Because of difficulties in anticipating the specific nature of circumstances that may impact upon the integrity of the payment system, it is necessary that such a power be expressed generally. Importantly, unlike the access powers under Division 3 of the PSRA, the RBA's standards power is not qualified by either a definition or by specific rules regarding its application.

Given that under the principles of statutory interpretation to which I have referred, a general power cannot be exercised to do that which is provided for by a special power subject to conditions, the proper construction of the PSRA does not permit the RBA to exercise RBA's standards-making power to set what is the most fundamental commercial term of access to the payment system, namely price, particularly where this will have substantial financial impact on existing participants in the system. Instead, the powers given under section 18 of the PSRA should be restricted to matters of a technical or operational nature. Otherwise, the legal safeguards in section 12 of the PSRA will have been bypassed in a manner which it is most unlikely the Parliament could have contemplated.

The principal contrary argument relies on the express terms of section 18 which appear to be unrestricted and unqualified. This therefore leaves open the argument that standards prescribed by the RBA can involve financial matters, including the rates of interchange fees. It cannot be gainsaid that linguistically this construction is open and could be adopted by a Court. However, for the reasons I have given, I think the contrary construction is the correct one. Moreover, I am reinforced in the conclusion by the other matters relating generally to the regulation of access in Australia as set out below.

4. ACCESS REGULATION IN AUSTRALIA

4.1 Nexus between a right of access and the price of access

Reference may also be had to similar statutes within the Federal jurisdiction which regulate access to assist in ascertaining the meaning of the access and standards provisions in the PSRA.

In particular, it may be noted that the EM envisaged that there would be close consultation between the RBA and the ACCC when preparing any access regime under the PSRA, hence parliament intended that the RBA would obtain the advantage of the ACCC's expertise in the field, derived from its direct supervision of access regimes under other legislation.

The current approach to access regulation in Australia can be derived from the report made in 1993 by the National Competition Policy Review, chaired by Professor Fred Hilmer ("**Hilmer Report**"). The Hilmer Report formed the basis of consultations with Governments and the public which ultimately resulted in the Competition Principles Agreement ("**CPA**") entered into in 1995 by the Commonwealth of Australia, the States, the Australian Capital Territory and the Northern Territory.

As a result of the CPA, the Commonwealth enacted the *Competition Policy Reform Act 1995* introducing Part IIIA, headed "Access to Services", into the *Trade Practices Act 1974*. Part IIIA provides for a procedure whereby a service can be "declared", with the result that an interested party can obtain access to the use of that service. The legislative intent of Part IIIA was to maximise the efficient utilisation of infrastructure of national importance and avoid wasteful duplication for the purpose of stimulating fair competition in the marketplace, subject to fair and appropriate terms and conditions.

The qualification that a right of access to a service be subject to "fair and appropriate terms and conditions" flowed from the recognition in the Hilmer Report of the link between a right of access to a service and the price paid for the service. The need to consider access and access pricing together arises in two contexts:

- firstly, without price regulation in combination with a right to access a service, an access provider is left with the ability to constructively refuse access to the service through prohibitively high access prices; and

- secondly, any terms of access can not be considered reasonable unless they ensure the access provider sufficient return on its investment.

As the Hilmer Report stated at 253:

> *"The legitimate interests of the owner of the facility must be protected through the imposition of an access fee and other terms and conditions that are fair and reasonable, including recognition of the owner's current and potential future requirements for the capacity of the facility […] Access to a facility should only be declared if the legitimate interests of the owner of the facility are protected through a requirement for a "fair and reasonable" fee for providing access, and other appropriate terms and conditions."*

It is important to note that the Australian Competition Tribunal has expressed reservations about the extent to which the Hilmer Report may be relied upon as an aid for the interpretation of Part IIIA of the *Trade Practices Act 1974*, stating that:

> *"Any submission as to the proper construction of the provisions of Pt IIIA of the Act, or as to the policy underlying Pt IIIA based upon the Hilmer report, must be considered with caution. The legal regime to enable access to essential facilities recommended by the Hilmer Committee was not implemented by Pt IIIA of the Act": Sydney International Airport [2000] ACompT 1 (1 March 2000).*

However, this reservation was expressed in response to a submission on a very different issue - whether the principal rationale of the regime was to give firms a right of access to a facility controlled by a vertically integrated monopolist. In relation to the issue of price regulation, the Tribunal stated that:

> *"The Hilmer Committee recommended an access regime which provided for an access declaration not only to indicate the facility subject to the declaration but also to indicate matters such as* ***pricing principles*** *governing access and any other terms and conditions to protect the legitimate interests of the owner of the facility. The recommendation provided for the Minister to make the access declaration but only if recommended by the Council and* ***on terms and conditions*** *either agreed by the owner of the facility or recommended by Council."*

Although Part IIIA did not adopt the recommendations of the Hilmer Committee to incorporate pricing principles in the Minister's declaration, it nevertheless required terms and conditions of access (including pricing) to be agreed or determined before access could be provided. The Australian Competition Tribunal described the nexus between the right to access and the terms and conditions of access under Part IIIA in its decision relating to Sydney International Airport as follows:

> *" … obtaining access to a service as defined [under Part IIIA of the Trade Practices Act] involves two stages. The first stage requires a declaration of the service which, of itself, does not entitle any person or organisation access to the service. Rather the declaration opens the door, but before an applicant to use the service can become entitled to use the service, the applicant must progress to the second stage and either reach agreement for access with the service provider or, in default of agreement, have its request for access determined through an arbitration by the Australian Competition and Consumer Commission ("the Commission"). It is at the second stage that the terms and conditions on and subject to which access is to be given are worked out and, in default of agreement, determined through an arbitration by the Commission."*

The regulatory regime for access under Part IIIA is therefore consistent with the recognition in the Hilmer Report of the necessity for the terms and conditions of access to be established for effective access to a service or facility to be provided. Hence, it is submitted, it is legitimate to refer to the Hilmer Report as an aid to interpretation in relation to this issue.

The application of post-Hilmer access reform has seen pricing guidelines as the main vehicle for giving effect to the objectives of access regulation. It is common to all extant access regimes for pricing principles to be treated as a central element of the access regime. For example, the *National Third Party Access Code for Natural Gas Pipelines Systems* provides that arrangements for access to the pipeline establish *"the policies and basic terms and conditions, including the tariff structure, which apply to third party access to the pipeline"*: *Duke Eastern Gas Pipeline Pty Ltd* [2001] ACompT 2 (4 May 2001). Regulators have emphasised the importance of considering pricing principles as part of the construction of access regimes so that the pricing structure adopted by service providers does not undermine the access regimes. As the Australian Competition and Consumer Commission ("Commission") recognised in 'Access undertakings – A guide to Part IIIA of the Trade Practices Act' published in September 1999:

> *"Part IIIA requires the service provider to provide details of terms and conditions of access as part of an undertaking. The Commission takes the view that access pricing arrangements are generally necessary in specifying the terms and conditions".*

5. ROLE OF STANDARDS IN ACCESS REGULATION

In addition to the requirement that an access regime include terms that are fair and reasonable to both the access provider and the access seeker, the Hilmer Report referred to the need for further qualifications on a right of access to protect the owner of the relevant facility. As the Hilmer Report stated at p. 256:

> *"In some cases it may be appropriate to qualify the right of access, such as by imposing quality requirements on the gas or water put in a pipeline, the minimum or maximum volumes of throughput or other conditions."*

This concept of standards of operation was adopted in Part IIIA of the TPA. The Commission recognised in 'Access undertakings – A guide to Part IIIA of the Trade Practices Act' published in September 1999:

> *"Product, technical and service quality are major concerns for both providers and users of any service. As with access pricing, there is clear potential for conflict of interest. From the users point of view, the service should meet quality requirements such as reliability safety and adequate capacity."*

This analysis indicates that there are significant parallels between the access powers set out in section 12 of the PSRA and access regimes that exist in other contexts. Section 12 of the PSRA is reflective of both the language and structure of the national access regimes currently in place for gas, electricity and telecommunications, each of which are based upon the generic access regime provided for under Part IIIA of the TPA. These parallels would assist a Court to find that the RBA is empowered to impose pricing regulation as part of an access regime, rather than a standard under the PSRA.

I advise accordingly.

JEFFREY S HILTON S.C.
Selborne Chambers
30 June 2001