

COMMONWEALTH OF AUSTRALIA

TRADE PRACTICES ACT 1974

IN THE AUSTRALIAN COMPETITION TRIBUNAL

File No: 7/03
9/03

**RE: APPLICATION FOR REVIEW OF THE
DETERMINATION OF THE AUSTRALIAN
COMPETITION AND CONSUMER COMMISSION,
AUTHORISATION A30224 AND A30225 IN RELATION
TO THE COLLECTIVE SETTING OF EFTPOS
INTERCHANGE FEES**

**BY: AUSTRALIAN RETAILERS ASSOCIATION;
AUSTRALIAN INSTITUTE OF PETROLEUM LTD;
AUSTRALIA POST;
BUNNINGS PTY LTD;
CALTEX AUSTRALIA PETROLEUM PTY LTD;
FRANKLINS PTY LIMITED;
MCDONALD'S AUSTRALIA LIMITED; AND
WOOLWORTHS LIMITED.
(THE "EFTPOS MERCHANTS GROUP")
(File No 7 of 2003)**

Applicants

**BY: COLES MYER LIMITED
(File No 9 of 2003)**

Applicant

SUBMISSION OF THE RESERVE BANK OF AUSTRALIA

I. THE RESERVE BANK'S ROLE IN THE PAYMENTS SYSTEM

1. The Reserve Bank's Payments System Board was established on 1 July 1998 with a mandate to promote the safety and efficiency of the payments system in Australia. The Reserve Bank was also given regulatory powers to enable it to give effect to the Board's decisions.¹

¹ Through the *Payment Systems (Regulation) Act 1998*, *Payment Systems and Netting Act 1998*, *Cheques Act 1986* and the *Reserve Bank Act 1959*.

2. The creation of the Payments System Board and the strengthening of the powers of the Reserve Bank with respect to the Australian payments system were a response by the Parliament to the recommendations of the Financial System Inquiry (the Wallis Inquiry). The Wallis Inquiry concluded that Australia's payments system fell short of international best practice in terms of efficiency. In particular, it found "that the overall cost of Australia's financial system is at the higher end of the middle range of a set of comparable countries"² and noted that "[p]ayments systems and related branch networks are responsible for the largest portion of most retail banks' costs".³ Consequently, it concluded "that significant improvement is possible if competition is allowed to run its course and international best practice is brought to the fore throughout the financial system".⁴
3. The Payments System Board's mandate is set out in Section 10B of the *Reserve Bank Act 1959*.
4. The regulatory powers that support this mandate are set out in a number of Acts, the most important of which, in the context of the current hearing, is the *Payment Systems (Regulation) Act 1998*. Section 10 of this Act provides that:⁵
 - (1) *Under this Part, the Reserve Bank is given the power to designate payment systems (see Division 2).*
 - (2) *The Reserve Bank has the following powers in relation to a designated payment system:*
 - (a) *it may impose an access regime on the participants in the payment system (see Division 3); and*

² Financial System Inquiry (Wallis Committee) 1997, *Final Report*, AGPS, Canberra, p. 202.

³ *Ibid.*, p. 206.

⁴ *Ibid.*, p. 202.

⁵ Section 26 of the Act also gives the Reserve Bank the power to collect information from participants in payment systems.

- (b) *it may make standards to be complied with by participants in the payment system (see Division 4); and*
- (c) *it may arbitrate disputes relating to the payment system (see Division 5); and*
- (d) *it may give directions to participants in the payment system (see Division 6).*

5. The *Explanatory Memorandum to the Payment Systems (Regulation) Act 1998* states that:

“Industry will continue to operate by self-regulation in so far as such regulation promotes an efficient, competitive and stable payments system. Where the RBA considers it in the public interest to intervene, the Bill empowers it to designate a payment system and develop access regimes and standards in close consultation with industry and other interested parties. Where a payment system is not designated, or where an access regime does not cover a specific matter, the ACCC will retain existing regulatory rights under the TPA.”⁶

6. Given the potential overlap in regulatory responsibilities, the RBA and ACCC have entered into a Memorandum of Understanding.⁷
7. The Reserve Bank has exercised its powers in two cases. In April 2001, it designated each of the credit card schemes operated in Australia by Bankcard, MasterCard and Visa as a payment system under the *Payment Systems (Regulation) Act 1998*.⁸ The Reserve Bank entered into a process of consultation

⁶ Payment Systems (Regulation) Bill (1998), *Explanatory Memorandum*, AGPS, Canberra, ¶ 4.1.

⁷ http://www.rba.gov.au/MediaReleases/1998/mr_98_joint_accr_rba.html

⁸ http://www.rba.gov.au/MediaReleases/2001/mr_01_09.html

on the appropriate regulations for these payment systems and finalised standards in August 2002⁹ and an access regime in February 2004.¹⁰

8. In February 2004, the Reserve Bank designated the debit card scheme operated in Australia by Visa as a payment system under the *Payment Systems (Regulation) Act 1998*.¹¹ The Bank is now in the process of consulting with interested parties on whether it is in the public interest to impose either standards or an access regime on the Visa debit scheme and what form these might take.
9. While the Reserve Bank has not exercised its powers with respect to the Australian EFTPOS system, it has consulted industry participants on the need for designation of the system. The Reserve Bank wrote to industry participants in December 2003 asking for their views on the possible designation of the Australian EFTPOS system.¹² This consultation was in keeping with the expectation expressed in the *Explanatory Memorandum to the Payments System (Regulation) Act 1998*: “While not required by law, it is expected that designation generally will occur only after substantial consultation with participants and after consideration of alternative regulatory approaches and voluntary arrangements have been exhausted.”¹³

II. THE JOINT STUDY

10. One of the first tasks undertaken by the Payments System Board was a stocktake of the Australian payments system.¹⁴ One fact that came out of that stocktake was that credit card use had grown strongly over the second half of the 1990s while debit card use had experienced relatively slow growth. Chart 1 below shows the relevant data.

⁹ http://www.rba.gov.au/MediaReleases/2002/mr_02_15.html

¹⁰ http://www.rba.gov.au/MediaReleases/mr_04_02.html

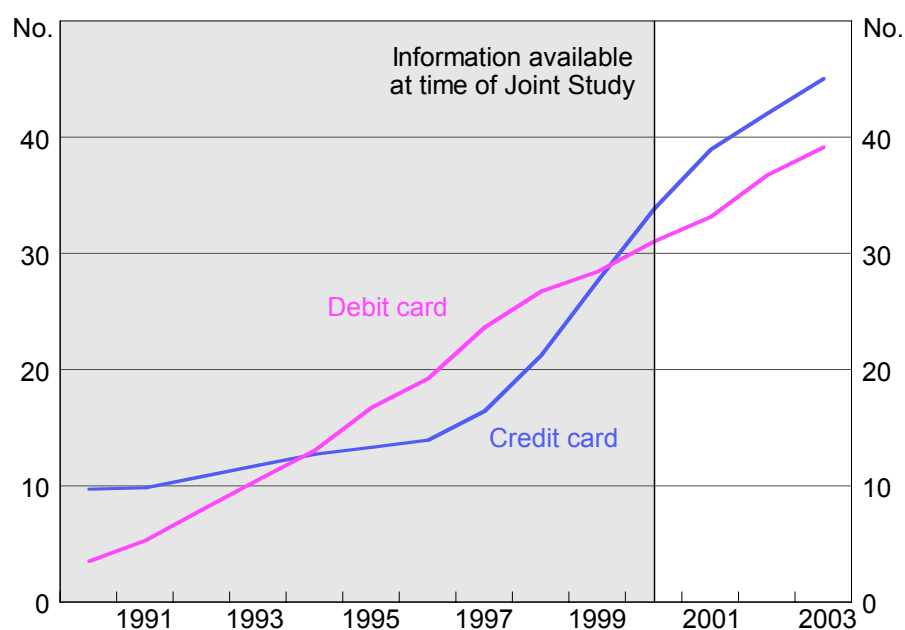
¹¹ http://www.rba.gov.au/MediaReleases/mr_04_01.html

¹² Reserve Bank of Australia (2003), Letter from Dr John Veale, 23 December. 2003.

¹³ Explanatory Memorandum, *op. cit.* ¶ 5.13.

Chart 1: Number of Card Payments per Capita¹⁵

Per year



Source: Reserve Bank of Australia Bulletin and ABS Catalogue No. 3101.0

11. The Payments System Board identified price signals as providing a possible explanation for these trends and noted the effect of interchange fees in card payment systems on the price signals faced by cardholders and merchants. However, at that time, there was very little information available on interchange fees or the costs of various payment systems.
12. Interchange fees in both credit and debit card systems had also been identified by the Wallis Inquiry as potentially important to the efficiency of the payments system. With respect to the EFTPOS system, it noted:

“Given the proprietary networks and current interchange arrangements, it appears that card issuers bear a disproportionate share of the cost of the EFTPOS network.”¹⁶

¹⁴ Reserve Bank of Australia (1999), *Payments System Board Annual Report*.

¹⁵ The data used in Chart 1 on the total number of debit and credit card payments are based on data collected from individual financial institutions by the Reserve Bank of Australia. The totals have been adjusted for a break in the series in January 2002 when the coverage of the statistics was broadened to include more institutions. This broadening led to a one-time upward shift in the debit and credit card transaction statistics. To adjust for this, the chart presents the data as it would have appeared had the number of institutions included not been expanded. As such, it presents a consistent picture of the trend in debit and credit card use.

13. In response to this, and other concerns expressed about interchange pricing in credit card networks, the Wallis Inquiry recommended:

“The PSB should consider whether interchange pricing arrangements are appropriate for credit and debit cards. A review of arrangements by the ACCC is warranted where such arrangements are priced contrary to efficiency principles.”¹⁷

14. In light of this, the Reserve Bank and the ACCC commenced a study into interchange fees and access for debit and credit card schemes in Australia in September 1999 (known as the Joint Study).¹⁸ The aim of the study was to assess whether interchange fees and access restrictions were promoting efficiency and competition in the Australian payments system. The study looked at the theory of networks and network benefits, their relevance to payment systems, and the role interchange fees play in payment systems and how they might affect efficiency. The study then applied this general framework to the ATM, credit card and debit card systems in Australia.
15. Application of the framework required detailed information on interchange fees and costs that had not previously been collected in Australia. The study therefore obtained information on debit and credit card interchange fees from a total of 30 financial institutions and the three credit card schemes in which interchange fees apply. Data on the costs and revenues associated with providing card services were obtained from a smaller group of nine financial institutions that accounted for most debit and credit card transactions in Australia. The Joint Study was and, as far as the evidence discloses, still is the only publicly available comprehensive data collection on the costs and revenues in debit and credit card systems in the world.

¹⁶ Financial System Inquiry (1997), *op. cit.*, p. 397.

¹⁷ *Ibid.*, p. 398.

¹⁸ http://www.rba.gov.au/MediaReleases/1999/mr_99_acc.html

Table 1: Costs of acquiring and issuing debit cards¹⁹
(\$ per transaction)

Acquiring		Issuing	
Operating expenses	0.08	Production/distribution of cards	0.06
Of which:		Authorisation	0.03
Staff	0.04	Processing	0.03
Data processing	0.01	Staff	0.01
Switching	0.03	Fraud	0.01
Overheads	0.18	Other	0.02
Of which:		Cost per transaction	0.15
Depreciation	0.06	Interchange paid	0.21
Telecommunications	0.05		
Other	0.07		
Cost per transaction	0.26		

16. The Reserve Bank and the ACCC spent a year collecting and analysing the data and published the results in *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access* in October 2000. Table 1 shows the results of the Joint Study with respect to debit cards.
17. In the absence of guidance from the theory, and the inability of participants to provide a convincing explanation of the direction and level of interchange fees in the Australian EFTPOS system, the Joint Study utilised some common methodologies to analyse the current arrangements. It made a number of different assumptions on who would benefit from the system and therefore how costs might be allocated. It concluded that: “Application of formal interchange methodologies does not provide a convincing case for a debit card interchange fee, in either direction. The study does not see a continued need for an interchange fee in the debit card network.”²⁰
18. It also noted that other payment systems exist without interchange fees:

¹⁹ This is an extract of the data presented in Table 6.1 of the Reserve Bank of Australia and Australian Competition and Consumer Commission (2000), *Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access*, October, p. 65.

“In Australia, interchange fees are a unique feature of card payment networks. Financial institutions do not agree to pay fees between themselves when their customers use cheques, direct debits or direct credits for making payments; customers pay fees and charges for these payment instruments which are intended to cover costs and produce a return on capital.”²¹

19. The Joint Study therefore concluded:

“Interchange fees may have played an important part in the development of these networks, but by their nature they have done so by reducing the potency of the normal market mechanisms which determine consumer choice and resource allocation. ...[A]lternative pricing arrangements exist under which providers of [debit] card services could recoup their costs directly from issuers, as they do with other payment instruments.”²²

The EFTPOS reform process to date

20. Immediately following the Joint Study, there was some discussion of the debit card interchange issue but no steps by participants to initiate reform.

21. Beginning in early 2002, the Reserve Bank convened a series of meetings of industry participants to explore the options for debit card reform. The Reserve Bank’s role in these meetings was to facilitate discussion between participants in the industry. The industry group consisted of the largest direct participants in the EFTPOS network, including Coles Myer.

22. Industry views on reform were quite diverse and strongly held; for this reason, the Reserve Bank encouraged the industry group to seek public input into the reform process. In July 2002, the industry group released a paper which outlined three basic options for reform: retention of current arrangements (with small

²⁰ *Ibid.*, p. 71.

²¹ *Ibid.*, p. 73.

²² *Ibid.*, p. 79.

modifications); adoption of collectively determined interchange fees calculated on a cost-based approach; and abolition of interchange fees.²³

23. Following publication of the paper, the industry group met with interested parties to discuss the options. Significant differences in commercial interests remained both within the industry group and among other interested parties. Despite the lack of unanimity, on 21 February 2003, an application to the ACCC for authorisation of a proposal to reduce interchange fees to zero was submitted by a group of banks, building societies and credit unions.²⁴ The proposal was authorised by the ACCC in December 2003,²⁵ the application for review of which is the subject of this hearing.
24. The Reserve Bank supported the proposal for zero interchange fees.
25. An important issue that arose from the ACCC's consideration of the application was access to the EFTPOS system. The Reserve Bank agreed with the ACCC that the issue of access to the EFTPOS system needed to be addressed.
26. An access project is currently being conducted by the Australian Payments Clearing Association (APCA). APCA administers the rules under which clearing of EFTPOS transactions occurs – known as the rules for the Consumer Electronic Clearing System (CECS).²⁶ It is undertaking work aimed at including provisions dealing with access in these rules. At present, members of CECS are not required to exchange EFTPOS payments with all other members. Instead, individual interchange agreements must be negotiated before one institution will accept EFTPOS transactions from another. One bank alone can effectively “hold up” access for any new participant by delaying the technical connections and the

²³ EFTPOS Industry Working Group (2002), *Discussion Paper: Options for EFTPOS Interchange Fee Reform*, July.

²⁴ ANZ Banking Group and others (2003), *Application to the Australian Competition and Consumer Commission for Authorisation of EFTPOS Interchange Fee Agreement*, ACCC, February.

²⁵ Australian Competition and Consumer Commission (2003), *Final Determination in Relation to Application for Authorisation of EFTPOS Interchange Fee Agreement*, ACCC, December.

²⁶ Australian Payments Clearing Association (2003), *CECS Manual for Consumer Electronic Clearing System (CS3)*, Sydney.

signing of interchange agreements, even when the new entrant has clearly met APCA's technical requirements.

27. The Reserve Bank is a member of the APCA Board and a member of the APCA-based working group that is conducting the access project. The Reserve Bank has indicated to the ACCC, and to APCA and its members, that were the process to falter, it would consider designating the EFTPOS system and imposing an access regime.²⁷

III. THE APPLICATION FOR REVIEW

28. This section considers the future with and without the authorisation of a zero interchange fee in the EFTPOS payment system. It concludes that the alleged detriments to competition put by the applicants for review cannot be sustained. In most cases they either mistakenly equate bilateral bargaining with competition or are based on a characterisation of behaviour by issuers and acquirers in actually setting interchange fees that is not supported by the facts; in particular they are based on an assumption of flexibility in EFTPOS interchange fees that cannot be demonstrated.

The future without the authorisation

29. If the application for review is successful, the *status quo* is likely to continue.
30. Interchange fees paid in the EFTPOS network are likely to remain unchanged at an average of around \$0.20 paid by issuers to acquirers. Experience over more than 15 years, documented in the Joint Study, indicates that once agreements are in place they have been very inflexible and that new agreements have been effectively based on old agreements.²⁸

²⁷ Reserve Bank of Australia (2003), Letter from Dr John Veale to the ACCC, 12 November.

²⁸ "Interchange fees for debit card transactions have hardly changed since they were introduced in the early 1990s. Newer agreements appear to have been based on earlier agreements, without regard for changes in costs that may have warranted a revision to interchange fees", Joint Study, *op. cit.*, p. 62.

31. Under existing arrangements there will continue to be a disincentive for cardholders to use the EFTPOS system with the price of using debit cards continuing to be affected by the interchange fee. At present, most EFTPOS cardholders pay a monthly account keeping fee which, for the five largest banks, ranges from \$0 to \$6 for a standard account, and a fee of around \$0.50 to \$0.60 per EFTPOS transaction once they have exceeded a fee-free limit, usually between 6 and 10 transactions per month. Paragraphs 74-77 provide a summary of these fees and evidence on how many cardholders pay them.
32. Some large merchants will continue to receive a payment from their acquirer, reflecting their ability to negotiate sharing of the interchange revenue received by the acquirer.²⁹ Smaller merchants will continue to pay a merchant service fee to their acquirer for each EFTPOS transaction.
33. Issuers, particularly those that do not do much acquiring, may continue to encourage their customers to use alternatives to EFTPOS.³⁰

The future with a zero interchange fee in the EFTPOS system

34. The applicants for review assert that the authorisation of a proposal to abandon existing bilateral interchange agreements and replace them with a uniform multilateral agreement to set interchange fees at zero will reduce competition.³¹
35. First, they argue that competition in the *issuer/acquirer market* will be reduced because an administratively set interchange fee will eliminate the possibility of bilateral bargaining between issuers and acquirers to set the fee. In addition, they claim that there will be increased barriers to entry in acquiring because new entrants to acquiring will be unable to offer to accept a lower interchange fee as part of a strategy of entry and gaining a larger market share.

²⁹ See for example Statement of Penelope Winn, ¶ 20 to 29 and Statement of David Howell, ¶ 53 to 67.

³⁰ Many small financial institutions, for example, issue Visa debit cards and encourage their customers to use them rather than the EFTPOS system.

³¹ See, for example, Australian Retailers Association and others, Application for Review, ¶ 10 to 14.

36. Second, they argue that competition in the *merchant network/acquirer market* will be reduced. Since, under the proposal, acquirers will have no revenue flow from issuers, the applicants for review argue that acquirers will have less pricing discretion in negotiating with merchants that have installed their own terminals. This, they claim, is equivalent to reduced competition.
37. Thirdly, the applicants for review argue that there will be reduced competition in the *merchant/acquirer market*. Again, because under the proposal acquirers will have no revenue flow from issuers, the applicants claim that acquirers will have less pricing discretion in offering services to merchants.
38. In addition, in both the second and third cases, the applicants for review argue that the fact that the interchange fee will be fixed for a period of time will reduce competition.

Effects on issuers and cardholders of a zero interchange fee

39. Since, under the proposal for authorisation, no interchange fees will be paid by card issuers to EFTPOS transaction acquirers, the costs incurred by card issuers will decrease by around \$135 million per year.³²
40. The price issuers charge cardholders for EFTPOS services is also likely to fall. Such a result could be reflected in a number of ways including lower charges for excess transactions above the fee-free limit, a higher fee-free limit or lower monthly account keeping fees.
41. Reduced charges for using EFTPOS will most likely lead to an increase in the number of EFTPOS transactions at the expense of other more costly payment methods. Faced with a higher number of fee-free transactions, those individuals who currently limit the number of transactions to below the fee-free limit would be expected to make additional use of EFTPOS. Similarly, those currently paying

³² Based on an average of \$0.20 per transaction and 671 million interchanged transactions in 2003. Source: Reserve Bank of Australia.

transaction fees would expect to use EFTPOS more frequently if the fee per transaction was reduced.

42. The extent of the fall in fees charged by card issuers to cardholders will depend on the intensity of competition in the market for card issuing. Although there are some costs incurred by the cardholder in moving an EFTPOS account from one institution to another, there are competitive offerings available with, for example, CANNEX listing 144 institutions offering such accounts with a wide range of choices in terms of fee structures.
43. It is unlikely that there will be many new institutions offering EFTPOS cards, since any new issuer has to be an authorised deposit-taking institution supervised by APRA. But improved access would give an alternative to existing institutions that are currently forced to use a relatively expensive gateway.³³ This would put downwards pressure on gateway fees, potentially reducing costs for smaller issuers and thus increasing their ability to compete for cardholders.

Effect on acquirers and merchants of a zero interchange fee

44. If a zero interchange fee is introduced into the EFTPOS payment system, the revenue earned by acquirers will fall by the same absolute amount as card issuers' costs fall.³⁴
45. Without interchange revenues, the costs (after interchange fees) of acquirers providing services to merchants will rise. It is likely that the price they charge will also rise. Acquirers will enter negotiations with large merchants with both sides recognising that there is no sharing of an interchange fee to be negotiated. The outcome of their bilateral negotiation will, as now, depend on the relative bargaining power of the parties. The actual outcome for merchants will depend on the extent of competition in the acquiring market and the presence of viable alternative suppliers of acquiring services.

³³ See, for example, Statement of Keith Wilson, ¶ 35-36.

³⁴ Although, in many cases, a single institution is both an issuer and an acquirer, institutions operate issuing and acquiring as separate business units, each of which has a pricing policy to its customer base.

46. There is a considerable prospect of new acquirers entering the market if access is liberalised. EFTPOS acquiring is largely a processing business. There is evidence that organisations are interested in entering this business, especially if access arrangements can be simplified.³⁵ The entry of new acquirers, the threat of entry by new acquirers and improved prospects that retailers could acquire their own EFTPOS transactions (as Coles Myer already does in some cases) should increase competition in the market for acquiring services and limit increases in prices faced by merchants as a result of the proposed change in interchange fees.
47. Finally, to the extent that a fall in EFTPOS transaction fees to cardholders encourages use of EFTPOS relative to more expensive payment methods such as credit cards, merchants will be better off. Even though the costs of accepting EFTPOS are likely to rise, the evidence suggests that for many merchants, it will still be cheaper to accept EFTPOS than to accept credit cards³⁶. A movement by customers from using credit cards to EFTPOS will therefore lower merchants' costs overall.

Effect on competition in the issuer/acquirer market

48. The applicants for review claim that, under the current regime, there is competition in a market for clearing and settlement of EFTPOS transactions.
49. However experience indicates that competition in the EFTPOS market has not taken the form of competition on interchange fees negotiated by acquirers and issuers. There have hardly been any variations in interchange fees under the current regime.
50. Contrary to the assertion that the agreement removes pricing flexibility, there is no evidence that prospective acquirers have used the ability to discount interchange fees in order to enter the market at any time during the more than 15 years the EFTPOS system has been in existence.

³⁵ See, for example, Statement of Paul Wood, ¶ 8-9, 29.

³⁶ Australian Retailers Association (2001), pp. 19-20.

51. The claimed benefits from the *status quo* are entirely theoretical and introduction of a zero interchange will not in practice reduce competition.

Effect on competition between acquirers for the business of merchants

52. The claim that competition amongst acquirers for the business of merchants will be reduced because acquirers will have less revenue flow from issuers is a mischaracterisation of the nature of competition in the market. The fact that revenue flowing to acquirers will *fall* from an average of \$0.20 per transaction to zero does not change the degree of competition in the market, though it may change the equilibrium price. However, to the extent that access to acquiring is liberalised, competition will increase and put downward pressure on the equilibrium price.
53. The applicants for review also claim that because the revenue flow will be fixed for a period of time, competition will be further reduced. However, since interchange fees have been effectively fixed since the system began, this argument cannot be supported.³⁷
54. There would, in fact, be no practical reduction in competition in this market as a result of these proposals. Acquirers would compete, to the extent they presently do, for the business of merchants wanting to accept debit cards. As is the case now, the competition would be in terms of merchant service and other fees, not interchange fees. Improving access to the business of acquiring – whether by independent acquirers or by merchants seeking to do their own acquiring – will increase competition. A reduction in interchange fees will change the starting point for negotiations but will not change the degree of competition.

IV. INTERCHANGE FEES IN THE AUSTRALIAN EFTPOS SYSTEM

55. This section sets out arguments on the role of interchange fees in payment systems and the evidence on whether a move to zero interchange fees in the Australian EFTPOS payments system would provide a net public benefit.

³⁷ Robert White argues at ¶ 143 of his Statement that the application would increase rather than reduce competition.

In principle justification

56. A payment system is of benefit to society if the benefits received by participants and users of the system are, in total, greater than the resource costs incurred in running the payment system. In the case of the EFTPOS system, the system will add to society's welfare if the resource costs of acquirers, issuers, merchants and cardholders are less than the benefits received.
57. Even if the system in total is socially beneficial, problems arise if either the acquiring bank or the issuing bank cannot recover all of its costs from its customers. For example, if the benefit to the merchant is less than the acquirer's costs, the merchant will not be willing to pay for the service and the acquirer will not be willing to participate in the EFTPOS network. Alternatively, if the benefit to the cardholder is less than the issuer's costs, the issuer will not be willing to offer the service.
58. When costs exceed benefits on one side of the transaction but not the other, side payments can be a means of establishing the system. These payments, commonly known in payment systems as interchange fees, are often a feature of card payment networks. These fees can redistribute the costs in order to allow both issuers and acquirers to offer the required services at a profit and therefore bring the system into existence.
59. The following example illustrates this proposition.³⁸ Suppose that the cost of providing the system is \$8 (\$4 borne by the issuer and \$4 borne by the acquirer) and the benefit of the system is \$10 (\$8 to merchants and \$2 to consumers). Total benefits are greater than total costs so the system will increase society's welfare. Without interchange fees, however, the system will not exist. The issuer will need to charge at least \$4 to cardholders and the acquirer will need to charge at least \$4 to merchants. But the benefit to consumers is \$2 and they will therefore not be willing to pay \$4, so issuers will not be able to recover their costs.

³⁸ The example was chosen to demonstrate the in principle justification for interchange fees – there should be no presumption that this reflects the balance of costs and benefits in the Australian EFTPOS system.

60. If, however, an interchange fee of \$3 is paid from the merchant’s bank to the consumer’s bank, the system will be established. The merchant will pay \$7 to their bank and have a net benefit of \$1 and the consumer will pay \$1 to their bank and have a net benefit of \$1. This is summarised in the table below.

Table 2: An example

	Gross benefit (1)	Costs incurred (2)	Fees paid (3)	Fees received (4)	Net benefit (1)-(2)-(3)+(4)
Merchant	\$8	—	\$7	—	\$1
Acquirer	—	\$4	\$3	\$7	\$0
Issuer	—	\$4	—	\$3+\$1	\$0
Consumer	\$2	—	\$1	—	\$1

61. There can be a range of interchange fees consistent with the operation of a payment system. For example, using the numbers from the example above, any interchange fee between \$2 and \$4 will result in the payment technology being used. More generally, depending on the relative sizes of the costs and benefits, the interchange fee needed for a system to operate could be paid to issuers by acquirers, or by acquirers to issuers. And if benefits exceed costs on both sides of the transaction, there is no need for an interchange fee to ensure the viability of the system.
62. It is therefore an empirical matter whether interchange fees are necessary in the Australian EFTPOS system.

Empirical Evidence

63. In order to assess whether the proposal for zero interchange fees will provide a net benefit compared to the EFTPOS payments system absent the authorisation, this section addresses three questions:
- Have EFTPOS interchange fees in Australia been set with regard to economic efficiency?

- Do the data suggest that interchange fees are, in fact, necessary for the Australian EFTPOS system to operate?
- Would a move to zero interchange fees in Australia's EFTPOS system promote efficiency?

Have EFTPOS interchange fees in Australia been set with regard to economic efficiency?

64. Interchange fees in the Australian debit card system have not been determined at a network level with network considerations taken into account. There has been no attempt, either by the banks making the application for authorisation, or the applicants for review, to analyse the EFTPOS network as a whole. Neither has any party attempted to demonstrate that an interchange fee is either necessary for the system to operate at all or to argue that the network would operate more efficiently with a particular level of interchange fees.
65. Rather, current interchange fees are the result of bilateral commercial negotiations which took place between various participants in the system as it was being established during the 1980s. No methodology based on the needs of the network, or the community at large, was used to justify the particular interchange fees. Nor, so far as the Reserve Bank is aware, has there been any ex-post attempt to argue that they can be justified on the basis of any methodology applied to the network as a whole.
66. Furthermore, interchange fees for debit card transactions have hardly changed since the 1980s. Newer agreements appear to have been based on earlier agreements, without regard for changes in costs or revenues that may have warranted a revision to interchange fees. As such, interchange fees in EFTPOS reflect bargaining power at the genesis of the EFTPOS system. No evidence has

been produced that suggests that interchange fees have been affected by changes in costs or competitive pressures since the 1980s.³⁹

Are interchange fees necessary?

67. Interchange fees are only necessary to make a payment system viable when costs exceed benefits on one side of the transaction. Many payment systems in Australia and around the world operate without interchange fees, suggesting that often benefits exceed costs on both sides. In Australia, the cheque system, the direct entry system and the high-value payment systems have operated for many years without any interchange fees. In some countries, debit card systems function without any interchange fees. Whether or not they are necessary in the Australian EFTPOS system therefore depends on whether benefits exceed costs on both sides of an EFTPOS transaction.

The costs and benefits of the EFTPOS system in Australia

68. Data on the costs to financial institutions of the EFTPOS system were collected by the Reserve Bank in 2000 and reported in the Joint Study. The average cost to an acquiring institution was found to be \$0.26 per transaction and the average cost to an issuing institution was found to be \$0.15 per transaction.⁴⁰
69. The benefits of the EFTPOS system accrue to both consumers and merchants.
70. Consumers benefit by being able to reduce the amount of cash they carry. They also benefit by being able to purchase goods even if they do not have cash at the time. Depending on the merchant, they may also benefit from being able to withdraw cash at a wide range of locations.
71. Merchants benefit from lower cash handling costs, including reduced banking costs and cash collection, security and movement costs. Real-time, PIN-based

³⁹ Even if there was evidence of competitive pressures, the nature of the market and the network effects involved mean that one can not argue that private negotiation results in a socially optimal result. Baxter (1983) argues, in fact, that decentralised setting of interchange fees will result in an inferior outcome to centralised setting of interchange fees.

⁴⁰ See Table 6.1 on p. 65 of the Joint Study, *op.cit.* and Table 1 of this Submission.

authorisation of transactions provides merchants with a guaranteed payment unlike, for example, cheques and without the same fraud and charge-back risks as in credit cards. Larger merchants receive further benefits from the EFTPOS system from investing in the terminals themselves. For example, Woolworths notes that:

“Rather than installing costly bank owned stand alone terminals Woolworths realised that it could speed up transaction time, streamline the transaction accounting process, and reduce costs if it could obtain its own EFTPOS infrastructure and integrate it with the Woolworths point of sale system and networks. This approach also addressed the increasing customer service issues associated with stand alone Pinpads as the service would be offered on every register, a service which was already being offered by one of Woolworths’ major competitors, Coles Myer Limited.”⁴¹

72. Economists commonly estimate benefits by using a basic principle: that people will pay no more for something than it is worth to them. This implies that if a consumer pays \$20 per annum for a credit card then the credit card must be worth at least \$20 to the consumer (and could be worth a lot more). In the same way, the amount that merchants and consumers are willing to pay for EFTPOS identifies a lower bound for the benefits they receive.
73. The benefit measured by revealed willingness to pay is net of any costs incurred by the merchant or consumer. For example, if a merchant’s internal cost to handle an EFTPOS transaction was \$0.10, and they experience a gross benefit of \$0.30 from using EFTPOS, they would be prepared to pay an acquirer up to \$0.20 for the service. Thus, the merchant’s revealed willingness to pay provides the lower bound on the net benefit the merchant receives taking into account any internal costs the merchant has to bear. A similar argument applies to consumers.
74. A measure of the willingness of consumers in Australia to pay for EFTPOS transactions can be obtained from information on fees charged and the number of

⁴¹ Statement of Penelope Winn, 16 March 2004, ¶ (18).

transactions undertaken by consumers. Australian consumers are charged a fee of between \$0.30 and \$2.00 for ‘excess’ EFTPOS transactions, but the most common charge is around \$0.50 to \$0.60. The table below provides information on selected bank accounts at the five largest retail banks; over 84 per cent of transaction accounts are held with these banks.⁴²

Table 3: Main transaction accounts at five largest banks¹

	ANZ	CBA	NAB	STG	WBC
Account Servicing Fee (\$ per month)	0	5	0	6	5
Minimum balances for waiver of ASF (\$)	NA	NA	NA	1,000	2,000
<i>Fee-free transactions (number)</i>					
Branch				2 ²	8 ³
Electronic	6	15	10 ⁴	10	
Internet	Unlimited		30 ⁴		
<i>Transaction fees (\$)</i>					
ATM	0.50	0.50	0.60	0.60	0.65
Branch	2.50	2.00	3.00	2.50	2.50
Cheque	0.50	1.00	1.00	0.60	1.00
EFTPOS	0.50	0.30	0.60	0.60	0.50
Internet	0.00	0.30	0.20	0.00	0.25
Phone	0.50	0.30	0.60	0.00	0.40

1. Other transaction accounts offered by the major banks charge higher account servicing fees in exchange for more and/or a wider variety of free transactions
2. Ten free transactions, two of which can be branch withdrawals.
3. WBC offers 8 ‘fee-free’ transactions of any type.
4. NAB offers a \$6 rebate on transaction fees. 10 free electronic transactions (and no Internet transactions) or 30 free Internet transactions (and no EFTPOS transactions).

Source: Banks’ websites

75. The fee structures are complicated and there is no single price for an EFTPOS transaction. Instead there are various combinations of account-keeping fees, fee-free transactions and fees charged for excess transactions. There is no direct information on how many transactions actually incur ‘excess’ transaction fees but the available data allow a number of inferences to be drawn.

⁴² Source: Australian Prudential Regulation Authority (2004), ARF 320.0, *Statement of Financial Position*.

76. Survey data from Roy Morgan Research show that 63 per cent of the Australian population aged 18 and over used EFTPOS in the four weeks prior to the survey and that, on average, they made 9.8 transactions.⁴³ Of those, 56 per cent conducted more than 10 ATM or EFTPOS transactions in total over the same period – that is 35 per cent of the population aged 18 and over.⁴⁴ When combined with the observation that most transaction accounts do not allow for more than 10 ‘fee-free’ transactions this suggests that around a third of the population aged 18 and over were probably charged a fee for ‘excess’ transactions on their accounts.⁴⁵ A further 16 per cent of the population aged 18 and over used a credit card but not EFTPOS in the four weeks prior to being interviewed.
77. Combining all of the information above suggests that a significant share of the population benefit from EFTPOS. Around a third of consumers receive a benefit that exceeds the ‘excess’ charge to them (the most common of which is \$0.50 to \$0.60) and significantly exceeds the actual cost of provision (\$0.15 to an issuer). A further quarter of consumers used EFTPOS but probably did not incur ‘excess’ transaction fees; they also receive a positive benefit from EFTPOS.⁴⁶ Finally, those people that used credit cards but not EFTPOS cards, would be expected to experience a positive benefit from the use of EFTPOS given their demonstrated

⁴³ Based on 52,379 face-to-face interviews conducted between January and December 2003. The data collected by Roy Morgan Research refers to the total activity of the consumer and is not specific to activity on one account. As a result, the calculations that follow may be affected to the extent that consumers actively use multiple transaction accounts.

⁴⁴ Total usage of transaction accounts is relevant in determining whether any ‘excess’ fee may have been charged on EFTPOS usage. The ‘fee-free’ transactions offered in conjunction with the most popular deposit accounts can always be applied to ATM or EFTPOS usage. Some banks also include other transaction methods in their ‘fee-free’ limits while others do not. The data presented here consider total ATM and EFTPOS usage but not other methods. Thus, the estimate presented is probably conservative.

⁴⁵ This is consistent with aggregate data on the income banks earn from fees on ‘excess’ transactions. The Joint Study found that banks earn an average of \$0.20 per EFTPOS transaction. CANNEX data show that the most common excess transaction fee is \$0.60. This suggests that around one third of all EFTPOS transactions incur an ‘excess’ fee. Consequently, it is likely that more than one third of consumers conducted an EFTPOS transaction on which an ‘excess’ fee was charged because most users have some fee free transactions.

As shown in Table 3, the basic transaction accounts offered by four of these five institutions offer 10 or fewer ‘fee-free’ transactions. Additionally, the transaction accounts offered by the major banks which do offer more, or a wider variety of, ‘fee free’ transactions charge higher monthly account keeping fees.

⁴⁶ 63 per cent of the population aged 18 and over surveyed used EFTPOS and 35 per cent conducted 11 or more ATM or EFTPOS transactions each. Thus, 28 per cent of the population (63 per cent – 35 per cent) used ATM or EFTPOS up to 10 times in the last four weeks and, therefore, probably did not incur an excess transaction fee.

willingness to use payment cards. Thus, at least three quarters of consumers (EFTPOS users plus credit card users who performed no EFTPOS transactions) are likely to have a positive valuation on EFTPOS. All of these consumers potentially use EFTPOS less than they would otherwise because of the relatively high price they are charged. The available data provide no information about the benefit the remaining 21 per cent of the population aged 18 and over would experience from using EFTPOS.

78. Fees charged to merchants in Australia provide some indication that a significant number of merchants attach a relatively high value to the ability to accept EFTPOS payments. Small merchants that do not own their own terminals pay acquirers to provide them with the ability to accept EFTPOS transactions; the Joint Study estimated they pay around \$0.80 per transaction.⁴⁷
79. Larger merchants that own their own infrastructure are paid by acquirers. Because of this fee flow, no useful information on the value larger Australian merchants attach to the ability to accept EFTPOS payments can be inferred.⁴⁸
80. Although there is little information for large Australian retailers, international experience provides evidence of the benefits merchants are likely to receive from accepting EFTPOS. In most other markets, interchange fees flow from the acquirer to the issuer so that merchant fees are positive. This suggests that the benefit to merchants in those countries from on-line debit products is significant and exceeds the total merchant and acquirer costs.⁴⁹
81. Further proof of a positive benefit to merchants comes from the widespread acceptance of this payments technology. In the UK large national supermarkets such as Safeway, Tesco and Sainsbury accept EFTPOS, in the US Wal-Mart,

⁴⁷ Joint Study, *op. cit.*, p. 63.

⁴⁸ The value is above minus \$0.20 but there is no basis to make any inference on whether it is, for example, positive or negative.

⁴⁹ Under perfect competition the merchant charge will be acquirer costs plus the interchange fee. If competition is less than perfect, the merchant charge will be higher. Thus, the acquirer cost plus the interchange fee is a lower bound on the merchant fee charged and, with interchange fees that flow from acquirer to issuer, must be above acquirer costs.

CVS and Safeway accept PIN-based EFTPOS, whilst in Canada over half the merchants accept PIN-based EFTPOS cards, including Hudson's Bay Company, Safeway, Sears and Wal-Mart.⁵⁰ All of these countries have either no interchange fees or fees which flow from acquirer to issuers. This suggests that a significant proportion of merchants in countries similar to Australia value EFTPOS at above its cost of provision.

Conclusion on the necessity of interchange fees in the Australian EFTPOS system

82. The evidence suggests that the benefits enjoyed by consumers and merchants exceed the costs of provision on both sides and the EFTPOS payments system can therefore function without an interchange fee.

Would a move to zero interchange fees in Australia's EFTPOS system promote efficiency?

83. There is no *prima facie* case for any interchange fees in Australia's EFTPOS system in order to make it viable. Furthermore, current interchange fees are not based on any principles of maximising social benefit. Notwithstanding this, it may be possible to claim that a move from one interchange fee to another promotes a more efficient payment system and, thus, a net social benefit. In particular, in the current context, would a move to a system with no interchange fees promote a more efficient payment system than the current set of interchange fees?

84. This submission has so far focused on EFTPOS in isolation from other payment systems. However, there are other payment systems available – cash, cheques, and credit cards. A proper evaluation of the interchange fees in EFTPOS requires a broader view. Much of the literature analysing payment systems assumes that there are only two payment mechanisms. Indeed, the literature usually focuses on only one payment system and uses the other payment system, commonly labelled cash, as a notional reference that is not examined in any detail. As such, only

⁵⁰ Source: Chip & Pin (UK) Ltd (2004), via <http://www.chipandpin.co.uk>, Star Systems (2004), via <http://www.star-systems.com>, Pulse EFT Association (2004), *Debit in Canada*, February.

limited additional insight can be gained from the existing literature.⁵¹ Nonetheless, fundamental economic principles and international experience can provide some useful guidance.

85. Two important dimensions of economic efficiency are productive and allocative efficiency. These occur when a given bundle of goods or services is produced at the least cost and prices reflect these costs. The fundamental service performed by a payment system is the facilitation of a transaction. Cash, cheques, debit cards and credit cards all perform this function by initiating a transfer of funds from the consumer to the merchant. However, distortions to price signals mean that consumers do not always use the payment method with the least cost to society. There are also differences in these payment methods that mean that consumers may prefer one over another absent any pricing distortions. Nonetheless, these principles of efficiency argue that in general an efficient payments system is one that *encourages*, but does not mandate, the use of the least cost payment system.⁵²
86. In order to judge whether efficiency would be promoted by elimination of interchange fees in the EFTPOS system, two pieces of information are required: (1) the relative costs of payment systems and (2) what interchange fees lead to price signals that reflect those costs and thus encourage the use of lower cost payment systems. There is no need to construct complex measures of costs and benefits to judge whether an outcome is efficient; the more closely prices faced by economic decision makers reflect the costs of producing the goods or services they purchase, the more efficient the outcome.

The social cost of payment systems

87. The sections above have already presented some data on the costs incurred by issuers and acquirers in providing an EFTPOS transaction. To estimate the social cost, or total cost to society, of payment systems, the resource costs borne by the

⁵¹ See also the Statement of Robert White at ¶ 28 which confirms this view from an experienced practitioner.

⁵² A similar argument is put by Robert White in his Statement at ¶ 36 and 89-92.

merchant and consumer in handling the particular payment method also need to be estimated.

88. In the United States, the Food Marketing Institute has conducted a detailed investigation of the costs its members incur in accepting various means of payment. Their study estimated that the resource costs associated with processing an EFTPOS transaction in the US were the same as the resource costs associated with processing a cash payment.⁵³
89. There has not been an estimate of resource costs to merchants in Australia of accepting different payment methods. However, the Australian Retailers Association produced some estimates that show the average cost of processing a cash payment for a merchant in Australia is \$0.12⁵⁴ and the cost of accepting an EFTPOS transaction is \$0.17.⁵⁵ Since these data include bank fees (and rebates) they are likely to overestimate resource costs.
90. There are no obvious costs to a consumer of carrying an EFTPOS card.
91. As an upper bound, these estimates suggest that the total cost to society of an EFTPOS transaction is around \$0.58.⁵⁶
92. Data collected by the Joint Study showed that credit cards are a relatively expensive method of performing a transaction compared with debit cards – with issuing and acquiring costs for credit cards several times those for debit cards.⁵⁷ Studies have consistently found cheques to be an even more expensive method of performing a transaction.⁵⁸

⁵³ Food Marketing Institute (2000), *It All Adds Up: An Activity Based Cost Study of Retail Payments*, Washington, p. 27 and p. 29.

⁵⁴ Australian Retailers Association (2001), *op. cit.*, p. 19.

⁵⁵ *Ibid.*, p.19.

⁵⁶ Consisting of acquirer costs of \$0.26, issuer costs of \$0.15 and merchant costs of \$0.17.

⁵⁷ See section 7.3 of the Joint Study, *op. cit.*, pp. 76-79.

⁵⁸ See, for example, the Food Marketing Institute (2000), *op. cit.*, and the Financial System Inquiry Committee (1997), *op. cit.*, p. 226.

93. The cost of using and providing cash has not been intensively studied in Australia. Nonetheless, some estimates are available.
94. On the issuing side, a reasonable estimate of the cost of providing cash is given by the cost of providing cash from an ATM. The Joint Study found that the average cost per transaction for an ATM withdrawal was \$0.49 (the average withdrawal was \$170). This suggests an average issuer cost of \$0.17 to provide \$58 in cash (the average size of an EFTPOS transaction).⁵⁹
95. Apart from the relatively low amount of interest that is foregone, there is no obvious cost incurred by a consumer carrying cash.
96. Estimates from the Australian Retailers Association suggest the cost to a merchant of processing a cash transaction is \$0.12.⁶⁰
97. Finally, the Financial System Inquiry found that a cash deposit (or withdrawal) over the bank counter costs around 4 to 5 times as much to process as EFTPOS. Given an average issuer cost of \$0.15 for EFTPOS, this suggests the cost of a cash deposit is around \$0.60. Information from the UK also provides an estimate of the cost of accepting cash deposits. The Cruikshank report estimated that it cost approximately 60p per £100 (0.6%) for a bank to accept a cash deposit.⁶¹
98. Putting these data together suggests that it costs a bank between \$0.35 and \$0.60 to accept a \$58 cash deposit. An estimate of the total cost to society for a cash transaction of the same size as the average EFTPOS transaction is between \$0.64 and \$1.21.⁶²

⁵⁹ This assumes that a customer withdraws a large amount of cash at one time which is then used for multiple transactions; this allows a saving on the fixed costs associated with ATM cash provision. If customers withdrew cash before making each transaction the average cost would clearly be higher. If the cash was obtained over the counter, the cost would be higher.

⁶⁰ As noted earlier, this estimate includes bank fees and is therefore an overestimate of resource costs.

⁶¹ Cruikshank, D. (2000), *Competition in UK Banking*, HMSO, Norwich, March, p. 60.

⁶² The lower estimate is obtained by summing the smallest estimates (\$0.35 for accepting a cash deposit, \$0.17 for providing cash from an ATM and the \$0.12 merchant cost); the upper estimate is obtained by summing the highest estimates (\$0.60 for accepting a cash deposit, \$0.49 for providing cash from an ATM and the \$0.12 merchant cost). To the extent that the merchant figures overestimate resource costs, these figures will also be overestimates.

Table 4: Estimated Resource Costs of Payments
(per \$58 transaction)

	Cash		EFTPOS		Credit Card
Issuer	0.17-0.40		0.15		≤ 1.47#
Acquirer	0.35-0.60		0.26		0.43
Consumer ⁶³	0		0		0
Merchant	0.12		≤ 0.17		≤ 0.17*
TOTAL	0.64-1.12		≤ 0.58		≤ 2.07

* Assuming the resource costs to merchants of accepting a credit card transaction is the same as for a debit card transaction.

An estimate of the resource cost of a \$100 credit card payment is \$1.58 from the Joint Study. This contains an amount of \$0.26 for the cost of an interest-free period on \$100. To obtain an estimate for the cost to issuers of a \$58 credit card payment the interest-free period cost was reduced by applying a factor of 0.58 to the \$0.26.

Conclusion on the social cost of payment systems

99. Table 4 summarises the estimates of resource costs for cash, debit cards and credit card transactions.
100. The calculations are indicative rather than definitive. But they are such that the broad conclusion that EFTPOS is a relatively cheap method of making point of sale payments cannot be seriously disputed.

Price signals and usage

101. Efficiency requires that prices reflect relative costs. The prices charged by banks to their customers are the signals that merchants and consumers react to. Interchange fees, by shifting costs between issuers and acquirers, affect the prices that consumers and merchants face. Similarly, competition and access also affect the prices faced by consumers and merchants.

⁶³ Or equivalently, there is no difference in the cost to the consumer of carrying cash, a debit card or a credit card.

102. For instance, the introduction of a higher interchange fee paid by issuers to acquirers will increase issuers' costs and effectively reduce acquirers' costs. Standard demand and supply analysis predicts that this will increase the price that issuers charge cardholders and reduce the price that acquirers charge merchants. (The actual price changes will depend on competitive conditions in the issuing and acquiring markets). This will, in turn, affect the incentives of cardholders and merchants to use the system.
103. If the interchange fee paid by issuers to acquirers is high, the cost to consumers of using the system would be relatively high and the cost to merchants would be relatively low. Conversely, a high interchange fee paid by the acquirer to the issuer would lead to a merchant cost that was relatively high and a consumer cost that was relatively low.
104. Neither of these arrangements would necessarily promote widespread use of the payment system. In the first case, there would probably be many merchants willing to accept EFTPOS but few consumers that wished to use it. In the second case, many consumers would be willing to use EFTPOS because it costs very little but merchants may be unwilling to accept it. Between these extremes, there may be a range of interchange fees that provides sufficient incentives to both sides of the transaction and maximises usage of the system.
105. Importantly, universal acceptance and usage is not generally achievable, nor is it desirable for economic efficiency. Instead, only those merchants and consumers that value EFTPOS more than the cost of providing it should accept or use it.
106. The range of interchange fees that achieve this balancing is an empirical matter. As discussed above, theoretical models are not sufficiently advanced to calculate the 'optimal' interchange fee in a world with multiple payment instruments.⁶⁴ Given this, the international evidence provides some guidance.

⁶⁴ Rochet and Tirole (2001) comment "Our welfare analysis has implicitly assumed that the competing payment methods are efficiently supplied. As is usual, distortions in the provision of the alternative means of payment would lead to a second best situation, in which the interchange fee and the no-discrimination rule should be also assessed in the light of their impact on the alternative means of payment... Our model can be used as a building block for this broader question, which, again, we leave for future research."

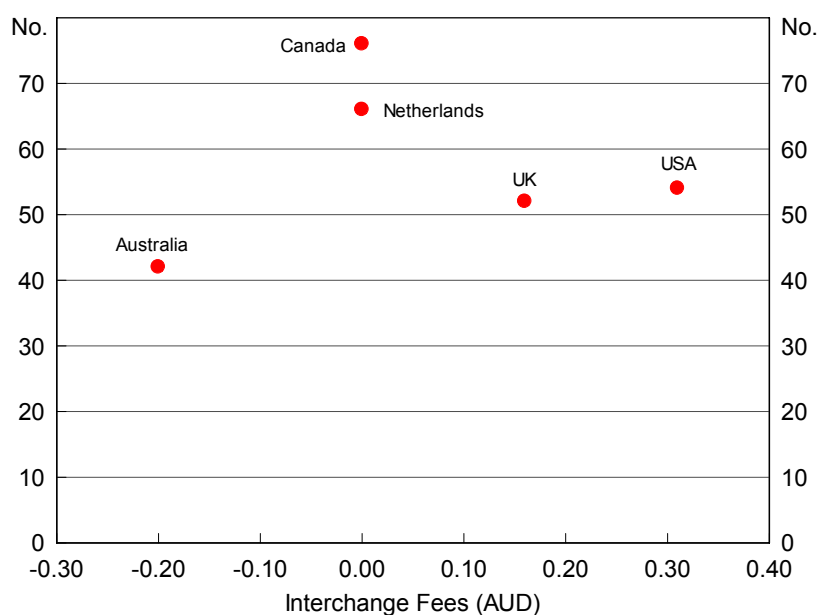
International evidence

107. Most overseas EFTPOS systems have interchange fees that flow, as in credit card systems, from acquirer to issuer. Australia appears to be the only country in which debit card interchange fees are paid to the acquirer by the issuer.
108. Consistent with the analysis above, two of the most widely used EFTPOS systems – those in Canada and the Netherlands – have no interchange fees at all. This can be seen in Chart 2 which shows the number of debit card transactions per inhabitant in 2002 against the average EFTPOS interchange fee in a number of countries. Australia, with an interchange fee that flows from issuer to acquirer is on the left side of the chart and the US, where interchange fees (averaging around \$0.30⁶⁵) flow from acquirer to issuer, is on the right side of the chart. Australia's average interchange fee is -\$0.20 and there were a little over 40 debit card transactions per inhabitant in 2002. The Canadian system has an interchange fee of \$0 (or equivalently no interchange fee) and had over 70 debit card transactions per inhabitant in 2002.
109. The chart shows that the countries with the highest number of debit card transactions per inhabitant are those countries, Canada and the Netherlands, with a zero interchange fee. Australia, with an interchange fee that flows from issuer to acquirer, has the lowest usage followed by the US and UK which have interchange fees that flow from acquirer to issuer.

⁶⁵ Bank for International Settlements (2003), *Payment and Settlement Systems in Selected Countries*, Basel, and EFTPOS Industry Working Group (2002), *op. cit.*

Chart 2: Debit Card Transaction

Per inhabitant, 2002

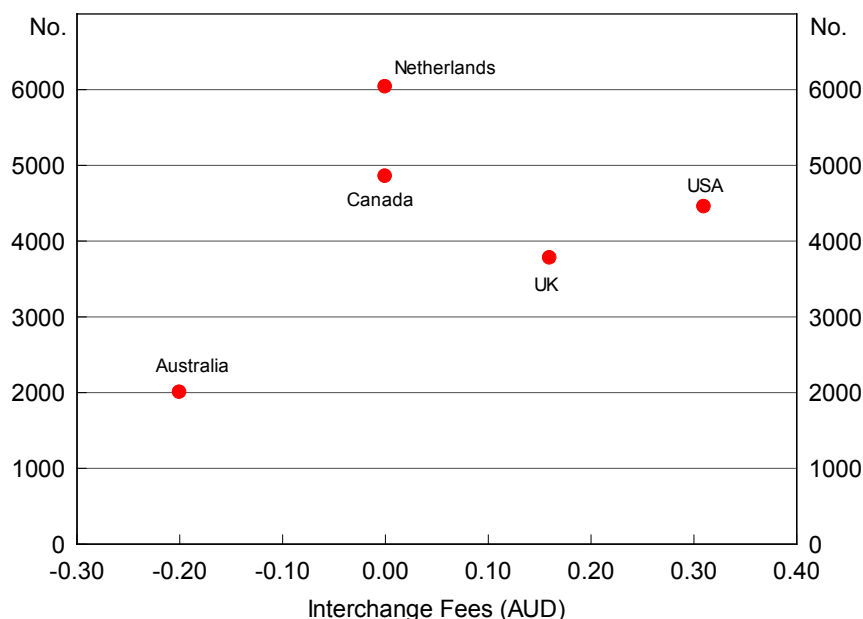


Source: BIS, EFTPOS Industry Working Group

110. Not surprisingly given the direction that interchange fees flow, the data indicate that there is a very high merchant acceptance of EFTPOS in Australia. Australia has the highest number of terminals per inhabitant of all the countries in the sample – over 20,000 POS terminals per million inhabitants in 2002. The United States had around 12,000 POS terminals per million inhabitants (and most of these do not accept PIN-based debit cards).
111. These two observations – relatively low use per capita and high merchant acceptance – are consistent with the direction of interchange fee flow in Australia. Merchants are strongly encouraged to accept EFTPOS transactions while consumers have less incentive to use the system.
112. Another way of looking at these facts is that there are a relatively low number of transactions per terminal in Australia. Chart 3 shows transactions per terminal against the average interchange fee for a number of countries. While there are a large number of terminals installed in Australia, by international standards, they are relatively underutilised.

Chart 3: Debit Card Transactions

Per terminal, 2002



Source: BIS, EFTPOS Industry Working Group

113. This suggests that the reason why EFTPOS is not more heavily used in Australia is not merchant acceptance or merchant investment in terminals but incentives to cardholders to use EFTPOS. By contrast, in Canada and the Netherlands, the countries with zero interchange fees, there are around 5,000 to 6,000 transactions per terminal. In the UK and the US, which have interchange fees that flow from acquirers to issuers, there are around 4,000 transactions per terminal.
114. This is entirely consistent with the relatively high prices that Australian consumers pay to use EFTPOS, which in turn reflects interchange fees. Under current arrangements, the most common charge Australian consumers face for ‘excess’ EFTPOS transactions is between \$0.50 and \$0.60. By contrast, in Canada, while there are ‘excess’ transaction fees, the ‘fee-free’ limits are generally much higher than in Australia⁶⁶ and in the Netherlands there are no per transaction fees for the use of debit cards.⁶⁷ Thus, Australian consumers are

⁶⁶ For example, Scotia Bank, one of the large Canadian banks, offers an account with 50 ‘fee-free’ transactions for \$5.50 per month.

⁶⁷ Bolt, W, (2003), *Retail payments in the Netherlands: Some facts and some theory*, Research Memorandum WO no. 772, De Nederlandsche Bank, p. 17.

discouraged, relative to their Dutch and Canadian counterparts, from using EFTPOS despite its widespread merchant acceptance.

Investment in EFTPOS infrastructure

115. The applicants for review have argued that a change in the interchange fee will remove their incentive to invest in EFTPOS infrastructure. Mr Rae argues that:

“Unless the acquirers and the merchant principals succeed in recouping their revenue losses from mandatory elimination of EFTPOS interchange fees, their incentives to participate in EFTPOS acquiring would be significantly reduced. The diminution would be likely to be most evident in their preparedness to invest in extensions and upgrades to the EFTPOS network.”⁶⁸

116. Mr Williams argues in Sections 7.1 and 7.2 of his statement that the proposed conduct would reduce investment by merchants in the EFTPOS system and, more broadly, across the entire economy. By way of example, Williams refers to the statement of Mr Howell that “If the revenue from debit transaction fees was to be removed from CML, I consider it unlikely that CML would continue with the 3DES upgrade as it is currently proposed.”⁶⁹

117. Both Ms Smith and Mr White also address this question. Ms Smith notes:

“In relation to investment in the EFTPOS network, investment may be excessive from a welfare perspective if the benefits from such investment are overstated. This could be the case if there is a flow of funds (the interchange fees) inappropriately going to merchant acquirers (including merchant principals).”⁷⁰

⁶⁸ Statement of Jeff Rae, ¶ 79.

⁶⁹ Statement of Phillip Williams, ¶ 138.

⁷⁰ Statement of Rhonda Smith, ¶ 79. Footnote omitted.

118. Mr White makes the points that:

“Merchants make decisions about whether to participate in the EFTPOS network. If they decide to participate, they then can make decisions about investing in the payments infrastructure if they believe there is a business case that supports that investment (eg the ability to lower their cost of accepting payments or meet particular consumer payment preferences).”

“The degree they will invest in the infrastructure themselves compared to obtaining services from acquirers is a classic “build” versus “buy” decision. The merchant either incurs the cost themselves or pays the acquirers’ fees, which the acquirer will use to recover its costs, including the cost of investment recovery.”⁷¹

119. Both witnesses note that subsidies paid to a party in the network may be justified in the start-up period but they question whether subsidies paid to acquirers (and merchants that have installed terminals) are still justified. They also raise the possibility that there may have been too much investment on the acquiring side.

120. The international evidence shows that countries with zero or positive interchange fees have not ceased to upgrade their EFTPOS networks. Indeed, many countries with interchange fees that flow from acquirer to issuer are currently engaged in an upgrade from signature to PIN based authentication and from single DES to the 3DES standard.⁷²

121. In any case, the international evidence makes clear that the relative lack of use of the Australian network is not under investment by acquirers or merchants in EFTPOS terminals.

⁷¹ Statement of Robert White ¶¶ 111-112.

⁷² The UK is currently upgrading to PIN-based authentication of transactions as is Canada, while Germany, Switzerland and The Netherlands have already upgraded to 3DES encryption. Source: APCA.

Conclusion on whether a move to zero interchange fee would promote efficiency

122. Efficiency in the payments system requires that relative prices reflect the relative cost of provision of different payment instruments. The available evidence suggests that EFTPOS has a lower overall cost and that this should therefore be reflected in prices facing economic decision makers. The international evidence suggests that current interchange fees in Australia have effectively restricted the usage of EFTPOS and that zero interchange fees will encourage greater overall use of the EFTPOS system. Overall this evidence suggests the conclusion that approval of the proposal for zero interchange fees would encourage higher use of EFTPOS, and promote the efficiency of the Australian payments system.

V. OVERALL ASSESSMENT OF THE PROPOSAL FOR ZERO INTERCHANGE

123. When weighing the public benefits against any anti-competitive detriments in a move from the current interchange fees to a regime of zero interchange fees it is submitted, on the presently available evidence, that:

1. The public benefits are real and substantial because an interchange fee of zero would promote the use of EFTPOS thereby reducing the overall costs of Australia's payment system. Moreover, the system would be viable without an interchange fee.
2. The detriments alleged by the applicants for review are overstated or do not exist.

8 April 2004