

Submission to the Reserve Bank of Australia

**Designation of Australia's EFTPOS and ATM
Systems**

July 2004

Coles Myer Ltd



1. Introduction

This submission is in response to the Reserve Bank of Australia's ("RBA") request on 11 June 2004, for comments from interested parties as to whether or not it would be in the public interest for the RBA to designate Australia's EFTPOS and/or ATM payment systems.

This request follows a similar request in relation to possible designation of EFTPOS in December 2003, where in a letter to interested parties the RBA advised that it had "identified a number of aspects of Australia's EFTPOS debit card payment system that raised important questions of competition and efficiency in its Joint Study with the Australian Competition and Consumer Commission ("ACCC") published in October 2000", and that "the study was particularly concerned about interchange fees and access in the EFTPOS debit card system.

With respect to the issue of interchange fees and access the RBA had earlier in November 2003 expressed to the ACCC its' support for an application by industry participants to move to zero interchange. It further expressed its' strong support for the Australian Payments Clearing Association's ("APCA") efforts to establish an access regime, and noted that it would be "watching progress closely and, were it to falter, would seriously consider, in the interests of promoting efficiency and competition in the Australian payments system, designating the EFTPOS system under Section 11 of the *Payments System (Regulation) Act* with a view to imposing an Access Regime under Section 12 of the Act."

In a confidential submission dated 13 February 2004 Coles Myer Ltd ("CML") submitted that it would not be in the public interest for the RBA to designate the EFTPOS system. CML noted that it did not accept that a zero EFTPOS interchange fee arrangement was in the public interest, and that the validity of the assumption that EFTPOS interchange fees required reform to increase competition and efficiency in the network would be challenged in the proceedings before the Australian Competition Tribunal ("Tribunal") (in respect of which the RBA was granted leave to intervene).

The Tribunal handed down its decision on 25 May 2004 and dismissed the proposal for zero interchange fees stating that it did not agree with the ACCC that the public benefits and detriments of the proposed agreement were finely balanced. It concluded,

*"[A]ny public benefits are clearly outweighed by the detriments" and that, "[T]here is real public detriment in the likelihood of a flow on of costs to consumers generally."*¹

In light of the Tribunal's resounding decision to reject the zero interchange fee proposal, and in the absence of any evidence before the Tribunal to support the need for EFTPOS interchange fees reform to increase competition and efficiency in the network, CML reiterates its position that designation of the EFTPOS system is not justified.

¹ Re EFTPOS Interchange Fee Agreement [2004] ACompT 7 para 157

In terms of the concerns the Joint Study expressed regarding access to the EFTPOS debit card system, we again reiterate the view we expressed in February 2004, that APCA is currently giving priority consideration to the liberalisation of access to the EFTPOS network with the introduction of a proposed access regime and as part of its' review of the Consumer Electronic Clearing System ("CECS") rules, a process in which both the RBA and CML are active participants.

Whilst the details of the proposed access regime are still currently being worked through, there is no suggestion that this process has faltered, necessary as the RBA suggested in November 2003, for it to consider, in the interests of promoting efficiency and competition, designation of the EFTPOS system.

In summary, for the reasons we have set out in the following sections, CML believes that designation of the EFTPOS system would not be in the public interest and that a decision to designate would be unjustified on the basis that no reasonable authority would have come to that decision.

With respect to the ATM system, concerns have been raised with respect to the ATM industry's direct charging proposals that they may disadvantage certain groups in the community, particularly those living in remote and rural areas. It is not clear that the industry has demonstrated that there are clear public benefits in moving to a "direct charging" model. CML believes that any proposal should be assessed by the ACCC to ensure consumer interests are properly protected.

2. What is the problem?

Designation is a form of regulatory intervention that involves substituting market forces for direct controls that the RBA may use at its discretion. Before such significant regulatory intervention is considered the question must first be asked, what is the problem requiring regulatory intervention?

In 2000 one of the most important questions the Joint Study attempted to assess was whether interchange fees for credit cards, ATMs and EFTPOS were too high. In order to attempt to answer this question the Joint Study sought to make comparisons of the costs and revenues issuers and acquirers earned in providing these payment services.

Whilst a more detailed analysis of the Joint Study is outlined below, a major criticism of the Joint Study is that it did not substantiate what an efficient level for these fees would be.

The Joint Study sought to conclude that Australia does not need an EFTPOS interchange fee.²

Banks and their supporters have suggested that interchange fees are undesirable. This sits oddly with the situation in relation to credit cards where both the RBA and the banking community have sanctioned interchange fees.

² Joint Study page 60

With respect to credit cards the Joint Study found that “a pricing system based on interchange fees still seems to be the most practical arrangement for the credit card network”. Although they did suggest that the level of fees were too high relative to costs.³ It also pointed out that the legality of credit card interchange fee arrangements under the Trade Practices Act were unresolved at the time.

As for the ATM system, it was suggested that interchange fees represented a substantial mark-up over the costs of providing ATM services. As mentioned though, it did not provide any indication as to what would be regarded as an efficient level for these fees.

Since the Joint Study the only industry report that attempts to shed any light on this issue is the Option Paper issued by the EFTPOS Industry Working Group (“EIWG”). EIWG did not have an impartial objective but was working to further the interests of the banks. At best this report could only talk of “perceived problems” and provided no evidence for the need for regulatory intervention.

3. The Tribunal’s Decision

Following the Joint Study’s findings with respect to EFTPOS interchange fees, with the support of the RBA, the banking industry sought to introduce zero interchange fees. The finding of the Tribunal was resounding. A zero interchange fee would result in a public detriment.

The Applicants for zero EFTPOS interchange fees claimed that their proposal would result in public benefits such as:

- ❖ Reducing the overall cost of the Australian payments system by decreasing the cost of EFTPOS, thereby encouraging its use in preference to credit cards and charge cards.
- ❖ Increasing the flexibility in setting future fees.
- ❖ Reducing barriers to entry for new market participants.

In responding to these claimed benefits CML presented evidence to show that zero EFTPOS interchange fees would not result in a public benefit, **a view adopted by the Tribunal**, for the following reasons:

- ❖ There is no evidence that zero interchange fees would result in reduced cardholder fees
- ❖ There is no evidence that zero interchange fees would lead to increased EFTPOS usage

³ Joint Study page 79

- ❖ Financial institutions will always have an incentive to promote credit cards as against debit cards
- ❖ Shifting costs from issuers to merchants does not give rise to public benefits

a) No evidence that zero interchange fees would result in reduced cardholder fees

The Applicants for authorisation claimed that one of the major benefits of their proposal for zero EFTPOS interchange fees was that issuers would incur lower costs and that these cost reductions may flow through to cardholders. However as acknowledged by the Tribunal the Applicants did not present evidence to support these claims.

“...the banks have provided virtually nothing by way of concrete commitment to this Tribunal or the ACCC, for the passing through to cardholders of savings from a zero interchange fee.”⁴ and

“...the evidence presented leaves us quite unable to make any worthwhile finding as to the quantification of that extent (quite apart, as we shall see, from the further question as to the effect any such reduction would have on cardholders’ decisions).”⁵

What makes the Applicant’s claims even more difficult to accept is that many cardholders currently do not pay any transaction fees for EFTPOS transactions that they undertake. The Tribunal noted,

“...there is a very high level of EFTPOS users who under current arrangements pay no fees anyway.”⁶

There was no suggestion that those customers who currently do not pay any fees will receive any rebate. It is also clear that there is cross subsidisation between different segments of bank customers and different banking products making it difficult to allocate costs, and secondly to establish whether or not cost reductions have been passed on.

As to the effect of competition to ensure that pass through occurred the Tribunal accepted the ACCC’s submission that card issuing and merchant acquiring are highly concentrated markets with the major banks dominating. They shared the ACCC’s concern that,

“...current competition between card issuers may not ensure the lasting pass through of savings to cardholders.”⁷

⁴ Re EFTPOS Interchange Fee Agreement [2004] ACompT 7 (EFTPOS Tribunal Decision) para 95

⁵ EFTPOS Tribunal Decision para 109

⁶ EFTPOS Tribunal Decision para 118

⁷ EFTPOS Tribunal Decision para 112

b) There is no evidence that zero interchange fees would lead to increase EFTPOS usage

Central to the Applicants' argument was the proposition that the imposition of zero interchange fees would remove a distortion and allow appropriate price signals to be sent that would increase the use of debit.

With respect to EFTPOS the price signals that were identified with the potential to cause a trend towards debit usage were, a higher fee free threshold or a lower fee per debit transaction, once the fee free threshold had been exceeded.

The Tribunal concluded that both the extent and the nature of any change in price signals to cardholders, given the complex bundle of bank charges, "is not likely to be attention-grabbing or conduct altering".⁸ This hardly seems all that surprising given that evidence was led that most consumers pay no fees anyway, so increasing their fee free threshold would have little or no effect, and cardholder's use of EFTPOS is inextricably linked to, and limited by, the funds in their accounts. There are also a number of non-price factors that also have a bearing on customer choice of payment.⁹

c) Financial institutions will always have an incentive to promote credit cards as against debit cards

Another important factor that the Tribunal relied on was the fact that the major banks make far more substantial profits from credit cards than debit cards even following the RBA's credit card interchange reforms. The Tribunal concluded,

*"...it is a fact of commercial life that the Banks will continue to have an incentive to encourage credit card use as against debit card use...it would be contrary to the Banks' shareholders' interests to do otherwise."*¹⁰

This view was later supported in an article published in the Australian Financial Review, which reported that internal National Australia Bank analysis of the RBA reforms had identified the threat to the banks as not just being credit card interchange fee reductions and more expensive loyalty programs but also the impact of increased customer usage of EFTPOS.¹¹

In final submissions CML summarised the position as follows:

"...there is an absence of firm evidence that issuing banks intend to introduce positive price signals to encourage the use of debit. Of equal importance is the fact that there is a total absence of evidence before the Tribunal that the issuing banks would seek to encourage the use of EFTPOS in preference to the use of credit. Finally, even if (contrary to their own commercial interests) banks did so, there is no evidence to support the view that consumers would change their behaviour. Many consumers would notice no difference, and even

⁸ EFTPOS Tribunal Decision para 115

⁹ There is a discussion of these non price factors at para 61-68

¹⁰ EFTPOS Tribunal Decision para 94

¹¹ Australian Financial Review, 14 May 2004, page 1

if they did, a significant proportion would maintain current habits for non-price reasons.”¹²

This was found by the Tribunal to be well-founded and accepted.

d) Shifting costs from issuers to merchants does not give rise to public benefits

The banks acknowledged that they would seek to impose new charges on merchants to replace lost interchange revenue as a result of the introduction of zero EFTPOS interchange fees.

Whilst it was accepted that this increase in costs to merchants would likely discourage some merchants from accepting EFTPOS for low value transactions or to reduce the functionality of EFTPOS to cardholders in other ways, such as surcharging or minimum purchase requirements, the Tribunal found that the most likely consequence (without excluding the possibility of other consequences) would be a general increase in prices.

The Tribunal concluded that the likelihood of a flow on of costs to consumers would result in real public detriment, and would likely have the effect of passing on \$170 million or a substantial part thereof in increased costs to consumers.

Rather than sending more transparent price signals, and contrary to the principle of ‘user pays’, the effect of transferring this \$170 million cost would be to “bury” the costs of EFTPOS transactions in higher retail prices charged by retailers to the detriment of **all** consumers.

4. EFTPOS Reform and the Tribunal’s decision

Following the Tribunal’s decision a number of parties who were represented at the Tribunal, have criticised the decision and the EFTPOS “reform” process.

All parties were given the opportunity to present the evidence available to them to support their position. The Merchants provided this evidence, including confidential commercial information to the Tribunal.

Conversely the banks, building societies and credit unions chose not to put forward evidence to support their position, other than to reiterate their reliance and support of the RBA’s 2000 findings in the Joint Study. The only reasonable inference that can be made from the behaviour of the banks in relation to their reluctance to provide evidence and information to the Tribunal, is that the information they held did not support the position that they were seeking to have authorised.

Further to this, and more specifically, despite repeated requests to do so, the banks, building societies and credit unions failed to give assurances that they would reduce fees to cardholders if interchange fees were reduced to zero.

¹² EFTPOS Tribunal Decision para 121

A robust process has been completed and the RBA should abide by the decision.

Had the RBA been dissatisfied with the decision of the Tribunal, an appeal process should have been instituted.

An exhaustive process has now been undertaken by all the participants. This has occurred through EWIG¹³, the process before the ACCC and the appeal before the Tribunal. The finding of the Tribunal was resounding. A zero interchange fee would result in a public detriment.

The RBA, in deciding whether or not to designate a payment system, has to have regard to the public interest. It would seem to be defiant and without foundation for the RBA to arrive at a decision other than that made by the Australian Competition Tribunal. In the event the RBA considered it had relevant information on this issue it was incumbent upon it to put that before the Australian Competition Tribunal.

It would be a dangerous precedent if a decision that had been robustly assessed and adjudicated by the Tribunal, was then discarded by the RBA in circumstances where, if the RBA errs, there is no appeal process or ability to have the decision independently examined.

5. The 2000 Joint Study

As mentioned the data and conclusions outlined in the Joint Study published back in October 2000, were significantly relied upon by the Applicants in the Tribunal hearing. Indeed the Tribunal noted that the only evidence before the Tribunal concerning respective costs and revenues of debit card transactions was the 1999 data contained in the Joint Study, which it described as a “snapshot now almost four years out of date”¹⁴.

The economic and payment system experts engaged by parties to the Tribunal made a number of conclusions regarding the Joint Study and its findings. They agreed:

- (a) the data recorded in the Joint Study was out of date, being data collected in 1999
- (b) the data was incomplete;
 - (i) it was only a snap shot in time and to the extent that the data was to be used to assess the relationship between price and long run average costs, data collected over a period of time would be more appropriate
 - (ii) it only included data from eight financial institutions and did not include merchants costs, despite recognising the significant investment and involvement of merchants particularly larger merchants who represent a significant proportion of total EFTPOS transactions

¹³ EFTPOS Industry Working Group

¹⁴ EFTPOS Tribunal Decision para 70

- (iii) the margins between revenues and average costs did not incorporate a return on capital committed to credit card issuing and acquiring, because the banks were unable to provide data on this, though it could be said they were simply unwilling to do so
- (iv) issuing revenue information was difficult to unbundle from other product and services revenue
- (v) there was no consideration of the extent to which customers pay any EFTPOS fees at all
- (vi) there was no detailed analysis of the different characteristics of payment types
- (vii) there was no data on the degree of substitutability between debit and credit, or any assessment of non-price factors that affect consumers choice of payment tender
- (viii) little attention was paid to the implications of its findings for investment and innovation.
- (ix) the Tribunal also questioned the validity of using transaction volumes as the basis of allocation of joint and common costs

As a consequence they agreed that they were unable to conclude from the data in the Joint Study whether or not banks were making profits in their acquiring activities that were any greater or less than that in a long-run equilibrium in a competitive market.

They also agreed that a key conclusion of the Joint Study that, '[t]he incentives in an economy should ensure that the lowest cost and most efficient payment instruments thrive at the expense of the more expensive or less efficient ones'¹⁵ could neither be supported by the data in the Joint Study, nor by any proposition in economics.

The Tribunal noted that,

*"...as a matter of allocative efficiency (as distinct from productive efficiency) one cannot assess the relative efficiency simply by comparing costs."*¹⁶

In other words it is simply not possible to assert that increased EFTPOS usage would result in a public benefit because it is a superior, or lower cost payment method.

The Joint Study did not present evidence to suggest that there is any justification for regulatory intervention to impose zero interchange.

Other economists, including the recently appointed ACCC Commissioner Dr Stephen King, have made similar criticisms. In an article co-authored by Professor Gans, they stated:

*"...the Joint Study starts from the assumption that an interchange fee is a necessary evil and that, in fact, a zero interchange fee is a clear benchmark. This assumption pervades the Joint Study's analysis. However, there is no economic basis for the assumption that the desired benchmark is a zero fee."*¹⁷

¹⁵ Joint Study at i

¹⁶ EFTPOS Tribunal Decision para 151

¹⁷ Observations on the Joint RBA/ACCC Study "Debit and Credit Card Schemes in Australia: A Study of Interchange Fees and Access", Gans and King, November 2000, Section 3

They further stated,

“The Joint Study avoids the important economic issues by focusing on a simplistic cost-based analysis. Even so, the Study ignores some payments and, when faced with conflicting results, appears to pick the result that is in line with the underlying and unjustified assumption that a zero interchange fee is an efficient benchmark.”¹⁸

They then concluded,

“We are left to conclude that the Joint Study is too incomplete to provide useful guidance. In particular its conclusions are based on tenuous analysis that could not be used as a basis for broad scale regulation of payment systems.”¹⁹

In summary, the Joint Study cannot reasonably be relied on in 2004 to support a decision to designate the EFTPOS payment system.

6. RBA’s Powers to Designate Zero

The RBA’s powers in relation to designation of a payments system relate to its ability to determine standards and impose access regimes, with the objective of promoting efficiency and competition in the payments system in question.

The imposition of an arbitrary interchange fee is not the determination of a standard, and as such it would not be within the RBA’s power to do so. To undertake a study into the setting of an arbitrary interchange fee would therefore be a waste of resources.

In submissions to the Tribunal Senior Counsel for the RBA, conceded,

“ The Reserve Bank has power to impose an access regime and has power to set standards. In relation to credit cards, it has set a standard by reference to what I’ll call in a very loose sense a cost base. There may be a difficulty with the Reserve Bank directly setting a standard that there shall be no interchange fee.”²⁰

As against this, Senior Counsel for the Banks acknowledged before the Tribunal, that the Banks, if successful in introducing zero interchange, may seek to move to positive interchange fees. The result of this would be fees flowing from acquiring banks to issuing banks with, no doubt, an underlying assumption that the merchants and ultimately the consumers would fund this additional bank revenue.

¹⁸ Gans and King Section 4

¹⁹ Gans and King Section 4

²⁰ EFTPOS Tribunal Transcript 14/4/2004 p64 /16-24

7. Open and Transparent Approach

Retailers and merchants have approached both the Tribunal process and interactions with key regulators, and industry participants in an open and transparent manner. CML particularly has provided a substantial amount of confidential information to assist in deliberations.

In contrast, the banks have been given the opportunity to present evidence and information to support their case for zero EFTPOS interchange fees, and to support their claims of public benefit, but have not done so. Indeed, the only lay witness put forward by the Banking Community was from the Bank of Queensland, which has less than 1% of the Australian market.

It should also be pointed out that those parties that have been quick to openly criticise the Tribunal's decision, refused to provide any evidence to support their claims.

8. Designating based on Access

The RBA could potentially designate the EFTPOS system in order to impose a suitable access regime for the Australian EFTPOS payments system.

In relation to access reform, the Tribunal has noted:

“All parties agree that access reform is desirable because it will enhance competition, and as a consequence efficiency, in the issuing and acquiring markets. However it seems preferable, all other things being equal, to achieve that objective by access reform rather than an agreement which is per se unlawful.”²¹

APCA is currently giving priority consideration to the liberalisation of access to the EFTPOS network with the introduction of a proposed access regime and as part of its' review of the Consumer Electronic Clearing System (“CECS”) rules.

Whilst the details of the proposed access regime are still being worked through, APCA members, the RBA and other interested stakeholders are actively engaged in the process, and designation of the EFTPOS payments system on the grounds of reforming the access regime would be unproductive while the APCA process is progressing.

The RBA heralded this process, both before the ACCC and the Tribunal, and has no basis for walking away from it at this time.

9. ATM Network

CML is not directly involved in the ATM network in Australia, and so makes the following comments as an observer of the ATM network. CML's current involvement

²¹ EFTPOS Tribunal Decision para 140

in ATM networks extends to providing physical ATM locations for customers to access accounts with financial institutions.

As noted above, the Joint Study suggested that ATM interchange fees represented a substantial mark-up over the costs of providing ATM services. It did not however provide any indication as to what level of fees would be regarded as efficient.

Following the Joint Study the AISG²² was formed to consider the various options available in relation to charging for ATM transactions. That group drafted a discussion paper recommending a direct charging regime whereby owners/operators of ATMs may levy a direct charge on all cardholders that use its' ATM. The card issuer may still charge a fee to the cardholder to facilitate the processing of the transaction.

The recommendations of the AISG place heavy reliance on competition to contain fees and charges at market driven levels and to improve customer access and services.

Subsequent to the release of the AISG's discussion paper, the Parliamentary Joint Committee on Corporations and Financial Services announced an inquiry into the level of banking and financial services available to rural Australia. As part of that inquiry, the Committee also considered reforms to foreign ATM fee structures as a supplement to its broader paper 'Money Matters in the Bush'.

Concerns have been raised that a move to direct charging may disadvantage certain groups in the community particularly those living in remote and rural areas. The suggestion is that unless there are safeguards these groups may incur significantly higher ATM fees.

The Parliamentary Committee recommended that the AISG include in its recommendations consideration of the special circumstances of fees and charges levied on banking services provided to regional, rural and remote communities.

The Committee also recommended that ASIG develop a framework for the real-time disclosure of ATM fees, as well as close monitoring of ATM fees by the RBA and the ACCC should a direct charging model be implemented.

Any move by the industry should be carefully considered to ensure that there are clearly demonstrated public benefits.

10. Summary

In regard to EFTPOS, the Tribunal overwhelmingly accepted the evidence presented by merchants, as well as the views of the economists engaged, that the Joint Study relied upon by the banks did not provide any justification for the imposition of zero interchange fees.

It found that introduction of a zero interchange fee would result in a public detriment.

²² ATM Industry Steering Group

The decision of the Tribunal ought to determine the RBA's decision whether or not to designate inasmuch as the evidence of public interest for designation and the evidence of public interest for authorisation are the same.

There is no basis for the RBA to take contrary steps to impose a zero interchange regime through designation.

In terms of access, as stated, there is currently underway a project to liberalise access to the EFTPOS network involving stakeholders including the RBA. It is clear that there is no public interest in evoking a regulatory regime when there is no suggestion from any party that this process has faltered.

As for ATMs, concerns have been raised with respect to the ATM industry's direct charging proposals. It is not clear that the industry has demonstrated that there are public benefits in moving to a "direct charging" model and as such we believe that any proposal should be assessed by the ACCC to ensure consumer interests are properly protected.