

Submission to the Reserve Bank of Australia

**Revised Draft Standard for setting EFTPOS
Interchange**

February 2006

Coles Myer Ltd



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1. Executive Summary

This submission is in response to the Reserve Bank of Australia's ("RBA") request for submissions following the publication of an amended version of a draft Interchange Standard for the EFTPOS system.

Our past submissions have outlined our concerns regarding the significant public detriments of the proposed Standard and its effect on competition. We remain of the view that there is no evidence of market failure or clear public benefit to warrant such market intervention.

The revised draft Interchange Standard proposes that a floor be placed under interchange fees in the EFTPOS system in addition to the cap proposed in the earlier Standard released for public consultation in February last year.

The RBA believes that restricting interchange fees to a relatively narrow range should ensure that negotiations over interchange fees cannot be used to adversely affect competition, either between existing participants or new entrants.

Whilst we support the amendments and believe they will mitigate some of these adverse impacts, we have further concerns with the proposed Standard:

- The proposed Standard does not allow for the recovery of the costs associated with the installation, operation and maintenance of secure PINpad terminals, and thereby under represents the costs of EFTPOS processing. It also discriminates against self acquirers in this regard.
- The RBA's decision to regulate EFTPOS interchange and not to regulate ATM interchange arrangements is discriminatory and anticompetitive. The proposed EFTPOS Standard restricts EFTPOS network owners ability to negotiate interchange fees for EFTPOS cashout transactions but ATM network owners are free to negotiate interchange fees for a cashout transaction at an ATM.
- The proposed Standard unfairly discriminates against some payment network owners by restricting their ability to negotiate commercial access fee arrangements, whilst allowing other payment network owners to continue to negotiate freely.

2. Proposed interchange Standard is not in the public interest

Reducing the EFTPOS interchange fee does not reduce costs. It will lead to the transfer of costs from issuing banks to merchants. As found by the Australian Competition Tribunal, to the extent possible, merchants can be expected to pass on the higher costs in a general increase in the price of goods and services.

Accordingly, the net effect of the RBA's proposed Standard will be to transfer costs associated with the use of a bank debit card away from debit cardholders (to the extent that they are charged) and the issuing bank and impose those costs on all consumers in the form of a general increase in the price for goods and services.

The proposal would see more cross-subsidised transactions, which is inimical to ‘transparent’ prices for payment services; a measure which the RBA regards as one of the practical benchmarks to assess competition and efficiency.

The RBA’s main objective for imposing an EFTPOS interchange Standard is to lower EFTPOS interchange fees, which it hopes will lead to significantly greater adoption and use of debit cards in substitution for credit cards. We do not believe the RBA’s intervention will achieve this outcome.

Lowering the EFTPOS interchange fee will do little to encourage the use of debit cards in preference to credit cards by consumers. Credit cards still retain a significant level of subsidy relative to the interchange level the RBA has proposed for EFTPOS. Banks will therefore continue to have a strong incentive to promote them and this is even more so the case with respect to the unregulated American Express and Diners Club cards.

Credit card interchange fees are still the cause of concerns around the mispricing and over use of credit cards. Therefore, we consider a more appropriate approach would therefore be to review EFTPOS interchange together with credit card interchange as part of the RBA’s announced 2007 review.

If the RBA proceeds with the proposed Standard and reduces EFTPOS interchange, in the absence of any data on the likely rate of substitution, we believe a fair question to ask is “How is the success of required reductions in EFTPOS interchange fees to be measured?”

Given the public detriments identified, a method for measuring the success of the reform needs to be established.

3. Eligible costs

We are concerned that the current draft Standard does not make explicit reference to the costs associated with installing, operating and maintaining secure PINpad terminals, and their associated infrastructure.

The current draft Standard defines eligible costs as those costs “directly related to processing and switching EFTPOS transactions incurred by an acquirer or merchant principal when performing the business responsibilities usually undertaken by an acquirer.”

An essential feature of the EFTPOS payment system is the security measures that are adopted to maintain the integrity of the system. As a merchant principal acquirer of EFTPOS transactions, Coles Myer is required to comply with all operational Standards that have been developed for the system in the interests of transaction integrity, security and cardholder service.

The key obligation for all EFTPOS acquirers is the requirement to operate and maintain EFTPOS terminals and PINpads.¹ The costs of maintaining and operating EFTPOS PINpads are directly related to the processing and switching of EFTPOS transactions, and are costs for which Coles Myer seeks recovery of through our network access fee, negotiated with debit card issuers.

The impact of the proposed Standard will be to deny a network owner the ability to recover its costs of maintaining this infrastructure investment through its wholesale interchange arrangements, which is particularly crucial at this current time when there is significant activity and investment underway to enhance security with the adoption of triple DES.

We are also concerned that removing or restricting CML's commercial right to a fair recovery of its costs for services CML provides through its network agreements is discriminatory and we continue to urge that a more equitable approach be adopted.

It is our view that the banks will simply recover their costs of PINpad infrastructure by imposing additional fees on merchants. This solution is not open to CML and will act as a competitive disadvantage in relation to the provision of debit transactions by CML.

In summary, in our view PINpad costs need to be included in the Standard as "eligible" costs. Whilst the RBA may have requested acquirers' PINpad costs, consideration needs to be given as to how the merchants' share of these costs are captured to ensure they are reflected in the Standard. Without the inclusion of these costs, the true cost of processing and switching EFTPOS transactions will be significantly understated.

4. EFTPOS cash withdrawals versus ATM cash withdrawals

The RBA's decision not to regulate ATM interchange and the recent announcement by one major bank to significantly increase the fees it charges customers for use of ATMs outside its' own network highlights another discriminatory impact of the proposed Standard.

Under the RBA's proposal, EFTPOS network owners' ability to negotiate interchange fees for EFTPOS cash withdrawal transactions will be significantly restricted, but ATM network owners will be free to negotiate interchange fees for cash withdrawal transactions at ATMs.

The proposed EFTPOS interchange fee cap could affect whether those retailers who offer cash withdrawal services continue to offer these services. This would in effect limit competition amongst providers of cash withdrawal services and increase the likelihood of ATMs being substituted by merchants to provide cash withdrawals, due to significantly greater revenue incentives, despite EFTPOS being a much cheaper source of cash for consumers.

¹ Part 5 CECS Manual – Acquirer Standards

We believe that this is not in consumers' interests and therefore not sound public policy. An EFTPOS cash withdrawal is a convenient, secure and cost efficient alternative to an ATM cash withdrawal. At a time when banks are increasing customer ATM fees, it is inappropriate in our view that the RBA would impose such a penalty on providers of EFTPOS cash withdrawal transactions, which will significantly reduce the commercial incentive to provide an EFTPOS cash withdrawal service.

In our view, now more than ever, ATM providers need to be subject to more competitive pressures to reduce fees faced by consumers. EFTPOS cash withdrawal services should be allowed to compete on equal terms with ATM cash withdrawal services. The effect of the RBA only regulating EFTPOS cash withdrawals is to interfere with the natural market forces that acts as a competitive balance between the fees for EFTPOS and ATM cash withdrawals.

Unless EFTPOS cash withdrawal transactions are carved out of the proposed Standard, there will be a clear incentive to discontinue EFTPOS cash withdrawals and instead provide ATM services to the detriment of consumers.

5. Other network arrangements

We also believe that the proposed Standard discriminates against merchant principals, as the Standard does not apply to arrangements in place for the processing of EFTPOS transactions via non EFTPOS participant owned EFTPOS networks.

For example, as it currently stands American Express is not an EFTPOS participant and therefore is not subject to the proposed Standard. American Express does however own and operate a network of terminals which capture EFTPOS transactions and switching them to a bank for processing.

Both Coles Myer and American Express have invested in networks capable of capturing and transmitting EFTPOS transactions on behalf of the banks, however under the proposed Standard American Express would not be subject to any regulatory cap with respect to the negotiation of any fees it seeks to charge banks for the capturing or processing of these EFTPOS transactions.

We can see no justification for the different treatment of fees payable to American Express, or any other third party, who own and operate their own network and merchant principles/self acquirers for the capture and processing of EFTPOS debit transactions.

6. Proposed interchange floor

The revised draft Standard proposes that a floor be placed under interchange fees in the EFTPOS system in addition to the cap proposed in the earlier Standard released in February last year.

In our last submission we outlined our concerns with respect to the proposed Standard and the potential for interchange negotiations over interchange fees to be used to adversely affect competition.

Whilst the proposed narrow range of interchange fees would, we believe, mitigate some of our concerns, it does leave some scope for parties with weaker negotiation positions to be disadvantaged. One suggestion proposed by another party in an earlier submission to alleviate any concern, would be to simply impose a benchmark interchange fee as a new multilateral EFTPOS interchange fee.

This would seem to be the fairest approach given that this Standard is already discounting the competitive benefits of bilateral negotiations.