The Allen Consulting Group

# Review of Reform of Australia’s Payments System

## Regulation of Credit Card Payments and the role of Diners Club

**September 6 2007**

Report to Diners Club (commercial-in-confidence version)

# Contents

# Executive Summary

This report is a Submission to the Reserve Bank of Australia's (RBA) 2007/8 Review of Australia's Payments System, particularly credit cards. The report argues that as a three party scheme with no interchange fees, the pre-conditions which led the RBA to regulate the interchange fees of the open card (four party) schemes do not exist for Diners Club. Furthermore, as a small scheme, Diners Club has no market power which it can exercise against merchants, and this is evidenced by the continual decline in its merchant service fees (MSFs). Unlike the large open card schemes, Visa and MasterCard, in the case of Diners Club there is no market failure to fix, and therefore no need for the RBA to regulate, any aspect of Diners Club's pricing. It does not follow, therefore, that just because the open (four party) schemes are regulated, so too should the closed (three party) schemes.

The RBA's reforms to interchange of four party credit card schemes have had a number of effects: merchant service fees have fallen; some card transactions are being surcharged; and cardholders are facing higher prices to hold and use credit cards. There has been only a minimal shift in market share from the regulated four party card schemes to the unregulated three party card schemes It is not clear whether there has been any shift from credit to EFTPOS or debit cards. This may be because credit cards offer more functionality than EFTPOS cards and can be used for long–term borrowing.

Diners Club has a niche strategy, which is to offer a high quality charge card service to cardholders and high value cardholders to merchants. While Diners Club's MSFs are generally higher than those of its competitors, this pricing reflects the quality of its products, not an ability to set high anti-competitive prices. Merchants can, and many do, make the decision not to accept Diners Club cards. Some merchants, while accepting Diners Club cards, encourage their customers to pay by other means.

Diners Club has experienced declining MSFs (which began before the RBA's reforms). Merchants have far less hesitation in surcharging Diners Club transactions than those of Visa and MasterCard. Surcharging has had demonstrably negative effects on the amount and value of transactions undertaken with Diners Club cards.

# *Chapter 1*
# Overview

*This chapter discusses the RBA's regulation of credit card payments and the economics of three party card schemes.*

## 1.1 Introduction

This report, prepared for Diners Club, is a Submission to the Reserve Bank of Australia's (RBA) 2007/8 Review of Australia's Payments System, particularly credit cards. The report argues that as a three party scheme with no interchange fees, the pre-conditions which led the RBA to regulate the interchange fees of the open card (four party) schemes, do not exist for Diners Club.[1] Furthermore, as a small scheme, Diners Club has no market power which it can exercise against merchants, and this is evidenced by the continual decline in its merchant service fees. Unlike the large open card schemes, Visa and MasterCard, in the case of Diners Club there is no market failure to fix, and therefore no need for the RBA to regulate, any aspect of Diners Club's pricing. It does not follow, therefore, that just because the open (four party) schemes are regulated, so too should the closed (three party) schemes.

## 1.2 The RBA Reforms

The RBA's reforms of credit cards were kicked off in October 2000 when it published a joint study with the ACCC, *Debit and Credit Card Schemes in Australia: a Study of Interchange Fees and Access.* The joint study found that despite the costs of open scheme credit card payments[2] being significantly higher than payments by debit card, cardholders faced much higher prices when using the EFTPOS (debit) system. The Joint Study attributed this apparent distortion to high interchange fees (the payment from acquirers of credit card transactions to issuers of credit cards), with these fees not only being set well above the costs of providing interchange services but also unresponsive to changes in those costs. The joint study also found fault with the schemes' no surcharge rules, which prohibited merchants from charging their customers an additional amount if they chose to pay by credit card (e.g. to pass on the merchant service fee charged to them by their acquirer), and the restrictive access arrangements which inhibited entry by new competitors to existing scheme members.

Following a process of designation and consultation by the RBA, surcharging was permitted from 1 January 2003, interchange fee were capped, based on a calculation of issuer costs, from 1 November 2003 (cutting them from about 0.95 per cent to about 0.55 per cent) and the schemes were opened to more competition in February 2004.

[1] This was the RBA's view at the time that it was considering regulating the interchange fees of the four party schemes.

[2] The open credit card schemes are Visa and MasterCard. A third scheme, Bankcard, has since become defunct.

The closed credit and charge card schemes, Diners Club and American Express, while not officially regulated, have given the RBA written undertakings to remove any restrictions which prevent merchants from surcharging.

## 1.3 Effect of the RBA Reforms

### *Merchant service fees*

Reducing interchange fees had the effect of lowering the average open scheme merchant service fee (MSF) by 45 basis points, slightly more (about 5 bp) than the fall in interchange fees. Simon (2005)[3] suggests that this slight cut in the margin between interchange fees and MSFs was due to greater competition among acquirers for merchants' business due to the increased focus on these fees following the reforms. Also as expected, issuers recouped at least some of the loss of interchange revenue by increasing the price faced by cardholders, in particular by winding back reward programs.

### *Surcharging*

The evidence on surcharging is mixed. Merchants with substantial market power do surcharge, especially in situations where consumers have little choice of payment instruments, such as with travel or telephone payments, or when there is essentially no prospect of their customers switching to alternative suppliers because of credit card surcharges (e.g. schools.) On the other hand, small merchants in competitive environments tend not to surcharge.

As discussed in Chapter 4 some merchants pass on the Diners Club MSF but not (or not to the same extent) the MSFs that they pay when cardholders pay by Visa or MasterCard. This reflects the market power that the open schemes have vis-à-vis merchants; and the corresponding lack of market power held by Diners Club.

### *Cardholder pricing*

As noted in the RBA Issues Paper, the price faced by holders and users of open scheme cards has increased. Annual fees have increased (i.e. the price of holding a Visa or MasterCard credit card has increased) while reward programs have become less generous (i.e. the price of using a Visa or MasterCard credit card has increased). These price increases reflect a re-balancing of pricing by the issuers of these credit cards, as they have sought to recover, at least in part, their loss of interchange revenue that they obtained (indirectly) from merchants, by charging more to people who are holders/users of credit cards.

### *Market shares*

Contrary to the predictions made by the open schemes when the reforms were first contemplated by the RBA (see the discussion in chapter 5), there has been only a minimal shift of market share away from the open schemes and toward the closed schemes, Diners Club and American Express. While a small shift did occur early in 2004, this can be explained entirely by the decisions of ANZ to distribute Diners Club and of NAB and Westpac to issue American Express.

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[3] John Simon, "Payment systems are different: shouldn't their regulation be too?", *Review of Network Economics*, 4(4), December 2005.

That there has been no significant shift in market shares between open and closed schemes should come as no surprise. First, as discussed above, open scheme credit cards are used by significant numbers of cardholders as a means of extending credit, which is something they cannot do with Diners Club and can do only with some American Express cards. Second, open scheme credit cards, which are mainly issued by banks, are a mass product that are easily obtained as part of a banking relationship, or by other means. On the other hand, the Diners Club business model is that of a niche product (see Chapter 2).

### *Shift from credit to debit?*

Whether the reforms have had any effect on shifting payments from credit cards to debit cards is more difficult to say. While, as noted by RBA[4] (2007, paragraph 76), over the past couple of years both the number of and value of debit card payments has grown faster than credit cards, formal statistical tests (Gans 2007[5], Hayes 2007[6]) fail to detect any structural breaks, that can be associated with the reforms, in the time series for credit card transaction values, credit card account numbers and credit card market shares.

It may be that these statistical tests have low power (i.e. are unable to detect a structural break that does exist) or it may that not enough time has elapsed to pass judgment. Complicating the analysis is the undoubted fact that many factors contribute to consumers' choice of payment instrument, and these factors are difficult to disentangle. An especially important factor is that open scheme credit cards are not just a payment instrument, they also provide consumers with the option of extended credit.

While credit card issuers do charge interest, this has not stopped cardholders from using them. From October 2003 to May 2007, credit card balances accruing interest grew at an annual rate 14.8 per cent, far ahead of the growth of the value of credit card transactions (9.6 per cent) and of the repayments (8.5 per cent).[7] The apparent preference by consumers to use credit cards as financing their purchases by borrowing money for extended periods may have blunted any shifts away from credit cards as a payment instrument *per se.* Over 70 per cent of credit card balances "revolve" — where cardholders do not pay off their balances in full each month.

Moreover, credit (or charge) cards offer functionality that EFTPOS/debit cards do not e.g. they can be used to make purchases overseas; consumers can quite easily get their money back if they use them to buy goods that don't arrive or don't work etc.

[4] Reserve Bank of Australia, *Reform of Australia's Payments System: Issues for the 200708 Review*, May 2007.

[5] Joshua Gans, "Evaluating the Impact of the Payment System Reforms", submission to RBA, 19 January 2007.

[6] Richard Hayes, "An Econometric Analysis of the Impact of the RBA's Credit Card Reforms: Preliminary Results", 19 January 2007.

[7] All figures derived from Reserve Bank of Australia Bulletin Table C1.

## 1.4 The economics of a small three party scheme

### *Diners Club has no market power*

Diners Club is a small three party scheme. It is a charge card only – all cardholders have to pay the balance of their accounts each month. Thus while Diners Club does offer credit to its cardholders, it does not offer extended credit.

The significance of Diners Club being a three party scheme is that it has no interchange fees. Diners Club charges fees to its cardholders and negotiates a MSF with each merchant who wishes to accept payment by Diners Club card. As discussed in Chapter 3, Diners Club's MSFs have been steadily declining over time, due to competitive pressure from other payment mechanisms (mainly other credit and charge cards).

The significance of Diners Club being a small scheme is that, unlike the case with Visa and MasterCard, merchants do not feel obligated to accept Diners Club cards, and many do not. Simon (2005) describes the merchants' situation with Visa and MasterCard as being like a prisoner's dilemma. Merchants accept these cards because other merchants accept these cards, a situation that arises in equilibrium because they are ubiquitously held. A merchant that does not accept Visa or MasterCard runs a very large risk of losing sales to a merchant that does accept them, but merchants as a whole do not increase their sales by accepting them. Thus merchants, especially small merchants, are not in a strong bargaining position when it comes to negotiating their MSF with acquirers of Visa and MasterCard transactions, though competition between acquirers does place downward pressure on MSFs.

With Diners Club, the situation is very different. Because Diners Club cards are not ubiquitously held or ubiquitously accepted, merchants feel under less pressure to accept them.

Thus, an equilibrium in the market exists where relatively few people hold the Diners Club card, which gives merchants a realistic commercial option of not accepting them — and many do not. Moreover, some merchants who accept Diners Club cards nonetheless actively suppress their use by cardholders. These merchants will accept payment by Diners Club if the customer insists, but would prefer that the customer pays by Visa or MasterCard (because their MSFs are lower).

In turn, because many merchants do not accept Diners Club cards (or make it clear that they would prefer that customers not use it), this makes the card somewhat less attractive to consumers.

The opposite is true for Visa and MasterCard. Because they are ubiquitously held, nearly all merchants feel obliged to accept them, and this further increases their attractiveness to consumers.

Thus, Diners Club has no market power, unlike Visa and MasterCard.

### Pricing

The result of these very different market dynamics is that merchants, especially large merchants, can bargain more much aggressively with Diners Club and are more likely to impose surcharges on Diners Club transactions than they with those of Visa and MasterCard. Diners Club negotiates its MSFs with each merchant separately.

While Diners Club's MSFs are generally higher than those of Visa and MasterCard, merchants are far more likely to surcharge Diners Club transactions (see chapter 4 of this report) while accepting Visa and Master Card MSFs as simply a cost of doing business. This is illustrated by the fact that the most common form of surcharging is where Diners Club and American Express are surcharged and Visa and MasterCard are not. Furthermore the rate at which they are surcharged is not the differential between the Visa and MasterCard's MSF and the Diners Club and American Express MSF, but the full three-party-scheme MSF rate. This demonstrates that firstly a merchant cannot run a business without accepting Visa and MasterCard and secondly the cost of accepting Visa and MasterCard is built into the merchant's cost base. As discussed above, Diners Club does not have any market power, so its higher MSFs reflect its status as a high quality niche product rather than any supra–competitive pricing.

Furthermore, while there should be no presumption that Diners Club's MSF is equal to the marginal cost of providing services to merchants[9], this does not represent a departure from a competitive market. As is well known[10], in a two-sided competitive market, the textbook efficient outcome whereby price equals marginal cost no longer holds. What is true instead is that in a competitive equilibrium, price is equal to marginal opportunity cost, where opportunity cost takes account of the externalities imposed on each side of the market by the other.[11] [12]

In Diners Club's case, competition with other payment mechanisms (especially other credit/charge cards) for merchants' business determines the MSF that Diners Club can charge, and on the other side of the market, competition determines the fees that can be charged to cardholders. In this competitive environment, Diners Club's business model is to offer a high–quality niche product to targeted consumers and business and government users of its charge card service.

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9 This is equally true for Visa, MasterCard and American Express.

10 Jean–Charles Rochet and Jean Tirole 'Two–Sided Markets: A Progress Report", *Rand Journal of Economics 2006,* Vol 37, issue 3, pp 645-667.

11 This departure from the standard case is more practical than conceptual, for even in the standard case the relevant cost concept is opportunity cost. However, since in this case externalities are not present, marginal opportunity cost becomes marginal physical cost (including both operating and capital costs). As has been pointed out by several critics, (e.g. Julian Wright, "One-sided logic in Two-sided Markets", *Review of Network Economics,* 3(1) March 2004), the RBA's cost-based determination of interchange fees for the open schemes was not theoretically sound. But the RBA has never claimed theoretical purity in this regard, making only the more modest claim that it made a "pragmatic" decision (Simon 2005, p376.) It is noteworthy that the RBA, in its recent regulation of debit interchange, did not base that regulation on measured costs.

12 Even in the regulated four party schemes, acquirers are not being asked by the RBA to justify their MSFs in relation to their marginal costs. The presumption is that the market failure in these schemes is associated with interchange fees, and regulation of interchange fees leads to more efficient outcomes.

### *No market failure*

Unlike Visa and MasterCard, there is no market failure associated with Diners Club that implies the need to regulate. As a small scheme Diners Club has no market power vis a vis merchants; it has no interchange fees; it competes vigorously with the other card schemes (while offering a differentiated product); and whatever margin exists between its MSFs and the marginal cost of acquiring merchants has no implications for competition in, or efficiency of, the payments system. As explained, Diners Club's merchant relationships and its pricing processes are very transparent. If Diners Club, due to its market strategy and MSF pricing stance, was to lose sales or merchants then that would be a matter for Diners Club. Far from indicating a market failure it would reflect the efficient operation of a price-value judgement by its customers in an open, competitive market.

*Chapter 2*

# Diners Club in Australia

*This chapter describes Diners Club's strategy and operations in Australia.*

## 2.1 Key features of the scheme

Diners Club operates a three party charge card scheme. The key features of the scheme are:

- Diners Club has the business relationship with both the cardholders and the merchants (hence it is a 'three party' or 'closed' scheme).
- It is a charge card scheme. Cardholders must pay their balances in full every month.
- Diners Club distributes its cards directly to customers of ANZ bank and other marketing partners.
- There are no interchange fees associated with Diners Club merchant service fees.
- Diners Club negotiates merchant service fees with its merchants on an individual basis.

## 2.2 Diners Club's strategy

Diners Club's strategy for cardholders is to offer a niche product for high net income individuals, corporates and governments. The value proposition for individuals centres around offering more and higher quality rewards than are offered by competitors' cards, and applying no spending limit. For corporates and governments, the value proposition is based around high levels of service, ATO-compliant reporting, rewards programs and other features.

For merchants, the value to them of accepting Diners Club cards is that cardholders tend to be high spenders, as well as better service than they receive from acquirers of other cards.

## 2.3 Market share and scale of operations

Diners Club is the smallest of the four Australian card schemes. In the year to May 2007, Diners Club's share of transactions volumes was c-i-c per cent, while its share of transaction values was c-i-c per cent – the average Diners Club transaction size is larger than that of the credit/charge market as a whole.

In 2006 Diners Club cardholders made c-i-c million transactions with a total value of $c-i-c million. Table 2.1 shows how Diners Club's business is split by type of account, while Table 2.2 shows the split of transactions by merchant category.

Table 2.1
**DINERS CLUB ACCOUNTS IN 2006**

| | Consumer | Corporate | Merchant |
|---|---|---|---|
| Accounts | c-i-c | c-i-c | c-i-c |
| Active rate | c-i-c | c-i-c | c-i-c |
| Sales ($m) | c-i-c | c-i-c | c-i-c |
| Spend per active account ($) | c-i-c | c-i-c | c-i-c |

Source: Diners Club, * Australia only

Table 2.2
**DINERS CLUB TRANSACTIONS IN 2006**

| Merchant type | Transaction numbers ('000) | Spend ($m) | Average transaction size ($) |
|---|---|---|---|
| Supermarkets | c-i-c | c-i-c | c-i-c |
| Retail | c-i-c | c-i-c | c-i-c |
| Service Stations | c-i-c | c-i-c | c-i-c |
| Taxis | c-i-c | c-i-c | c-i-c |
| Airlines | c-i-c | c-i-c | c-i-c |
| Restaurants | c-i-c | c-i-c | c-i-c |
| Hotel | c-i-c | c-i-c | c-i-c |
| Auto | c-i-c | c-i-c | c-i-c |
| Telephone | c-i-c | c-i-c | c-i-c |
| Marketing | c-i-c | c-i-c | c-i-c |
| Travel | c-i-c | c-i-c | c-i-c |
| Professional Services | c-i-c | c-i-c | c-i-c |
| Other | c-i-c | c-i-c | c-i-c |
| Cash | c-i-c | c-i-c | c-i-c |
| Utilities | c-i-c | c-i-c | c-i-c |
| Medical | c-i-c | c-i-c | c-i-c |
| **TOTAL** | **c-i-c** | **c-i-c** | **c-i-c** |

Source: Diners Club

## 2.4 Competitive Implications of Diners Club strategy

Diners Club's niche strategy necessarily means that it holds only a small share of the credit/charge card payments market. This means that, unlike Visa and MasterCard, merchants have significant discretion as to whether they accept Diners Club cards, depending on whether they think this will attract additional sales, or better satisfy the payment preferences of their existing customers. For some types of merchants, such as hotels, that is likely to be the case, given the kinds of people who stay at hotels (i.e. high spenders). For other types of merchants, such as utilities, their need to accept Diners Club cards is less pressing.

This being the case, Diners Club, unlike Visa and MasterCard, has no market power that it can exercise against merchants. On the contrary, Diners Club has comparatively little bargaining power when it comes to negotiating merchant service fees, especially when taking account of the competition it faces from the large schemes. The fact that Diners Club has (generally) higher MSFs than Visa and MasterCard is *not* an indication of any market power. Rather, it reflects Diners Club's strategy, which is to offer a higher quality product than its competitors.

*Chapter 3*

# Evidence of competition I: Diners Club's MSFs

*This chapter shows that the Merchant Service Fees (MSFs) that Diners Club has received have declined over time, indicating the highly competitive nature of market in which Diners Club operates. These declines began before the RBA's reforms.*

## 3.1 Introduction

As discussed in Chapter 1, one effect of the RBA's reforms was that the average MSFs of the open schemes fell on average by about 45 basis points, slightly more than the amount by which interchange fees were cut by the RBA's regulations. The RBA's Issues Paper (2007) notes that since the reforms, the MSFs of the unregulated three party schemes have also fallen (due to competitive pressure), with the average Diners Club falling by c-i-c basis points.

While it is true that the three party schemes are under intense competitive pressure, the average Diners Club fee has fallen by much more than stated in the Issues paper and, importantly, it started falling before the RBA's reforms.

## 3.2 MSFs over time

Table 3.1 shows how Diners Club's MSFs have declined since 2001 i.e. from before the RBA's reforms.

Table 3.1

**DINERS CLUB MERCHANT SERVICE FEES 2001–2007 (%)**

| 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |

Source: Diners Club

## 3.3 MSF by particular merchant

Table 3.2 shows MSFs by Diners Club's 10 largest merchants from 2000 to 2007. Like Table 3.1, it shows declining MSFs over time, including declines well in advance of the RBA's reforms. There is also significant variation between merchants.

In summary, competitive forces have led to falls in Diners Club MSFs over time. From the time that merchants have been permitted (but not obligated) to surcharge, these falls have been particularly large.

Table 3.2

**DINERS CLUB MERCHANT SERVICE FEES (10 LARGEST MERCHANTS, %)**

| Merchant | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |
| c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c | c-i-c |

Source: Diners Club

## 3.4 Conclusions

Diners Club, as a small scheme, has relatively little bargaining power when it comes to negotiating MSFs with merchants and as such has faced continual downward pressure on its MSFs. This pressure predated the RBA's reforms.

*Chapter 4*

# Evidence of competition II: Surcharging by merchants

## 4.1 Introduction

This chapter discusses the effect of surcharging by merchants of Diners Cub transactions, using a number of case studies. For reasons discussed in Chapter 1 of this report, merchants feel more confident in their ability able to surcharge Diners Club than other types of credit cards and some have chosen to surcharge Diners Club (and American Express) but not Visa or MasterCard. The effect of surcharging Diners Club has been to significantly reduce the number of transactions that are paid for using Diners Card cards.

## 4.2 Case Studies

Table 4.1 shows what happened when c-i-c started surcharging Diners Club and American Express cards in c-i-c. Both the value and volume of transactions fell by over c-i-c per cent, as consumers switched their payments to other means (probably Visa and MasterCard, as these were not surcharged).

Table 4.1

**EFFECT OF SURCHARGING DINERS CLUB TRANSACTIONS: C-I-C**

| Notes | Average monthly transactions | Pre surcharging (12 months prior) | Post surcharging (12 months post) | Effect (%) |
|---|---|---|---|---|
| c-i-c | Value ($'000) | c-i-c | c-i-c | c-i-c |
| | Number of transactions | c-i-c | c-i-c | c-i-c |

Source: Diners Club

Table 4.2 shows what happened when c-i-c introduced surcharging. While c-i-c surcharged all credit card payments, it charged Diners Club and American Express by c-i-c more (an amount which exceeded the difference in MSFs). The effect was dramatic, with the value of Diners Club payments falling by c-i-c per cent, and the volume falling by c-i-c per cent.

Table 4.2

**EFFECT OF SURCHARGING DINERS CLUB TRANSACTIONS: C-I-C**

| Notes | Average monthly transactions | Pre surcharging (7 months prior) | Post surcharging (12 months post) | Effect (%) |
|---|---|---|---|---|
| c-i-c | Value ($'000) | c-i-c | c-i-c | c-i-c |
| | Number of transactions | c-i-c | c-i-c | c-i-c |

Source: Diners Club

Table 4.3

**EFFECT OF SURCHARGING DINERS CLUB TRANSACTIONS: C-I-C**

| Notes | Average monthly transactions | Pre surcharging (12 months prior) | Post surcharging (12 months post) | Effect (%) |
|---|---|---|---|---|
| c-i-c | Value ($'000) | c-i-c | c-i-c | c-i-c |
| | Number of transactions | c-i-c | c-i-c | c-i-c |

Source: Diners Club

Finally, it should be noted that it is differential surcharging that primarily has caused the decline in Diners Club transactions, not surcharging *per se*. This can be seen in Table 4.4, which shows the effect (or lack it) when c-i-c started surcharging all cards equally, in c-i-c. Both the value and volume of Diners Club transactions increased after the surcharging was introduced. Clearly, surcharging as such would not have caused more transactions, which would have been due to the demand for c-i-c, but when all cards were surcharged, there would have been no incentive for consumers to switch from one card to another, and there was no obvious negative effect on Diners Club transactions.

Table 4.4

**EFFECT OF SURCHARGING DINERS CLUB TRANSACTIONS: C-I-C**

| Notes | Average monthly transactions | Pre surcharging (12 months prior) | Post surcharging (12 months post) | Effect (%) |
|---|---|---|---|---|
| c-i-c | Value ($'000) | c-i-c | c-i-c | c-i-c |
| | Number of transactions | c-i-c | c-i-c | c-i-c |

Source: Diners Club

## 4.3 Conclusions

Because Diners Club is a small scheme, merchants feel less restricted in their ability to surcharge its transactions than they do with Visa and MasterCard, where the risk of offending consumers is high.

This experience is consistent with the MSF experience described in the previous chapter. Unlike Visa and MasterCard, Diners Club is too small to affect the competitive environment in which it operates. In contrast, Visa and MasterCard's ubiquity in the marketplace provides them with leverage over merchants, who are far more prepared to absorb the cost of Visa and MasterCard MSFs than they are with Diners Card i.e. they are far more likely to pass on Diners Club MSFs as surcharges. They are also more likely to surcharge at the full Diners Club MSF rather than just the difference between Diners Club's MSF, and those of Visa and MasterCard. This gives a further competitive advantage to Visa and MasterCard.

*Chapter 5*

# The false "level playing field" argument

## 5.1 Introduction

When the RBA was considering designating (regulating) the (then) 3 four party credit schemes, it was argued by some that if the RBA did not also regulate the three party schemes, Diners Club and American Express, that this would create an inefficient distortion in the market and confer on the three party schemes an unfair competitive advantage.

For example, in its submission to the RBA of 17 April 2001, *Inclusion of Three Party Schemes in the Designation Process*, Visa argued (pp3-4) that

> The cards issued under the closed schemes provide the same payment service to consumers and have the same impact upon merchants as cards provided through the open card schemes. They exhibit the same characteristics in areas such as the provision of a line of credit (whether or not it is a revolving line of credit), payment of merchant service fees, target markets, product offerings and distribution. The scrutiny of card schemes that exhibit the same or similar characteristics cannot be selective and be on the basis of ownership.
>
> If the Reserve Bank were to proceed with the designation process but did not include closed card schemes, it would result in substantial policy failure with adverse economic efficiency consequences.
>
> If the closed schemes are not included in any designation process, the Bank would also bestow substantial competitive advantage to one sector of the card industry, a sector owned by large foreign multi-national corporations. This competitive advantage for closed schemes would be at the expense of open credit card schemes that are predominantly locally owned.

Visa further argued (pp5-6)

> it is difficult to argue that competitive pressures would force the closed schemes into a reduction of their merchant service fees in a half-regulated environment ... History demonstrates that competitive pressures would not force a lowering of merchant service fees by the closed schemes

and that (p7)

> It seems clear that cards issued under closed schemes (eg. Amex and Diners) are close substitutes to those issued under open schemes (eg. Visa and MasterCard). Both consumers and merchants are likely to view the cards of both schemes as almost interchangeable, in terms of the services they provide.
>
> If the 'substitutes' proposition is accepted, then it follows that regulating cards issued under open schemes but leaving cards issued under the other type of closed scheme unregulated, could cause significant economic efficiency losses.

## 5.2 Assessment of the argument

As matters have turned out, Visa's prediction was wrong. The four party schemes have not lost significant market share to the three party schemes – only a small amount that can be explained entirely by some banks deciding to distribute Diners Club and American Express cards.

The reasons for lack of effect in the case of Diners Club are not difficult to find. While the four party cards and three party cards may be closely substitutable as payments instruments, four party cards offer a service that Diners Club cards do not — the provision of extended credit, which, as shown in this Report, has been extensively taken up by Australian consumers.

Furthermore, the business strategy of the three party schemes (certainly Diners Club) is to differentiate themselves from Visa and MasterCard and so they market their cards as niche, not mass, products, limiting their perceived substitutability.

### 5.3 Diners Club: there is no market failure

Most importantly, the Visa argument fails to take account of the fact that, unlike the four party schemes, there is no market failure associated with the three party schemes, and therefore no need to regulate them.

As has been discussed at length in this Report, unlike Visa and MasterCard, the three party schemes

- have no interchange fees which cannot or do not respond to competitive market forces; and
- in particular with Diners Club, because they have small market shares, they cannot exert any market power over merchants, who have the discretion to not accept the cards, the ability to bargain down MSFs, and the willingness to pass on MSFs to consumers in the form of surcharges.

Thus, unlike Visa and MasterCard, there is no reason to regulate Diners Club, because its unregulated operations are entirely consistent with the efficient working of the payments system.

The Allen Consulting Group

## Jerome G. Fahrer

Director

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- Newcastle Coal Infrastructure Group on competition at Port Waratah (2007)
- The Victorian Department of Justice on competition in wagering (2007)
- Consumer Affairs Victoria on competition in real estate services (2007)
- NRMA on competition in the petrol industry (2007)
- The Competitive Carriers Coalition on competition in broadband (2007) and structural separation of Telstra (2006)
- VERNet on access pricing on its telecommunications network (2006) and competitive benchmarks for that network (2007)
- The G9 group of telecommunications companies on competition in fibre-to-the-node telecommunications networks (2006)
- New Zealand Commerce Commission on calculating the cost of the Telecommunications Service Obligations (2006)
- Wilson Transformer Company on the calculation of damages in an alleged price fixing arrangement (2006)
- BHP Billiton on proposals by the WA Government to create reservations of natural gas for domestic use (2006)
- The Victorian Department of Treasury and Finance on competition in wagering and gaming (2006)
- Optus on competition in local call resale and broadband markets (2005, 2006)
- NEMMCO on the structure of Participant Fees (2002, 2005, 2006)
- Reserve Bank of Australia on competition in EFTPOS systems (2005)
- Tote Tasmania on competition in wagering markets (2005)
- Macquarie Bank on telecommunications competition and regulation (2004, 2005)
- Fosters Group on its acquisition of Southcorp (2005)
- Betfair on competition in wagering (2004, 2005)
- Victorian Department of Infrastructure on possible re-aggregation in the energy sector, including vertical mergers (2005)
- ANZ Bank and the Australian Bankers Association on competition in and regulation of payments systems (2000-05)
- NEMMCO on changes to the Competition Test for system restart ancillary services in the National Electricity Code (2004)
- DCA Group on its acquisition of MIA (2004)

Jerome has been retained as an independent expert in a number of matters including:

- NEMMCO on compensation for Directed Parties under the National Electricity Rules (2005 – ongoing)
- NEMMCO on competition in system restart ancillary services (2005)
- A major energy utility on the trade practices implications of the sale of the Dampier to Bunbury Natural Gas Pipeline (2004)
- AMP Henderson, for whom he wrote a regulatory consultant's report for their Airports Funds Prospectus (2001)

Jerome's recent major project evaluations and sectoral studies include:

- The Australian Formula 1 Grand Prix for the Victorian Auditor General (2007)
- The Australian construction industry for the Australian Constructors Association (2007)
- The proposed Australia Chile Free Trade Agreement for BHP Billiton (2007)
- The not–for-profit sector for the Department of Victorian Communities (2007)
- The Australian supermarket industry for ALDI (2007)
- A third coal loader at Port Waratah, for the Newcastle Coal Infrastructure Group (2006)
- The EastLink tollway, for the Southern and Eastern Integrated Transport Authority (2006)

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