APPENDIX B FINAL REPORT

Economic analysis of Visa's Honour All Cards rule

REPORT PREPARED BY NECG FOR
VISA INTERNATIONAL

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Executive summary

The Reserve Bank of Australia (RBA) has expressed to Visa a view that the Honour All Cards rule may have a detrimental impact on the degree of efficiency and competition in the Australian payments system.

NECG understands from Visa that the RBA views the rule as a tying arrangement that is potentially anti-competitive. In light of Visa's response to the Wal-Mart action in the USA, the RBA has asked Visa to explain how the Honour All Cards rule is consistent with the promotion of competition and efficiency in the Australian payments system.

In the Australian context, the Honour All Cards rule is facilitating both efficiency and competition in the payments system. The pro-efficiency and pro-competitive effects of the Honour All Cards rule overwhelm any potential negative impacts (if any).

In terms of efficiency, the Honour All Cards rule reduces transaction costs faced by consumers without harming merchants. It also enhances efficiency by increasing the ability of Visa to offer a wider choice of card services.

In terms of competition, the Honour All Cards rule has enhanced the ability of credit unions and other small financial institutions to compete as issuers. The rule accomplishes this by enforcing vertical separation of acquiring and issuing, and hence reduces entry barriers into the issuing function. Absent the rule, excess costs would end up being imposed on smaller issuers.

Even if, for the sake of argument, we accept that the Honour All Cards rule is a 'tying' rule, the Wal-Mart case is not an applicable precedent to Australia because:

- the relevant law in the US under which the Honour All Cards rule was found to be illegal tying is based on a different principle to the relevant sections of the Australian Trade Practices Act (TPA). In the US tying is per se anti-competitive. In Australia tying is not per se anti-competitive. It is considered anti-competitive only in situations where it has the purpose or effect of substantially lessening competition or where a firm engages in tying to take advantage of substantial market power for an anti-competitive purpose. The Honour All Cards rule does not substantially lessen competition and is not intended for an anti-competitive purpose; and
- it was not clear even to the judge in the US Wal-Mart case, and in US jurisprudence generally, that tying should be per se illegal regardless of effects on competition.

The European Commission's finding that the Honour All Cards rule as it applies in Europe is not anti-competitive serves as a strong precedent of greater relevance to the Australian context. It is of greater relevance to Australia than the US Wal-Mart case because it analyses the efficiency and competition effects of the rule, which seems to be the

framework that the RBA is seeking to apply to this issue. The European Commission bases its conclusion on its overall finding that the Honour All Cards rule does not diminish efficiency or competition. In contrast, the finding in the US Wal-Mart case did not consider the efficiency and competition effects of the rule, only whether the rule can be considered as tying, which is illegal in the US but not in Australia or the European Union.

Recent and planned changes to Visa debit interchange fees directly address the RBA's and merchants' concerns about the Visa debit card product, making changes to the Honour All Cards rule unnecessary. There is a real risk that by mandating changes to the Honour All Cards rule, the RBA would reduce efficiency and competition in the Australian payments system.

1 Introduction

Visa International (Visa) has commissioned this report following an invitation from the Reserve Bank of Australia (RBA) for Visa to assist with its inquiries into the Honour All Cards rule. In this report a number of claims are examined about the impact of the Honour All Cards rule, as implemented by Visa Australia, on both efficiency and competition in the Australian payments system.

At this point in time, the RBA has not set out its arguments in full or in writing. This report is structured to address points and lines of argument raised verbally by the RBA during discussions with Visa.

The main finding of this report is that not only is the Honour All Cards rule not detrimental to either efficiency or competition; rather, the rule actually promotes both efficiency and competition in the Australian payments system.

Section 2 discusses the objectives of the Honour All Cards rule.

Section 3 sets out Visa's understanding of the nature of the RBA's concerns about the Honour All Cards rule.

Section 4 explains how the Honour All Cards rule promotes both efficiency and competition in the Australian payments system.

Section 5 examines recent decisions in the US and Europe regarding the Honour All Cards rule and discusses their relevance for Australia.

2 What is the 'Honour All Cards' rule?

Visa's Honour All Cards rule requires that merchants that elect to accept a Visa branded card — for example, and as is the case in Australia, a card bearing the blue, yellow and gold bands design, the Visa "Flag" product — accept all Visa Flag branded cards, irrespective of which financial institution issued the card and whether the card is a personal credit card, business credit card or debit card. The RBA has said that, in this sense, it has an 'honour all banks' dimension and an 'honour all products' dimension, although this is not a view that is adopted by Visa.

This rule is not unique to Visa or open card schemes generally. All major payment card brands — including MasterCard, American Express, and Diners Club — have a similar rule that they apply to their participating merchants. The rule also is not unique to Australia. It is applied internationally by major payment card brands throughout the world. Its goal is to ensure that Visa cardholders whose card bears a particular acceptance

logo, such as the Visa Flag logo, can be confident that their Visa cards will be accepted at any Visa-accepting merchant that displays the same acceptance logo, anywhere in the world, including in Australia.

The rule helps give open card schemes the ubiquity that is so vital to their existence and growth and to the convenience and security of their cardholders.

3 RBA concerns about the Honour All Cards rule

In light of Visa's response to the Wal-Mart action in the USA, the RBA has asked Visa to explain how the Honour All Cards rule is consistent with the promotion of efficiency and competition in the Australian payments system.

NECG understands from Visa that the RBA is concerned that the Honour All Cards rule is a 'tying' rule in the competition law sense of the word. That is, it compels merchants to accept all cards with the Flag brand, not just one type of card: thus, if a merchant elects to accept Visa Flag credit cards, that merchant must be prepared to accept Visa Flag debit cards.

NECG also understands from Visa that the RBA is concerned that the Honour All Cards rule may be anti-competitive. To be prohibited under Australia's competition laws, the Honour All Cards rule must be in breach of section 47 of the TPA (see Box 1).

Box 1 Section 47 of the Trade Practices Act

Section 47 of the TPA deals with the conduct of exclusive dealing. Exclusive dealing generally falls into three general categories:

- restrictions on dealings with competitors;
- customer and territorial restrictions (e.g. restricting the acquirer's freedom to re-supply goods or services purchased from the corporation); and
- third line forcing (where the terms of supply include a condition that the acquirer will acquire goods or services from another person).

'Tying' arrangements, also known as 'full line forcing', belong in the first category. Subsection (1) of Section 47 of the TPA prohibits the practice of exclusive dealing, subsections (2) to (9) define what exclusive dealing involves, and subsection (10) provides that, with one exception, the prohibition in subsection (1) does not apply unless the conduct has the purpose, effect or likely effect of substantially lessening competition. The exception is essentially for conduct defined as 'third line forcing'.

NECG understands that in discussions between Visa and the RBA, the RBA referred to the recent Wal-Mart case in the US as an example of and precedent for considering the Honour All Cards rule as a form of tying and consequently, of anti-competitive behaviour.

NECG further understands from Visa that the RBA also expressed the view that the Honour All Cards rule has expanded beyond its previously legitimate boundaries. Specifically, the RBA suggested that the Honour All Cards rule was originally intended as an 'honour all banks rule' and not as an 'honour all card products' rule. That is, the rule was originally intended as a mechanism to ensure merchants accepted all cards of a particular brand irrespective of issuer. The RBA seems to be questioning the appropriateness of the 'honour all products' dimension to the rule, implying that this aspect of the rule involves tying and may be anti-competitive in the sense defined above.

4 How the 'honour all cards' rule promotes efficiency and competition

This section explores the importance of the Honour All Cards rule to the sustainability of the Visa branded cards. It identifies the competition and efficiency enhancing properties of the Honour All Cards rule. Section 4.1 examines the efficiency effects of the rule, while Section 4.2 examines its effects on competition.

4.1 The effects of the Honour All Cards rule on efficiency

This section considers the direct and indirect benefits of the Honour All Cards rule to cardholders as consumers and merchants. It also considers the potential detrimental impact of the rule to merchants. On balance, Visa considers the benefits far outweigh any detriment.

4.1.1 Savings in search costs to cardholders and indirect network-wide benefits

An important requirement for any successful payment network is that the means of payment be widely accepted. Consumers use payment networks such as that offered by Visa because of this guarantee. To put it another way, the service delivered by Visa consists of two parts — the Visa promise of guaranteed acceptance to issuers for the benefit of their cardholders, and Visa's guarantee of payment to acquirers for the benefit of their merchants. Participating merchants clearly benefit from the second component of guaranteed payment. It enables a merchant to accept any card with the Visa brand on it and be confident that as long as authorisation and other relevant procedures outlined by the applicable card network rules are followed, the acquiring bank will be paid (enabling it to pay the merchant), regardless of whether the acquiring bank or the merchant knows the customer, regardless of whether the customer pays the issuer, and so on.

The Honour All Cards rule enables Visa to deliver on the other component of the Visa service, namely guaranteed acceptance of whatever card Visa cardholders choose to use

when making purchases. It is the other half of the quid pro quo, which facilitates mutually beneficial arrangements for all participants. Just as merchants clearly derive value from the confidence that they will always be paid following any transaction with a Visa cardholder, Visa cardholders clearly derive great amenity value from knowing that their means of payment will be accepted by participating merchants in the Visa network, regardless of who they are, regardless of who their issuer is, and regardless of what type of card they use, as long as they follow the appropriate procedures.

To understand why the Honour All Cards rule is essential to this guaranteed acceptance service for cardholders, imagine the situation where Visa's merchant networks are just as comprehensive and wide ranging as they are currently but where the Honour All Cards rule was not enforced. Under these circumstances, Visa would not be able to guarantee acceptance for all Visa cardholders.

This is quite simply because in any given locality where a Visa cardholder would want to shop, even if 100% of merchants in that locality were participating Visa merchants, they could well vary in terms of the types of Visa cards they accepted. For example, some percentage might accept only Visa credit but not Visa debit cards, others might accept all Visa credit and some debit cards, while yet others might only accept Visa debit cards.

In practice, the extent to which the Visa cardholder would be able to enjoy the guaranteed acceptance service fostered by the Visa network would depend on the type(s) of Visa card(s) held by the cardholders. Those Visa cardholders who held cards that were less popular with merchants in a particular shopping precinct would incur greater search costs than other Visa cardholders. However, importantly, all Visa cardholders would incur greater search costs in the absence of the Honour All Cards rule because they would need to ascertain that the merchants that they were planning on transacting with accepted their particular cards. If not, then they would face three options:

- obtain another type of Visa card; one that is accepted by the merchant;
- switch to a payment method that may involve a higher (implicit and/or explicit) cost or a lower benefit; or
- search for another merchant that offers the required goods or service that is the best match with whatever portfolio of cards they hold.

Cardholders would have to plan their purchases in advance, at least initially, if they wanted to avoid being turned away if they used their particular Visa payment cards. In other words, Visa would only be able to offer a highly qualified 'guaranteed acceptance'. Given the qualified nature of that acceptance, card-holders might well need to hold multiple means of payment or engage socially wasteful search costs so as to be confident of their ability to make transactions as and when needed.

Making exceptions to the Honour All Cards rule would consequently change the nature of the Visa payment card, which is characterised by guaranteed acceptance wherever the acceptance logo is displayed.

There are, of course, other ways Visa could deal with this problem. One way is simply by allowing its members to issue only one type of card. Another way is to invest more in ensuring that separate, equally extensive merchant networks are available for all its varieties of cards. However, the implementation of this second alternative is complicated by the fact that there is not a neat line of demarcation between what a credit card is and what a debit card is. Products such as the deferred debit product are hybrids. Additionally, it leads to other costs that are discussed in Section 4.1.2.

As the discussion, set out above, of the world without an Honour All Cards rule suggests, an important part of the value added by facilitating 'guaranteed acceptance' is the savings in search costs to consumers who use Visa payment cards. As a payment service provider, Visa is in the business of making transactions easier for its customers. The provision of guaranteed acceptance services allows Visa to make transactions easier for its customers by reducing their search and other transaction-related costs.

In economic terms, search costs are as real as any other costs[1] — the fact that they are not incurred as pecuniary costs (i.e. as part of some bill of sale) does not make them any less real because the time expended on searches of the kind discussed above involves opportunity costs of time that could be spent on other valued activities.

However, as noted before, guaranteed acceptance is only one half of the complete service offered by the Visa network, the other being guaranteed payment. The two components of the Visa service are interdependent. Because open credit card networks result in cards being issued by numerous members around the world, the integrity of the network — that is, the value of the brand associated with the network — is best served by ensuring that all cards on issue are treated equally, something which the Honour All Cards rule facilitates.

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[1] There is a large body of economic literature dealing with the implications of higher or lower search costs. See, for instance, Ariely, D. and J. Lynch 2001, 'Wine online: Search costs and competition on price, quality and distribution', MIT Sloan Working Paper No. 4191-01; Hortascu, A. and C. Syverson 2003, 'Product differentiation, search costs and competition in the mutual fund industry: A case study of S&P index funds', *NBER paper*; Diehl, K., L. Kornish and J. Lynch 2003, 'Smart agents: When lower search costs for quality information increase price sensitivity', *Journal of Consumer Research* 30; Johnson, R. 2002, 'Search costs, lags and prices at the pump', *Review of Industrial Organisation* 20; Minkler, A. 1992, 'Why firms franchise: A search cost theory', *Journal of Institutional and Theoretical Economics,* 148.

Without the Honour All Cards rule, the value of a Visa branded card to cardholders would be reduced, since none of them can be completely sure that even when they make purchases from a participating Visa merchant that they will be able to make purchases using their particular Visa card. Holders of less common Visa cards (e.g. as is the case in Australia currently, debit cards) would likely get a lot less value out of joining the network than holders of more popular Visa products (e.g. currently in Australia, credit cards). The confidence cardholders have in the Visa brand would be diluted by the highly qualified nature of its 'guaranteed acceptance'. The loss of utility from carrying a Visa card would be particularly marked where foreign travel is involved or even where cardholders venture outside familiar areas.

The cumulative effect of all these developments would be a shrinking of the Visa cardholder network as many cardholders felt less inclined to continue to hold a Visa branded card, while potential cardholders decided not to take up the Visa brand. In other words, even if only a minority of participating Visa merchants decided to pick and choose which Visa cards to accept, by undermining the guaranteed acceptance of the Visa brand their actions would have an adverse effect on the take-up of even the Visa cards that are most popular with merchants.

Shrinkage of the Visa network would in turn also ultimately reduce the benefit to Visa merchants of participating in the network. This is because the larger the pool of Visa cardholders, the greater the number of additional transactions that participating Visa merchants can expect to enjoy from accepting Visa. Merchants would ultimately lose the transaction-facilitating benefits of both:

- the Visa cards they may be less willing to accept if the Honour All Cards rule were removed; and
- their preferred Visa product due to the effect of their actions on network size and brand popularity.

These adverse effects would be magnified by the fact that the Visa network is characterised by both interdependent demand and network externalities.

This means that a payment card transaction cannot occur unless the transaction is acceptable to both the cardholder and merchant. Therefore, the demand for Visa payment cards is an 'interdependent' demand of the cardholder and merchant. As less cardholders and merchants carry a Visa card because of reductions in their perceptions of the value of the Visa brand, the less likely it is at any given moment that merchants who still accept Visa cards and consumers who carry Visa cards will be able to successfully make transactions using Visa cards.

It also means that both consumers' decision to hold a Visa card and merchants' decision to accept a Visa card affect the value of the network as a whole to other consumers and merchants. The more consumers use a Visa card, the larger the number of merchants who will accept a Visa card. The more merchants that accept a card, the more it is valued by consumers. This in turn means that more consumers will carry the card, which affects its value to merchants to accept it, and so on. This is the 'network externalities' characteristic of the Visa card network.

The likely detrimental effect of removing the Honour All Cards rule on the Visa card network was recognised by the EC in its 2001 decision on open card scheme regulations (see Section 5.3).

4.1.2 The role of the Honour All Cards rule in fostering greater choice of card services

Since 1975 Visa has offered a variety of payment cards on a single brand[2]. The number of Visa products has grown in response to differing and changing needs of cardholders and, in some instances, regulatory restrictions on issuers. The Honour All Cards rule enables Visa to customise its product to suit cardholders with different needs. This is because few, if any of these card varieties, could on a stand-alone basis support the expense to develop and maintain a separate brand and acceptance network.

There is a variety of Visa products, each serving a unique need and each with its unique set of costs, features and services. These include:

- Visa Classic credit cards, Visa Gold credit cards, and Visa Platinum cards (to which card issuers attach such benefits as travel features, rewards programs, security, comprehensive statementing, and concierge services);
- co-branded cards (such as with retailers and airlines);
- affinity cards (with charitable, civic, or educational groups);
- charge cards;
- debit cards (some of which may offer an overdraft or credit line facility);
- deferred debit cards (which take funds from a deposit account);
- commercial cards;
- student cards;
- stored value cards (which, figuratively speaking, have money "loaded" on the card); and

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[2] It has also developed other brands, such as Electron and Interlink, in some countries. However, these other brands are not available in Australia.

- cards provided by an issuer on the basis that credit is secured by collateral provided by the cardholder or a third party.

Absent the Honour All Cards rule, Visa issuers would likely need to invest in separate brand and acceptance networks for each variety of card if they wanted to ensure that all cardholders could be confident of being treated equally, in the sense of knowing that their card would be accepted on an equal footing with other Visa-branded cards. Obviously, given the proliferation of cards offered by Visa issuers, such an investment would be unjustified, meaning that consumers would have less choice than they currently do.

Looking at this another way, there are scale and scope economies on both the supply and demand side that would have to be foregone if Visa issuers had to develop separate networks for different types of Visa cards.

On the supply side, there are economies of scale in developing and sustaining any payment card network. Currently Visa issuers are able to take advantage of these supply side economies of scale while still competing with each other vigorously to attract cardholders. Issuers also benefit from economies of scale in building and maintaining the infrastructure needed to process payment transactions and because they can benefit from positive network externalities (discussed previously) associated with other Visa issuers also signing up merchants. By ensuring that all issuers, and all card types, can benefit from these scale economies, Visa makes it easier for its network to obtain economies of scope, i.e. gains from making available, within a single system, a wide variety of card types.

On the demand side, there are efficiencies associated with the increased scope for network externalities among cardholders and merchants (which in effect make it easier to expand an already large network of users). Because of the Honour All Cards rule, merchants need only sign one agreement and abide by a single set of regulations, standards and connectivity to enjoy the capacity to accept all kinds of Visa cards. In the process merchants build multiple relationships with issuers through a single contract for acquisition. Among other benefits, this ensures that merchants only need to use a single processing platform for all Visa transactions, which allows scale economies not merely in processing but also in staff training and more generally in the handling of Visa payments.[3]

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[3] Of course, economies of scale and scope might also prevail absent the rule as competition ensured that larger acquirers, who offered access to a wider range of cards, displaced smaller or more specialised acquirers. However, as is discussed in more detail below, one consequence of relying on such a process to secure scale economies is that it could seriously compromise competition in the issuing function. More specifically, these larger acquirers would be in a position to discriminate against entrant issuers, especially if they were also potential competitors in the acquiring function.

As these economies would be compromised or foregone if Visa issuers had to develop separate networks to support separate brands, it seems likely that absent the Honour All Cards rule, or some similar rule, different Visa card products would not have been developed in the first place. If all open card schemes were prevented from enforcing a Honour All Cards rule, the diminution in consumer choice could be substantial. This reduction in consumer choice represents a real loss of economic welfare.

In addition to fostering innovation by allowing card issuers to take advantage of the economies discussed above, the Honour All Cards rule also fosters innovation by bringing new players into the card issuer market — in particular, credit unions. The pro-competitive implications of this are discussed in greater detail in Section 4.2 but it is worth noting here the efficiency enhancing implications of this innovation effect. The Honour All Cards rule provides a platform for credit unions to participate in the provision of payment card services side by side with the bigger banks. Absent this rule, credit unions might have to bargain with participating Visa merchants to get them to accept their debit cards. Credit unions would most probably have less ability to establish acceptance networks successfully than the big banks and therefore would not be able to offer their customers the same degree of guaranteed acceptance as they currently can under the Honour All Cards rule.[4]

4.1.3 How could the Honour All Cards rule impose costs on merchants?

The main 'harm' that merchants allege comes from the application of the Honour All Cards rule is that they are forced to accept some Visa payment instruments that they otherwise would not accept. This is because the cost of processing transactions using these payment instruments is higher than they would be willing to bear if they were not bound by the Honour All Cards rule.

In particular, some merchants may see issues in being required to accept Visa debit cards as part of their obligations under the Honour All Cards rule. In effect, if they were to accept payments made using normal EFTPOS they would not have to contribute to the cost of interchange fees paid from one bank to another; whereas when they accept a payment made via Visa debit, the interchange fee traditionally has been similar to that they currently face when accepting Visa credit cards. As a result, when merchants accept Visa debit they have to contribute to the interchange fees paid by their acquirer banks to the issuer banks of the cardholder.

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[4] If credit unions, when they issued cards, had to bargain with their competitors to gain access to their acceptance networks, the likely result would reflect the inequality of bargaining power between the negotiating parties. One outcome of this would be that the credit unions, when they innovated in their card issuing and marketing strategies, would have to give up to the acquirers a potentially substantial share of the economic benefits generated from those innovations. This would deter entry and innovation in issuing.

As a matter of economics, it is generally held that when two products are tied, the price of the tying product must be reduced to compensate for the higher effective price of the tied product. As a result, the impact of tying on the 'bundled price' is ambiguous, and focusing on a single component within the bundle may yield misleading results. That said, there are a number of points that can be made in response to the types of concerns some merchants have raised about the impact of the Honour All Cards rule.

First, almost all Visa products are widely used by Visa cardholders, which suggests that consumers at least value use of these products, even if some merchants do not. In any assessment of overall welfare consequences, the benefit that is enjoyed by cardholders needs to set against the perceived harm borne by merchants.

Second, removing the Honour All Cards rule would be a self-undermining proposition from the perspective of the merchants. It would, by reducing the size of the Visa network, undermine Visa's brand value among consumers, and thereby reduce the benefits that merchants derive from more popular (among merchants) Visa products.

Third, it is also significant that the Australian Retailers' Association has never argued publicly for the abolition of the Honour All Cards rule, even though it has been concerned about Visa debit interchange rates. If Visa debit interchange rates are the main concerns of merchants, then this issue can be addressed without abolishing the Honour All Cards rule (see below).

Fourth, among the people who typically use debit cards are those who value the convenience of guaranteed acceptance but do not need, or do not wish to utilise or qualify for, a line of credit. If the Honour All Cards rule were removed, these people might end up using charge cards (i.e. payment cards issued by closed card schemes), which have been found to be more costly for merchants to accept than debit cards. Alternatively, and perhaps more likely, they might simply switch to credit cards, so that there would be no net gain to merchants. Finally and most importantly, Visa has done its utmost to address merchant concerns about the costs of accepting its card products through various initiatives aimed at reducing interchange fees. The impact of these lower rates needs to be assessed taking account of the ability merchants now have to surcharge credit, and hence to "steer" demand among alternative payment instruments.

4.2 The effects of the Honour All Cards rule on competition

Visa, as an open card scheme, is able to achieve lower costs and greater productive and allocative efficiencies than closed card schemes[5] in part because the open scheme structure

[5] Visa International 2001, 'Delivering a level playing field for credit card payment schemes' prepared by Network Economics Consulting Group.

allows for intra-scheme competition. That is, not only is there competition between different open card schemes (for example, between MasterCard and Visa)[6], there is also competition between issuers and acquirers that belong to the same open card scheme (e.g. between different banks that issue Visa cards). The fact that open card schemes involve both inter and intra system competition is an important element in their superior efficiency.

There are non-price as well as price-based methods of competition. Both are equally important and both are promoted by the Honour All Cards rule. It is widely accepted that product innovation is an essential component of non-price based competition. As discussed in Section 4.1.2, the Honour All Cards rule plays an important role in facilitating greater customising of Visa products, and hence a greater variety of Visa card products for consumers to choose from. The Honour All Cards rule has a powerful pro-competitive effect because it intensifies the level of non-price competition between competing Visa issuers.

The Honour all Cards rule promotes competition in both of these dimensions – that is, on an inter-system as well as intra-system basis. As far as inter-system competition is concerned, the rule ensures that when Visa promotes its acceptance mark — as it now vigorously does — it knows that the benefits will flow to **all** its members. This in turn underpins continuing strong agreement among members for sustained investment in marketing of the acceptance mark as such. In contrast, absent the rule, promotion of Visa as a competitor to other brands would be weaker, because:

- membership support for central promotion would be weakened, as the benefits of that promotion would not accrue to all members; and
- individual members would not make up any resulting shortfall in brand promotion, since they do not have the same incentives to use their own resources to promote the acceptance mark as such: first because some of the resulting benefit spills-over to other members and second because they are usually members of more than one card issuing system.

At the same time, the rule facilitates and encourages vigorous intra-system competition. To begin with, it eliminates entry barriers that might otherwise confront new or smaller issuers.

Under the current rule, when an acquirer signs up a participating merchant, this benefits all current and potential issuers. The acquirer does not have the discretion to limit the range of Visa cards the merchant accepts or to seek to influence the merchant's decision in that respect. This prevents those banks that are large acquirers from favoring their own

[6] Of course, these open schemes also compete with the closed schemes.

activities as issuers to extract concessions from other issuers to ensure that their cards get widespread acceptance. The mirror image of this benefit is that smaller issuers can enter more readily and on a larger scale, all the more so as the rule allows them to avoid the need to enter both issuing and acquiring (or of negotiating individually with acquirers). Entrant issuers, and smaller issuers more generally, can thereby benefit from the scale economies of acceptance in a very large network, even though they would be extremely unlikely to secure such wide acceptance off their own bat.

The rule, in other words, facilitates entry into issuing on a basis vertically separated from entry into acquiring and hence (1) makes the benefits of system scale more readily accessible to all issuers (resulting in a greater number of issuers than would otherwise prevail), and (2) reduces the barriers potential competitors might otherwise face in the issuing function. Absent the rule, either the system would need to enforce some alternative anti-discrimination provision (which would likely involve materially higher policing costs) or excess costs would end up being imposed on smaller issuers, undermining their competitive efficacy.

This would not only undermine price competition in issuing but would reduce non-price competition as well. As discussed in Section 4.1.2, the Honour All Cards rule plays an important role in facilitating greater customising of Visa products, and hence a greater variety of Visa card products for consumers to choose from. One aspect of this is that it makes it easier for innovative issuers to market their product, as card-holders are assured of widespread acceptance.

As well as promoting competition in issuing, the rule also makes for greater competition in the acquiring function. In particular, under the terms of the rule, acquirers cannot gain a competitive advantage by providing exclusive access to cards that are especially widely held. Rather, all acquirers by necessity are able to provide, and do provide, access to all cards. In contrast, were the rule abolished, and absent low-cost alternatives to the rule being devised, there would be scope for acquirers to directly or indirectly develop close links to particular types of cards or to particular issuers. This could directly undermine competition in the acquiring function.

Additionally, in a world in which entering into an acquisition agreement did not provide access to all cards, merchants would potentially face higher costs both in identifying alternative sources of supply and in switching among them. While it is arguable that in practice, the growth of especially large acquirers would lead to scale and scope economies in acquisition being realized nonetheless, this would likely involve a substantial reduction in competition in the acquiring function.

These benefits of the current rule are important in general terms and are especially important in Australia, where the banking system is relatively concentrated and where

there is a close relationship between the type of financial institution involved in issuing and the type of cards that institution issues.

This is because the smaller financial institutions, including credit unions, are the biggest issuers of the Visa products that are relatively less popular among merchants. This has been the case since the Visa debit card product was first introduced into Australia. Bendigo Bank, then a building society, and credit unions issued the first Australian Visa debit cards in 1982. In December 1983, the predecessor body of CUSCAL (the credit union industry association) became a principal member of the Visa International Card network. Credit unions in New South Wales, Queensland, Victoria, South Australia, Western Australia and the ACT gained access to a dual Redicard-Visa network. By 2001, Australia's credit unions, building societies, St George Bank, and Bendigo Bank had issued a substantial number of Visa debit cards.

This association between the smaller financial institutions and Visa debit arose because the smaller financial institutions faced many competitive and regulatory obstacles in the 1970s and 1980s that prevented them from issuing credit cards. Many were not allowed to participate in the Bankcard scheme that began in 1976.

Also, among the smaller financial institutions, including credit unions and building societies, a higher proportion of customers typically do not want a credit card or do not qualify for credit cards. This situation persists to this day and will be a continuing factor accounting for the disproportionate involvement of the smaller financial institutions in the issuing of the Visa debit card product.

Given these circumstances, the Visa debit card was a perfect opportunity for the smaller financial institutions to:

- overcome barriers to their participation in the payments system; and
- provide their members and customers with an efficient payment card without the reliance on a credit facility.

It is no exaggeration to say that one reason the smaller financial institutions such as credit unions and building societies have been able to compete more effectively with the larger banks is because of the opportunity to issue Visa debit cards.

Although the retail banking market has changed considerably since the 1980s, the importance of Visa Debit as a means for smaller financial institutions to better serve their customer base and therefore compete effectively with major banks remains. In fact, as technology has delivered new access channels for merchants such as the Internet, the value of the Visa debit product has grown for its issuers.

In light of these considerations, caution is required when considering the overhaul of arrangements such as the Honour All Cards rule, which facilitate the ability of the smaller financial institutions to continue offering Visa debit cards. This is because these small issuer institutions have limited access to capital markets and are especially vulnerable to any sudden declines in revenue that may come from a shrinkage of Visa debit card use, if, for instance, the Honour All Cards rule were abolished.

It is therefore not surprising that in a letter to the RBA on this issue, the Credit Union Services Corporation, St George Bank, Bendigo Bank and the Australian Association of Permanent Building Societies warned that[7]:

> Smaller financial institutions … are especially vulnerable to the sudden impacts that may result from piecemeal regulatory intervention. An outcome that disadvantages smaller financial institutions or which causes them to exit the business, thereby reducing competition in the marketplace, would be a hollow victory for consumers and negotiators.

5 The relevance of overseas precedents

The RBA has suggested that the recent Wal-Mart case in the US supports a line of reasoning that the Honour All Cards rule implemented by Visa Australia is a form of tying and may be anti-competitive. In this section, we explain why the Wal-Mart case sets no example or precedent of relevance to the Australian payments system. Section 5.1 summarises the development of the Wal-Mart case in the US and its findings. Section 5.2 presents reasons for the inapplicability of Wal-Mart to Australia. Section 5.3 discusses a more relevant regulatory development in Europe that supports the view that the Honour All Cards rule is not anti-competitive.

5.1 History and description of the Wal-Mart litigation and judgements

In October 1996, several prominent merchants and merchant trade associations led by the world's largest retailer, Wal-Mart, filed a lawsuit against Visa USA and MasterCard International alleging that the card associations' Honour All Cards rule violated federal antitrust laws by illegally 'tying' the acceptance of branded debit cards to branded credit cards. A tying arrangement, defined in the US as 'an agreement by a party to sell one product but only on the condition that the buyer also purchase a different (or tied) product'[8], is per se illegal under section 1 of the Sherman Antitrust Act in the US.[9]

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[7] Letter to the Governor of the RBA, 17 August 2001.

[8] Yentsch v. Texaco, Inc., 630 F.2d 46, 56 (2d Cir. 1980).

The plaintiffs sought a court order that would prohibit Visa from enforcing its Honour All Cards rule. This court order would, in effect, permit participating Visa merchants to refuse to accept particular Visa cards. The plaintiff merchants also sought damages.

In terms of harm alleged to arise from this practice, the plaintiffs have claimed that the Honour All Cards rule forces retailers to pay 'supra-competitive, exorbitant and fixed prices' for acceptance of payment cards that they otherwise would not want to accept, and raises the prices paid by all of their retail customers. It was also alleged that the Honour All Cards rule limits retailers' ability to accept and receive the forms of payment that they deem cost effective and efficient for themselves and their customers.

The most recent judgement delivered on the Wal-Mart case was by Justice Gleeson of the US District Court on 1 April 2003[10]. He made the following findings:

- As a matter of law, to show that the Honour All Cards rule is illegal under the per se test in the US, four elements must be established: (1) that the tying arrangement affects a substantial amount of interstate commerce; (2) the two products tied are distinct; (3) the defendant actually tied the sale of the two products; and (4) the seller has appreciable market power in the tying market.
- With respect to the first and third elements, it was beyond dispute that the tying arrangement affected a substantial amount of interstate commerce and that Visa actually tied the sale of two products (in this case, Visa debit and Visa credit).
- There is no need to show 'foreclosure' or 'anticompetitive effect' in the tied product market (in this case, the tied market was found to be the market for debit card services).
- The second element of the test — that the two products tied (debit and credit card services) are distinct is also satisfied because merchant demand for credit card services is distinct from merchant demand for debit card services.
- In judging whether the second element of the test is satisfied, what is at issue is not whether it was more efficient to offer debit card services and credit card services together, but whether the nature of the demand is such that those services could be offered separately. This is another way of saying that according to US law as interpreted in the Wal-Mart case, showing that there was some sort of transactional efficiency from tying the two products is insufficient to exonerate the behaviour.
- The fourth element of the test was satisfied in the case of Visa but not MasterCard. That is, Justice Gleeson found that Visa possessed appreciable economic power in the

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[9] Allegations under other provisions were also made but the section 1 allegation is the one that is central to our discussions of matters with the RBA.

[10] In Re Visa Check/Mastermoney Antitrust Litigation, April 1 2003.

tying product market (defined as the market for provision of general purpose credit and charge card services). Justice Gleeson found that Visa had appreciable market power because merchants have not switched to other payment devices despite significant increases in the interchange fees on the defendants' credit cards. Justice Gleeson distinguished this fact from the fact that consumers might switch if faced with surcharges since the relevant elasticity of demand in this case is merchants' demand. He found that the fourth element was not made out for MasterCard because its market share was substantially lower.

- Most significantly, Justice Gleeson also made a caveat to his hitherto per se treatment of tying arrangements. Despite ruling for the merchant plaintiffs on several elements of the per se claim (as noted above), the judge agreed with Visa that there should be a determination of whether competition had been harmed and whether consumers benefit from the Honour All Cards rule. The basis of his ruling was his acknowledgement that per se analysis had generally fallen into disfavour in antitrust analysis and his interpretation of the Jefferson Parish case[11] as authority that there must be a substantial potential for impact on competition in order to justify per se condemnation (this is significant for reasons we will discuss in the next subsection). Though Justice Gleeson was 'not convinced' that the threshold for per se analysis as prescribed by Jefferson Parish required consideration of actual anti-competitive effects, he thought it appropriate that there should at least be a 'significant probability' of anti-competitive effect in the tying market. Nonetheless, he noted that it was unclear whether the per se standard should be invoked at 'this stage' of the case.

On these bases, Justice Gleeson dismissed the merchants' motion for summary judgement on the basis of per se claims relating to section 1 of the Sherman Antitrust Act because he thought that these factual matters should be further developed in a later trial. Specifically, he ruled that:[12]

> … the merchants' motion for summary judgment on their per se claims is denied. A trial will be held on, among other issues, those that lie at the heart of the merchants' Section 1 claims: whether Visa and MasterCard's Honour All Cards rules harmed competition in the debit card services market, and whether the defendants acted together to produce that result.

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[11] Jefferson Parish Hospital District No. 2 v Hyde 466 US 2, 19 (1984).

[12] Re Visa Check/Mastermoney Antitrust Litigation, April 1 2003, Order on motions for summary judgement, US District Court , p. 10 of online PDF version.

5.2 Implications of the Wal-Mart case for the Australian payments system

Even if the Australian and US markets are considered to be structurally similar, and Visa does not concede that they are, Visa believes it is a mistake to apply the findings of Justice Gleeson in the Wal-Mart case regarding the Honour All Cards rule, as practiced by Visa in the US, to support an interpretation that the Honour All Cards rule is an anti-competitive tying arrangement.

Any such contention draws on Justice Gleeson's ruling for the plaintiffs in the Wal-Mart case that the plaintiffs had, at least in the case of Visa, satisfied all four elements of the per se test for tying because:

- the Honour All Cards rule affects a substantial amount of interstate commerce;
- the two products of Visa debit and Visa credit bundled by the Honour All Cards rule are distinct;
- Visa actually tied the sale of the two products in enforcing the Honour All Cards rule; and
- Visa has 'appreciable' market power in the tying market (i.e. the market for general purpose credit cards).

Setting aside the issue of whether Visa regards these four contentions as correct, we explore the implication of these findings for an evaluation of the legality of the Honour All Cards rule in Australia. In short, the trial judge's findings are of little relevance to Australia for two key reasons.

First, the treatment of tying under Australian law is very different from its treatment under US law. Under US law, tying agreements are prohibited **regardless of their actual competitive effects on the relevant market** as long as the firm engaged in the tying has market power. By contrast, under Australian law, tying is not considered anti-competitive simply because the firm engaged in tying has any particular degree of market power. Australian law has always adopted what is in effect a 'rule of reason' approach to tying – that is, tying or full line forcing, like other forms of exclusive dealing (with the exception of third line forcing), is not prohibited unless it is motivated by an anti-competitive purpose or leads to a substantial lessening of competition in relevant markets (see Box 2).

Box 2 Australian Trade Practices Act provisions relating to tying

Section 47(2)(d) of the Australian TPA which covers tying agreements states that:

> A corporation engages in the practice of exclusive dealing if the corporation:
>
> (a) supplies or offers to supply, goods or services at a particular price; or
>
> (b) supplies, or offers to supply goods or services at a particular price; or
>
> (c) gives or allows or offers to give or allow, a discount, allowance, rebate or credit in relation to the supply or proposed supply of goods or services by the corporation;
>
> on the condition that the person to whom the corporation supplies, or offers or proposes to supply, the goods or services or, if that person is a body corporate, a body corporate related to that body corporate;
>
> (d) will not, or will not except to a limited extent, acquire goods or services, or goods or services of a particular kind of description, directly or indirectly from a competitor of the corporation or from a competitor of a body corporate related to the corporation.

Tying as a form of exclusive dealing is not prohibited unless, according to section 47(10) of the TPA:

> the engaging by the corporation in that conduct has the purpose, or has or is likely to have the effect, of substantially lessening competition or;
>
> the engaging by the corporation in that conduct, and the engaging by the corporation, or by a body corporate related to the corporation, in other conduct of the same or a similar kind, together have or are likely to have the effect of substantially lessening competition.

Second, in the US the per se treatment under Section 1 of the Sherman Antitrust Act is highly controversial. Indeed, that treatment has not only been criticised by virtually all the leading academic commentators, but has also been repeatedly questioned by the Courts[13].

In the Wal-Mart case, the trial judge seemed to imply that in theory a per se case might be made under section 1 of the Sherman Antitrust Act, however as a matter of good public policy a ‘rule of reason’ approach should be applied to take account of competitive effects. That is, while the trial judge thought a per se case of illegal tying could be made out if a per se treatment under section 1 of the Sherman Antitrust Act was applicable, he was equivocal about whether such treatment was indeed justified. As documented in Section 4.1, the trial judge held that per se treatment might be appropriate where (emphasis added):[14]

> … a defendant with sufficient economic power in one product market uses that power to force downstream consumers to accept another product on the defendant’s own

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[13] See Appendix A for a review of recent thinking on this.

[14] Re Visa Check/Mastermoney Antitrust Litigation, April 1 2003, Order on motions for summary judgement, US District Court, p. 8 of online PDF version.

> economic terms and where this arrangement **has a significant probability of anticompetitive effect on competition in the tied product market**.

The trial judge went on to say that at the 'heart' of the merchants' section 1 claims is (emphasis added):

> … whether Visa and MasterCard's Honour All Cards rules harmed competition in the debit card services market, and whether the defendants acted together to produce that result.
>
> … **it is not clear to me** whether the Second Circuit's per se standard in fact requires proof of a fifth element, i.e., foreclosure of competition or anticompetitive effect in the tied product market.

The trial judge also noted that per se analysis had fallen into 'disfavour' in antitrust jurisprudence.

The Wal-Mart case is not the only case where a tension has arisen between consideration of US law as it applies to tying in its present form and good public policy. A similar tension arose in the influential *Jefferson Parish* case[15] cited by Trial Judge Gleeson in the Visa Wal-Mart case. The Jefferson Parish case also deals with a tying arrangement and contained a significant opinion by Justice O'Connor who came out even more strongly in favour of 'rule of reason' treatment of tying arrangements than Judge Gleeson.

The Jefferson Parish case involved a hospital that tied its anaesthesiology services with its surgery. Any patient planning to undergo surgery at the East Jefferson Hospital had to use the anaesthesiologists on the hospital staff. The majority of the court in that case concluded that the conduct did not involve an illegal tying arrangement under the per se test of section 1 because the hospital lacked market power within its geographic market. However, one significant aspect of this case is the opinion by Justice O'Connor who was concerned about the appropriateness of per se treatment and advocated a full rule of reason treatment of tying arrangements. The majority of her colleagues also expressed concern about the appropriateness of per se treatment and stated that per se treatment was only justified subject to some threshold probability that there would be anti-competitive effects.

Justice O'Connor outlined many cogent criticisms of the per se treatment of tying arrangements. She began by noting that while treatment of tying arrangements was nominally supposed to be per se, it has in practice involved some initial attempt at assessing, even if at a very general level, the competitive effects of the arrangements.

> Some of our earlier cases did indeed declare that tying arrangements serve "hardly any purpose beyond the suppression of competition." Standard Oil Co. of California v. United States, 337 U.S. 293, 305-306 (1949) (dictum). However, this declaration was

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15 Jefferson Parish Hospital District No. 2 v Hyde 466 US 2, 19 (1984).

> not taken literally even by the cases that purported to rely upon it. In practice, a tie has been illegal only if the seller is shown to have "sufficient economic power with respect to the tying product to appreciably restrain free competition in the market for the tied product …" Northern Pacific R. Co., 356 U.S., at 6. Without "control or dominance over the tying product," the seller could not use the tying product as "an effectual weapon to pressure buyers into taking the tied item," so that any restraint of trade would be "insignificant." Ibid. The Court has never been willing to say of tying arrangements, as it has of price fixing, division of markets, and other agreements subject to per se analysis, that they are always illegal, without proof of market power or anticompetitive effect.

Therefore the dilemma was created in US antitrust law that:

> The "per se" doctrine in tying cases has thus always required an elaborate inquiry into the economic effects of the tying arrangement. As a result, tying doctrine incurs the costs of a rule-of-reason approach without achieving its benefits: the doctrine calls for the extensive and time-consuming economic analysis characteristic of the rule of reason, but then may be interpreted to prohibit arrangements that economic analysis would show to be beneficial. Moreover, the per se label in the tying context has generated more confusion [466 U.S. 2, 35] than coherent law because it appears to invite lower courts to omit the analysis of economic circumstances of the tie that has always been a necessary element of tying analysis.
>
> The time has therefore come to abandon the "per se" label and refocus the inquiry on the adverse economic effects, and the potential economic benefits, that the tie may have. The law of tie-ins will thus be brought into accord with the law applicable to all other allegedly anticompetitive economic arrangements …

Justice O'Connor concluded that:

> These three conditions — market power in the tying product, a substantial threat of market power in the tied product, and a coherent economic basis for treating the products as distinct — are only threshold requirements. Under the rule of reason a tie-in may prove acceptable even when all three are met. Tie-ins may entail economic benefits as well as economic harms, and if the threshold requirements are met these benefits should enter the rule-of-reason balance.
>
> The ultimate decision whether a tie-in is illegal under the antitrust laws should depend upon the demonstrated economic effects of the challenged agreement.

It is also worth noting that according to the majority opinion in *Jefferson Parish*:[16]

> … the Sherman Act does not prohibit "tying", it prohibits 'contracts … in restraint of trade." Thus in a sense the question whether this case involves "tying" is beside the

[16] Footnote 34 of the majority judgement.

> point. The legality of petitioner's conduct depends on its competitive consequences, not whether it can be labelled "tying".

The eminent US antitrust commentator Hovenkamp[17] also comments, in line with Justice O'Connor's observations that:

> … the so-called per se rule applied to tying arrangements is idiosyncratic in two respects. One, it is unique in requiring proof of market power in the tying product, which usually entails a relevant market definition. Second, even when market power is established courts ordinarily permit the defendant various defences.

More evidence on the strong agreement among many economic and antitrust commentators on the undesirability of a per se prohibition on tying is presented in Appendix A.

The ideas suggested by Justice O'Connor's dissent are similar to the conclusions by the trial judge in the Wal-Mart case itself — namely that meeting a per se case for tying is ideally suggestive but should not be decisive of the issue of whether regulatory intervention is warranted. The implication here is that even if at one time, there may have been strong judicial support for per se treatment of tying, this perspective is losing ground and if anything, the US now seems to be moving towards a more 'rule of reason' approach which involves assessment of competitive effects and other public benefits of the practice.

It would therefore be inappropriate to put too much weight on the satisfaction of a per se test by Visa's Honour All Cards rule in the Wal-Mart case. There is strong dissent in US antitrust jurisprudence regarding the extent to which tying in the presence of market power is a necessary, let alone a sufficient, condition to establish that a tying arrangement is anticompetitive. [18]

5.3 The European Commission's inquiry into Visa's card scheme regulations

Since 1992 the European Commission (EC) has conducted inquiries into various aspects of Visa's conduct, including the no surcharge rule (known as the no-discrimination rule in

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[17] S 10.7a of Hovenkamp, H. 1999, *Federal antitrust policy: The law of competition and its practice,* 2nd edition.

[18] More recent antitrust literature also supports these contentions. See, for instance, Hylton, K. and M. Salinger 2001, 'Tying law and policy: A decision theoretic approach', Boston University School of Law, Working Paper Series, Law and Economics, Working Paper No. 01-04 which concludes that, 'the per se rule against tying simply has no economic foundation … Because beneficial tying is so pervasive, rules against tying could be harmful even with a small rate of "false convictions".'. This paper is discussed in greater detail in Appendix A.

Europe), territorial licensing, rules on cross border issuing, the rule on no acquiring without issuing, and the Honour All Cards rule. After extensive investigations and consultations, the EC released on 9 August 2001 its findings on these various card scheme rules[19].

The EC made many findings concerning the competitive and efficiency effects of the Honour All Cards rule. In relation to at least what the RBA calls the 'honour all banks' dimension of the rule, the Commission found that it agreed with Visa that (emphasis added):

> … the honour all cards rule promotes the development of its payment systems since it ensures the universal acceptance of the cards, irrespective of the identity of the issuing bank. **The Visa payment system could not properly function if a merchant or an acquiring bank were able to refuse, for example, cards issued by a bank established abroad (or, for that matter cards issued by other domestic banks).** The development of a payment system depends on issuers being able to be sure that their cards will be accepted by merchants contracted to other acquirers. Without such assurance, a brand or logo on a payment card loses most of its meaning and utility, especially where an international card is concerned, and cards are often relied upon by travellers for foreign payments …
>
> Leaving it up to an individual merchant whether to accept or not a particular Visa card, solely on the basis of the merchant fee which it is charged by its bank, would seriously endanger the universal acceptance of Visa international payment cards. Cardholders would not know in advance whether their Visa card would actually be accepted. It has also to be taken into account that the type of Visa card issued may vary from issuer to issuer and in particular from one country to another. Clearly, if it were left to merchants whether or not to accept a particular Visa card, solely on the basis of the merchant fee they may have to pay, this would endanger the international function of the card.

The EC also found that what the RBA refers to as the 'honour all products' dimension of the Honour All Cards rule imposed no harm to competition:[20]

> The fact that under the honour all cards rule, merchants are obliged to accept all valid cards with a certain brand, regardless of the type of card and regardless of the merchant fee, cannot be said to be restrictive of competition.

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[19] Commission decision of 9 August 2001 relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA Agreement (Case No. COMP/29.373 – Visa International)

[20] Commission decision of 9 August 2001 relating to a proceeding under Article 81 of the EC Treaty and Article 53 of the EEA Agreement (Case No. COMP/29.373 – Visa International) at para. 68.

It is also worth noting that the Commission made other findings which seemed to contradict the conclusions reached in the Wal-Mart case about whether the Honour All Cards rule would satisfy a per se tying test. The Commission did not rule out the possibility that the Visa products bundled together were really not distinct products at all but might be related:

> The fact that the fees that acquiring banks may charge to merchants may be different does not demonstrate that different types of Visa cards are unrelated products.

The EC investigation of the Honour All Cards rule, conducted as it was as a competition assessment, is more consistent with the 'promotion of efficiency and competition' test that the RBA is seeking to apply to this issue than the US per se test. The findings of the EC therefore serve as a more solid precedent than the findings of the Wal-Mart case.

A Antitrust literature on vertical restraints and tying

There is substantial agreement among noted antitrust and economic commentators on the undesirability of per se prohibitions on tying in particular and even vertical restrictions in general (of which tying is one category). For instance, in a notable 1984 article Judge Easterbrook argued that the main purpose of vertical restraints is to improve efficiency and therefore they should pose no *a priori* antitrust concerns[21].

More recently, Hylton and Salinger[22] concluded that:

> 'the per se rule against tying simply has no economic foundation … Because beneficial tying is so pervasive, rules against tying could be harmful even with a small rate of 'false convictions'."

Their conclusion is based on a rigorous decision theory analysis of tying rules. Because they survey and provide insights and criticisms of other schools, their article is worth reviewing in some detail. Key points made by the authors are:

- There are essentially three possible ways of treating tying arrangements. One is through a per se illegality rule. The second is a rule-of-reason test that weighs the social costs and benefits of tying in a particular case. The third is a per se legality rule.
- The best legal rule is the one that minimises the overall expected costs of error. The expected cost of a particular type of error, for instance, the cost of a false acquittal, is the product of the false acquittal rate and the cost of a false acquittal.
- The implication of this is that a per se legality rule becomes more desirable, the more the expected cost of a false conviction increases relative to that of a false acquittal, which in turn becomes more likely as either the probability or the cost of a false conviction increases.
- For false conviction costs to be large relative to false acquittal costs (or symmetrically, for false acquittal costs to be small relative to false convictions) the following conditions should be met: there are (1) market constraints on the firm's conduct, (2) strategies other than tying that the firm could use to gain the same advantage in the market, or (3) no clear incentive to use tying in order to harm consumers.
- Arguably, tying seems to meet many of these conditions. Hylton and Salinger argue that: "There are plenty of instances of tying in which one cannot reasonably argue that the seller's only plausible objective is to restrict competition. Goods are often sold

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[21] Easterbrook, F. 1984, 'Vertical arrangements and the rule of reason', *Antitrust Law Journal* 53: 135-74.

[22] Hylton, K. and M. Salinger 2001, 'Tying law and policy: A decision theoretic approach', Boston University School of Law, Working Paper Series, Law and Economics, Working Paper No. 01-04

together in competitive markets when the joint selling either saves cost or provides convenience. Indeed, even a monopolist has an incentive to cut costs and provide convenience.”

- They note that the ‘Chicago school’ literature has shown that the likelihood of anti-competitive harm is extremely small when the market for the tied good is competitive, so that the only substantial area of scrutiny needed when examining tying arrangements is when the market for the tied good is susceptible to monopolisation. However, even here, if the savings that result from bundling are sufficiently large, they may so far outweigh any losses due to competitive barriers that all consumers are better off under the tie-in.
- They argue, however, that both the Chicago school approach and the traditional ‘inhospitability’ approach of prohibiting tying arrangements involve unrealistic assumptions. Whereas the ‘inhospitability’ approach assumes that expected false conviction costs are essentially zero, the Chicago school approach seems to assume that false acquittals costs are zero.
- Surveying more recent economically sophisticated ‘post Chicago’ models, Hylton and Salinger find that even the post-Chicago literature can find at best arguments for a rule-of-reason approach, assuming that the following necessary conditions can be met: (1) the tie-in involves separate products, (2) there is market power in the tying good market, (3) there is substantial foreclosure in the tied good market, and (4) there are entry barriers in the tied good market.
- They argue that in light of the frequency with which beneficial tying probably occurs, such a rule-of-reason approach should put a high burden of proof on the plaintiff.

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