

**Response to Discussion Paper by
EFTPOS Industry Working Group**



Australian Institute of Petroleum

12 September 2002

Contents

- 1. Executive Summary..... 3
- 2. Introduction 6
 - 2.1 Background..... 6
 - 2.2 Objectives 6
- 3. The Oil Industry’s Role in EFTPOS 7
 - 3.1 Card Processing Infrastructure and Costs..... 9
- 4. The Australian EFTPOS System 11
 - 4.1 Costs..... 15
 - 4.2 Efficiency..... 18
- 5. Process & Timeframes 20
- 6. Scope of Review 21
 - 6.1 EFTPOS and Scheme Debit Cards 21
 - 6.2 Other Card Reviews in Australia 22
- 7. Overseas Schemes 23
 - 7.1 Canada 23
 - 7.2 United Kingdom..... 24
 - 7.3 South Africa 26
 - 7.4 Germany 28
 - 7.5 New Zealand..... 29
 - 7.6 USA 30
 - 7.7 Lessons From Overseas 31
- 8. Interchange 33
 - 8.1 Impact of Changes to Interchange 37
 - 8.2 Response to Working Group’s Options 37
 - 8.2.1 Perceived Problems with EFTPOS Interchange Arrangements..... 38
 - 8.2.2 Option 1 – Bilateral Interchange Arrangements..... 39
 - 8.2.3 Option 2 – Multilateral Interchange Fees..... 40
 - 8.2.4 Option 3 – No Interchange Fees 41
 - 8.2.5 Multilateral Pricing Methodologies 41
- 9. Access..... 43
- 10. Recommendations 45
- 11. Appendix 1 Letter re Timeframes and Process..... 46

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1. Executive Summary

The oil industry has been an integral part of EFTPOS since its inception and has been crucial to its on-going success. The oil companies have made a considerable investment in EFTPOS infrastructure; they are major stakeholders in the EFTPOS system and must be part of any decision making process on its future. At the service stations of the four major oil companies involved in this submission, almost 300 million total card transactions worth some \$11 billion dollars were made in 2001. 16% of all EFTPOS transactions in Australia were conducted at these service stations.

The Review Process

It is essential that any review of EFTPOS must be balanced, transparent and objective. The AIP does not believe these criteria are currently being met. The current structure allows an unrepresentative sub-group to control this review and make the final recommendations to the Reserve Bank. The Working Group should be reconstituted to be fully representative of the major stakeholders, including the oil companies.

The EFTPOS Industry Working Group must outline a timetable for reform and a process for industry consultation.

The scope of the review should be expanded to cover all debit cards. There is a trend emerging around the world where scheme based debit cards are replacing proprietary debit card systems, invariably with higher costs and usually with an ad valorem interchange fee. It is possible that the local EFTPOS cards could be switched to "scheme" cards in the future, thereby rendering impotent any outcomes of this review if it is restricted to only the local EFTPOS system.

The Australian EFTPOS System

The current system is world class with all transactions being PIN authorised and with on-line checking of the account balance. Mr Manuel Rio, an international expert on payment systems, has said: **"It [the Australian EFTPOS system] is considered to be the best in the world in terms of quality, convenience, safety, technological advancements, overall cost, reliability, processing speeds and increased efficiency."**

The RBA/ACCC study has shown that debit cards are the lowest cost card payment instruments in Australia. This is supported by data from the Australian Retailers Association which shows debit cards are the lowest cost method of payment at retail outlets and are cheaper than credit and charge cards, cheques and cash.

The current interchange arrangements have been central to the success of Australia's EFTPOS system. They have provided incentive for acquirers and merchants to invest in infrastructure. This has allowed Australia to have the highest penetration of points of access to banking services and highest penetration of EFTPOS machines of the 12 major countries studied by the Bank for International Settlements (BIS). In fact, the countries with the highest penetration of EFTPOS terminals (Australia) and highest EFTPOS usage per head of population (New Zealand) both have negative interchange - **this is not a coincidence.**

The BIS, which is comprised of the major central banks around the world, including the RBA, defines interchange as a “transaction fee set by the network organisation and paid by the card issuing institution to the acquiring institution for the cost of deploying and maintaining ATMs and EFTPOS terminals.” **In other words, the international banking body responsible for payments and settlements supports negative interchange for EFTPOS.**

There are a number of examples around the world where issuers make payments to acquirers in recognition of the investment made in providing the acquiring infrastructure. It should also be noted that when debit cards are used at an ATM, interchange fees flow from the issuer to the acquirer, not just in Australia but all around the world. There seems to be no logical reason why the flow should differ when the same card is used for EFTPOS transactions. This view on the direction of interchange fees for both EFTPOS and ATMs is supported by the Bank for International Settlements.

The current arrangements allow merchants to receive income from acquirers in exchange for investment in payments system infrastructure the banks would otherwise have to provide themselves.

The current interchange ensures “sustainability” of EFTPOS services over the long term and provides a justification for acquirers and merchants to continue to invest in new technology needed to maintain and upgrade the network. This is one of the key objectives of the EFTPOS Industry Working Group. Should the current interchange arrangements change, it puts future major investment by the oil companies and other major retailers at risk.

The primary objectives of the banks when they initiated EFTPOS in Australia was to move customers from transacting at branches to using lower cost electronic transactions. This “branch replacement strategy” has been highly successful and has allowed banks to make substantial savings through large scale branch closures, reduction in over-the-counter transactions and reduction in paper processing and cheques. Any analysis of EFTPOS costs must take account of these savings that have accrued to the banks.

An important element of the current bilateral interchange fee arrangement is that it allows for fees to be set as the result of normal competitive processes. The current interchange flow also adheres to the commercially sensible “user pays” principle.

There is simply no evidence that there are any problems with the current EFTPOS interchange arrangements. In fact, to the contrary, there is much evidence that the system is a world leader and is the most efficient retail payment system in Australia. It would make no sense at all to make any significant changes and risk the benefits which are being shared by all Australians.

Avenues for Key Efficiency Gains

Access to the EFTPOS system is also an important issue. As with credit cards, it is important for the efficiency of the Australian payments system to allow open access and to encourage new entrants in both acquiring and issuing, subject to prudential requirements being satisfied. Such open access will increase competition and will drive costs down.

Similarly, the introduction of standard EFTPOS software and interfaces would help remove barriers to entry, as has happened in Canada.

Key Recommendations

- extend the timeframe of the EFTPOS review to allow proper consideration of all issues and the impact of any changes
 - reconstitute the Working Group to make it representative of all stakeholders
 - expand the scope of the review to cover all debit cards, including international “scheme” debit cards, and broaden the focus beyond interchange
 - ensure all parties, including members of the EFTPOS Industry Working Group, make submissions and that time is given for analysis and response to these submissions
 - ensure the relativity to other reviews (credit, Visa debit, ATMs) is covered
- do not change the existing EFTPOS interchange arrangements as they have been instrumental in providing Australia with a world class system and delivering long term sustainability of the EFTPOS network.

2. Introduction

2.1 Background

The Australian Institute of Petroleum (AIP) is the key representative body of Australia's petroleum industry. The AIP's mission is to promote and assist in the development of a strong internationally competitive Australian petroleum products industry, operating efficiently, economically and safely, and in harmony with the environment and community standards.

The AIP's members comprise companies engaged in the refining, marketing and/or distribution of petroleum products. This submission is made on behalf of the following member companies:

- BP Australia Pty Ltd
- Caltex Australia Petroleum Pty Ltd
- Mobil Oil Australia Pty Ltd
- The Shell Company of Australia Limited

The current investigation into EFTPOS is of significant interest to the oil industry. The oil industry is a key stakeholder in the card payment system in Australia and this role is discussed in detail later in this document.

It is important to understand the relative roles of the oil companies and the service station operators. While each of the company's operations will differ, in general terms the oil companies negotiate an acquiring agreement with a bank acquirer for EFTPOS (and for credit cards). However, in the majority of cases each site operator or franchisee is a separate merchant with their own merchant agreement. Settlement funds for card transactions are reimbursed directly to the site operators' accounts and any merchant fees are charged directly to the site operators.

The oil company plays a role in negotiating terms and conditions and merchant service fees and providing a card processing network and infrastructure. The oil companies are responsible for the development of card payment terminals and for the testing, certification and maintenance of these systems.

The networks operated by these four companies have more than 6,000 service stations across all parts of Australia. It should be noted that this exceeds the total number of bank branches.

2.2 Objectives

The key objectives of this submission are:

- to demonstrate the current EFTPOS system is working well and is world class
- to respond to the issues outlined in the EFTPOS Industry Working Group's paper
- to demonstrate that the oil companies are major stakeholders in the EFTPOS system and must be part of any decision making process
- to argue that any review of EFTPOS must be open and transparent
- to make recommendations on the best way forward

3. The Oil Industry's Role in EFTPOS

The oil industry is a major player in the Australian card payments system. The major oil companies issue and acquire their own fuel cards, accept and process cards issued by banks, T&E companies and other third party issuers and have developed and implemented their own card payment infrastructure.

The oil industry has played a vital role in the development, acceptance and usage of EFTPOS in the Australian market. The first introduction of EFTPOS in Australia occurred in 1984 at an Ampol service station in Melbourne with the National Australia Bank (NAB). This was quickly followed by the acceptance of Westpac cards at selected BP service stations, Commonwealth Bank (CBA) cards at Mobil outlets, and other banks' cards at Shell, Caltex, and Amoco service stations. At this early stage there was no interchange for debit and each card terminal could only process debit cards issued by the provider of that terminal, e.g. Westpac terminals at BP outlets could accept only Westpac cards, and so on.

It soon became clear, following pressure from the oil companies and other retailers, that EFTPOS would not gain widespread acceptance until all major cards could be processed through a single card terminal. The oil companies and retailers did not want to restrict usage of this new payment method to customers of any one bank; nor did they want four or more card terminals at the Point of Sale (POS). As a result, interchange was introduced for EFTPOS in 1985.

It should be noted that while EFTPOS interchange was achieved in 1985, just one year after being launched, full ATM interchange was not achieved until 1997 despite the fact that ATMs preceded EFTPOS. The earlier adoption of EFTPOS interchange was due purely to the impact of the oil companies and retailers and underlines their importance in the spread of EFTPOS and its contribution to a more efficient payments system. As the EFTPOS Industry Working Group itself states: "Usage of EFTPOS in Australia initially was moderate but was spurred by acceptance at petrol retailers."¹

Oil companies, along with supermarkets, were also instrumental in the widespread acceptance of cash out, thereby further moving customers from branch transactions to electronic banking. As the report on Australia by the Bank for International Settlements (BIS) says, "Many EFTPOS points offer a cash-back facility to cardholders making purchases. Terminals operate whenever the merchant is open; for some merchants, such as petrol stations, this is 24 hours a day, seven days a week."²

The oil companies have played a key role in taking banking systems to the customers, replacing the traditional model of making customers go to bank branches for their point of access. This argument applies equally to EFTPOS and ATM access. This move has made payment systems considerably more convenient for customers. Not only do they not have to carry as much cash, they can now pay by card and/or obtain cash at a far wider range of locations at times convenient to the customer. If wanting to withdraw cash at night, customers can now do so in the safety of a well lit retail outlet such as a petrol station or convenience store (using either cash out or an ATM) rather than on a street outside a bank branch.

¹ "Discussion Paper: Options for EFTPOS Interchange Fee Reform", EFTPOS Industry Working Group, July 2002, Page 2.

² "Payment Systems In Australia", prepared by The Reserve Bank of Australia & The Committee on Payment and Settlement Systems, Bank for International Settlements, June 1999.

This increase in alternative banking formats for customers, including the provision of EFTPOS services by oil companies, has enabled banks to reduce their branch network and has also reduced their operating costs significantly. This issue is discussed in more detail in Section 4.1.

In fact, the oil industry has been at the forefront of EFTPOS developments in Australia since its inception and has been responsible for a number of innovations. Some of these include:

- the first EFTPOS transactions were at a service station, as discussed earlier.
- the oil companies, along with Coles Myer, were the first non-financial institutions to install their own front end processors and switches. This is something a number of the EFTPOS issuers still have not done.
- in-pump card readers were the first widespread deployment of unattended EFTPOS in Australia. The cost of the development and deployment of this technology was funded by the oil companies themselves.
- the oil industry was among the first adopters of multiple acquirer technology

In addition, the fuel cards issued by these companies are also considered to be world leaders. These fuel card systems have a level of sophistication the banks have been unable to achieve with cards they issue themselves. The functionality provided by these cards includes on-line PIN based authorisation, on-line fraud prevention functionality (such as validation of odometer readings, limits and controls, velocity checking and exception reporting) and detailed data collection including customer specific data. Many of the limits and controls can be implemented at either a card or a customer level. The point is, the oil companies are sophisticated in card issuing, processing and acquiring and continue to make a significant contribution to the card payment system in Australia.

The importance of the oil industry's role in card payments is demonstrated by the usage at service stations. In 2001, at the service stations of the four major oil companies:

- **there were almost 300 million card transactions worth some \$11 billion dollars**
- this equates to card spend of \$1.6 million per service station per annum of which \$470,000 per station is on debit cards
- debit cards account for more than half of transactions on bank issued cards at service stations and more than one third of all card transactions (see graph below)
- there were more than 100 million EFTPOS transactions worth in excess of \$3 billion at these stations.
- **In 2001, 16% of all EFTPOS transactions in Australia were conducted at these service stations.**

The Oil Industry is a key stakeholder in the Australian card payment system and in EFTPOS in particular.

The oil industry has made a considerable investment in developing, implementing and maintaining a secure on-line PIN based card processing system which continues to be crucial to the on-going success of EFTPOS.

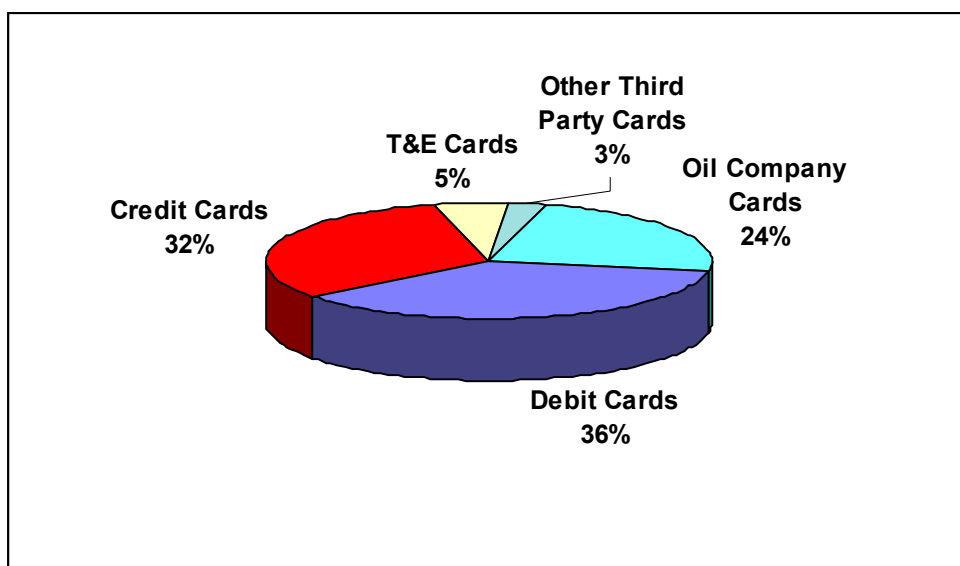


Chart 1 - Card Transactions at Australian Service Stations

3.1 Card Processing Infrastructure and Costs

The major oil companies in Australia have made a considerable investment in card processing infrastructure. This has included:

- card terminals
- secure PIN pads
- integrated point of sale systems at certain sites,
- in-pump card readers and/or driveway card acceptors at some sites
- placement of ATMs at selected convenience stores and service stations
- front-end processors / switches
- communications networks

In addition to investments in card processing hardware and software, the oil companies also incur major recurring costs in operating and maintaining card processing systems. These costs include:

- data communications
- retail support (help desk)
- equipment maintenance
- consumables

The four major oil companies have installed almost 11,000 card terminals at their sites - these are owned by and have been specifically developed for each oil company. These include indoor card terminals, in-pump card readers and kiosk paypoints, but exclude ATMs, of which there are also significant numbers. All four companies have at some stage installed and operated their own fault tolerant front end processor and switch.

The capital and associated investment by the four companies in card processing infrastructure is well in excess of \$100 million. In addition, there are significant annual costs covering maintenance, repairs, on-going development and day-to-day operating costs of more than \$10 million per annum. These are real out-of-pocket costs, which need to be recovered, and on which a return needs to be made.

The major oil companies have independently negotiated arrangements with acquirers to allow them to access and use this infrastructure. In return the acquirer, who does not have to provide this infrastructure itself, pays the relevant oil company a “network access fee” for transactions conducted at sites equipped with the oil company’s system. The income the major oil companies receive as network access fees from the acquirer is in recognition of the considerable capital investment the oil companies have made in putting a card processing infrastructure in place and the substantial on-going maintenance costs associated with this equipment.

4. The Australian EFTPOS System

EFTPOS has played a significant role in the development of Australian payment systems. As a 1998 report by the RBA says: "Growth in non-cash payments in recent years has been driven mainly by growth in EFTPOS transactions."³

Reference has been made to the fact that the Australian EFTPOS interchange system is unique in that the interchange fee flows from the issuer to the acquirer (often called "negative interchange"). The inference has often been that this somehow means Australia has "got it wrong" compared to other countries. Such an inference is unsustainable and does not take account of the particular benefits offered by the Australian EFTPOS system.

Firstly, while negative interchange is indeed unusual for debit cards at the point of sale in other parts of the world, there are other instances of bank card interchange fees flowing from issuer to acquirer.

For example, in South Africa the banks have issued debit cards specifically for use in service stations. These private motorist debit cards, called Petro Card or Garage Card, operate on the basis of negative interchange. Credit and debit cards also involve a payment by the issuer to the acquirer, although the "normal" scheme positive interchange arrangements also apply. The banks also issue fleet cards for use by businesses at service stations and these also involve a negative interchange fee. The South African situation is described in more detail in the section on Overseas Schemes.

Another example is in the Philippines where the net payment of fees for credit cards flows from the issuer to the acquirer for transactions at "service merchants" (i.e. petrol stations, supermarkets, fast food restaurants, etc.). While the base interchange arrangements for credit cards are fairly standard, these "service" merchant categories have merchant service fees (MSFs) which are below the interchange rate. This has occurred because these industries refused to accept credit cards because of the high cost.

In order to cope with these low MSFs, Visa and MasterCard have introduced an "Issuer Allocation Cost" (IAC) for these merchants and left the interchange fee unchanged. The issuer pays the acquirer a fixed fee per transaction which is greater than the interchange fee. This is effectively negative or reverse interchange. For a typical petrol purchase, the issuer pays a net fee (i.e. after deducting interchange) equivalent to around 2% to the acquirer.

New Zealand also has a negative interchange fee for debit cards of 6 cents per transaction.

The most common instance of interchange fees flowing from the issuer to the acquirer is when debit cards are used at an ATM. Debit interchange arrangements in Australia follow the same principle as used for ATM interchange, not just in Australia but in virtually all countries. **It should be remembered that an ATM card and a debit card are the same piece of plastic.** When this piece of plastic is used at an ATM the issuer pays the acquirer an interchange fee which consists of a fixed fee per transaction. **This is logical and sensible**, as shown below.

³ "Some Features of the Australian Payments System", Reserve Bank of Australia Bulletin, December 1998

The acquirer has made an investment in a processing infrastructure, including the ATM itself, in order to allow the issuer's card to be used at that ATM. The alternative would be for the issuer to install its own ATM (and therefore pay no interchange), increasing its costs dramatically and ending in a far less efficient system overall. If the same piece of plastic is used at a card terminal at a merchant's premises it is hard to see why the flow of interchange fees should be any different.

It could be interpreted that for ATMs, banks cannot gain fees from merchants, so the fees flow in the "proper" and logical direction, not only in Australia but around the world.

This view on the direction of interchange fees is supported by the Bank for International Settlements (BIS), which is comprised of the major central banks around the world, including the RBA. The BIS defines interchange thus:

interchange fee transaction fee set by the network organisation and paid by the card issuing institution to the acquiring institution for the cost of deploying and maintaining ATMs and EFTPOS terminals.⁴

In other words, the international banking body responsible for payments and settlements itself supports the view that:

- 1. the issuer pays the acquirer,**
- 2. the purpose of the interchange fee flowing in this direction is to cover the investment made in ATMs and EFTPOS terminals, and**
- 3. that there is a logical link between ATM interchange and EFTPOS interchange and the fees should flow in the same direction.**

It is understood that changes have been proposed for ATM interchange in Australia. Although no final decisions have been made, it is believed that the main change will be the introduction of a fee at the time of the cash withdrawal – referred to by the RBA as the "direct charging" model⁵.

For example, if a customer is using an ATM owned by a party other than his/her card issuer, to withdraw \$100 in cash, the customer will be told that a fee of say \$2 will apply. The customer will then be requested to confirm or cancel the transaction. When the customer receives his/her statement, \$102 will have been deducted from the account. **This in fact is only a minor variation to the current practice.**

The table below demonstrates the steps under both the current situation and the proposed scenario (for cases where the card is used at an ATM not owned by the card issuer).

⁴ A Glossary of Terms Used in Payments and Settlement Systems, Bank For International Settlements – Committee on Payment & Settlement Systems, January 2001 (revised July 2001), P.21.

⁵ RBA Payment Systems Board Annual Report, 2001 – Section on Competition and Efficiency.

Existing Scenario	Proposed Scenario
Customer enters \$100 cash withdrawal request at ATM	Customer enters \$100 cash withdrawal request at ATM
	Customer is told a fee will apply and asked to confirm for transaction to proceed
Request is authorised on-line and cash is dispensed	Request is authorised on-line and cash is dispensed
Customers account is debited for \$100 + a fee (foreign ATM fee)	Customers account is debited for \$100 + a fee (direct charging fee)
Issuer reimburses ATM owner for the amount actually withdrawn + a fee	Issuer reimburses ATM owner for the amount actually withdrawn + a fee

Table 1 - Current & Proposed Fee Scenarios for ATMs

The effect of this is:

- In both cases the customer is charged a fee for use of the ATM
- In both cases a fee is reimbursed to the acquirer by the issuer
- In both cases the acquirer receives income to offset “the cost of deploying and maintaining ATMs”

The main reason given for this change to ATM interchange is to increase competitive forces. However, there is no evidence provided that fees will reduce as a result of this change. In fact, there is evidence overseas to suggest fees may well increase. For example, in the USA, where there is “direct charging”, these ATM fees are typically US\$2.00 to US\$2.50 (A\$3.70 to A\$4.60). Of course one of the benefits to the banks from this change is that the issuer no longer has to justify any charges to the cardholder’s account – the issuer can now blame the ATM owner for the fee.

It has been suggested that this direct charging model for ATMs does away with interchange. This not true. There is still a fee paid by the issuer to the acquirer - and surely a fee paid between an issuer and an acquirer is an interchange fee.

If this methodology was to be repeated for EFTPOS – i.e. the terminal owner asks the customer whether or not he/she wants to pay a fee – it would result in chaos at the point of sale. Transactions would take longer and queues would lengthen. Significant and costly software and procedural changes would also be required. Under such a scenario, it may also be that there would be reduced usage of EFTPOS as customers are asked to pay a fee every time they use their debit card (but not their credit card – providing the merchant does not surcharge).

The AIP urges that under no circumstances should the “direct charging” model be considered for EFTPOS.

It should also be noted that while the EFTPOS Industry Working Group is looking at schemes in other countries as a reference point, a number of experts consider the Australian system as the paragon. For example, Manuel Rio of France, a long standing expert in payment systems and consultant to the French Government in payment systems, has said⁶:

⁶ “Australia’s EFTPOS”, unpublished submission to the European Commission Enquiry into the Visa MIF, Manuel Rio, Paris, March 30 1999.

“The EFTPOS (electronic funds transfer at point of sale) system in Australia is a real time, on line, PIN based, debit card system. **It is considered to be the best in the world in terms of quality, convenience, safety, technological advancements, overall cost, reliability, processing speeds and increased efficiency.** It has been a resounding success in Australia and it has been adopted by the Australian consumer and by merchants with enthusiasm.”

Mr Rio goes on to say:

“The success of EFTPOS with bank customers and merchants alike, has been and continues to be a major factor in the modernization of the Australian payments systems, reducing cash and cheque usage.

“The cost of the EFTPOS system to the economy is a fraction of the cost of the credit cards system.”

and

“Fee flow recognises the economic principle of user pays.”

“On top of this, the negative interchange fees, and the reverse merchant fees, both bilaterally negotiated, adequately compensate, on a case by case basis, acquirers and merchants for their investments in infrastructure and the continuing modernization of the system.”

“Market forces produce an efficient system.”

“The system works well as there are incentives for the network providers to develop and enhance the system and the customer interface. These incentives are not present in the less efficient, less technically advanced and more expensive credit card system.”

The effectiveness and widespread acceptance of the current system is confirmed by the fact that 70% of adults in Australia use EFTPOS.⁷

Another important element of the Australian debit system is the low rate of fraud. The investment by the major merchants in PIN based on-line debit systems has allowed card fraud in Australia to be kept at very low levels with major cost savings for the banks. For example, fraud on debit cards in the UK, which is based on signature authorisation, is many orders of magnitude higher than in Australia.

In 1997 (the most recent figures available), some 16,500 debit card transactions in Australia were reported as unauthorised where the cardholder was liable⁸ in a year when 1.4 billion transactions (EFTPOS and ATM) were conducted. In the same year just over 5,000 transactions were conducted fraudulently where the issuer was liable. For debit cards, fraudulent transactions represent 0.0015% of total transactions. No estimate of the dollar amount that these transactions represent is available although these transactions are generally of higher value than average transaction values.

In the UK, card fraud (for all card types) is currently running at 0.18% of total card sales⁹. In fact, comparison with the UK demonstrates the advantages of Australia's EFTPOS system and the benefits achieved by the investment in infrastructure made by the acquirers and merchants. This system has also benefited credit cards. In November 2001, the ANZ

⁷ “Australia – EFTPOS, ATMs”, Paul Budde Communication, 2002

⁸ Australian Payment Systems Council Annual Report, 1996/1997

⁹ Data from APACS web site.

estimated credit card fraud was US\$25 million in Australia. Credit card fraud in the UK in 2001 was US\$400 million by comparison.

4.1 Costs

As discussed earlier, EFTPOS was introduced into Australia in 1984 by the four major banks. It was established as a means for customers to access their bank accounts without going into a branch.

While there were a number of considerations, the primary drive for the banks was branch re-engineering or “branch customer displacement”¹⁰. In other words, the introduction of EFTPOS, combined with an increased emphasis on ATM usage, was designed to move people out of branches and reduce the number of over-the-counter transactions. The aim was to encourage customers to rely on electronic banking and reduce the banks’ costs by utilising electronic delivery to replace branch transactions. To achieve this, the banks had to add value to debit cards beyond just ATM usage.

There were a number of other considerations which influenced the banks move into EFTPOS, although these were secondary. These other drives included:

- the replacement of cheques (particularly for retail purchases)
- the elimination of paper account passbooks
- to attract customers to make more use of low (or no) interest current accounts to which the debit card was linked.
- as part of a drive to get salaries paid directly into workers’ bank accounts - this would not happen unless workers could gain easy access to their salaries.
- reduction in costs by reducing the handling of paper based transactions for both cheques and credit cards. Credit cards would also be processed via the electronic card terminals put in place to process the on-line, PIN based debit cards.
- the generation of a new revenue stream from retailers through terminal rental and debit transaction fees.

In the period 1990 to 2000, there was a significant drop in the number of bank branches. At the same time there was an explosion in the number of EFTPOS terminals deployed and the usage of EFTPOS. The following table and graph show the magnitude of these changes and clearly demonstrate the success of EFTPOS as a “branch displacement” policy.

	Number (1990)	Number (2000)	Change 2000 vs 1990
Bank Branches	6,921	5,003	-28%
ATMs	4,636	10,818	+133%
EFTPOS Terminals	15,514	320,372	+1965%

Table 2 - Relativity Between Bank Branches, ATMs and EFTPOS Terminals, 1990 to 2000¹¹

¹⁰ This information was gathered from bankers who were involved with the introduction of EFTPOS

¹¹ Source: RBA Statistical Tables

In other words, in 1990 there were just over 2 EFTPOS terminals for every bank branch in Australia – there are now 64 EFTPOS terminals for every bank branch. The graph below also demonstrates the relative growth in ATMs and EFTPOS terminals and decline in bank branch numbers.

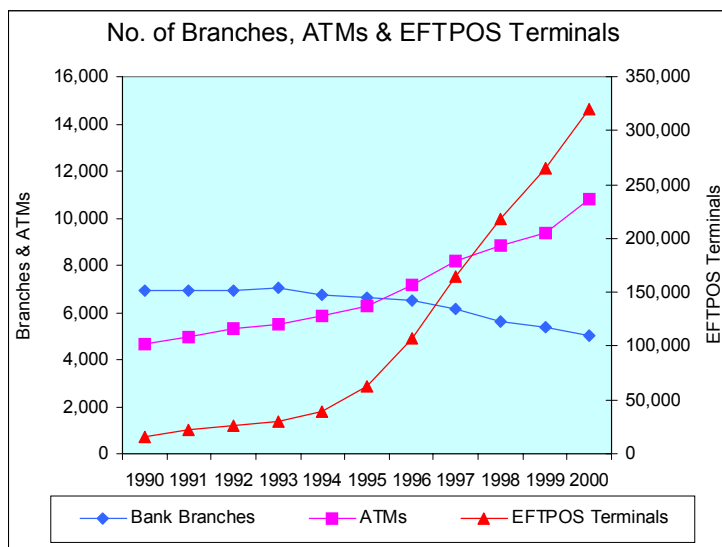


Chart 2 – Number of Branches, ATMs and EFTPOS Terminals in Australia

In a recent study by PriceWaterhouse Coopers (PWC) which compared Australian banks with international banks,¹² it was stated that “Australia has the highest total points of access (ATM / EFTPOS / Branches) per person relative to a selection of other economies”. This was based on figures supplied by the Bank for International Settlements (BIS). The report goes on to say that “Australia boasts one of the most accessible payment networks among major OECD economies.” The graph below from the PWC report demonstrates the relativity.

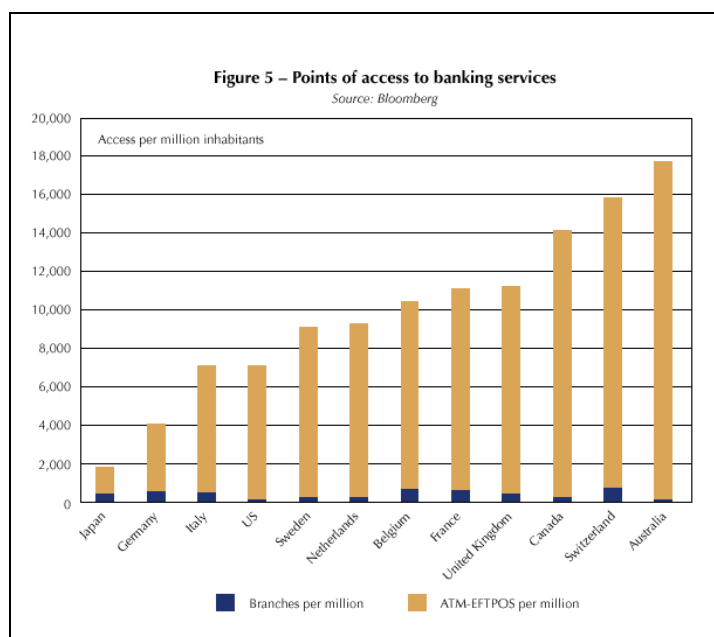


Chart 3 - Points of Access to Banking Services in Various Countries

¹² “How Our Banks Stack Up”, Rahoul Chowdry & Simon Gray, Perspectives (PWC publication), June 2002

Australia has not only the largest number of total points of access, it also has the highest penetration of EFTPOS terminals (i.e. the highest number of EFTPOS terminals per million head of population).

The reason for this is simple. **The current interchange arrangements provide a justification for merchants to invest in an EFTPOS card processing infrastructure which is technologically advanced and secure.** The oil companies have been at the forefront of such investments.

It should also be noted that, to a large extent, the credit cards have been able to leverage off the EFTPOS network. The number of credit card transactions conducted on paper vouchers has dropped from almost 100% at the introduction of EFTPOS to around 50% by 1993 and currently only 8.6% of credit card transactions are on paper vouchers (as at May 2002)¹³.

One of the objectives of the EFTPOS Industry Working Group is:

“Sustainability – Interchange fees should be consistent with continued provision of EFTPOS services over the long term and investment in new technology needed to maintain and upgrade the network.”

It is clear that the current interchange arrangements very successfully meets this criteria. Chart 3 clearly demonstrates that Australia meets this criteria better than any of the other major countries in the OECD.

The large majority of card terminals installed at service stations will need replacement in the near future. Most were installed in the early to mid 1990's and need replacing to ensure the efficiency of the system and to meet forthcoming card scheme requirements such as EMV compliant chip card readers. **Any changes to the current EFTPOS interchange arrangements will put at risk this substantial investment.**

The implementation of EFTPOS processing systems, by the oil companies and the major supermarkets in particular, has allowed the banks to pursue a strategy of branch closures which has resulted in significant savings for the banks. Any analysis of EFTPOS costs **must** take account of these savings that have accrued to the banks.

According to the PWC report, “In the recent round of half yearly results, the major banks delivered record profit levels of \$5.4 billion combined, with two of the banks posting half yearly profits of over \$1 billion for the first time.” This is partly due to cost cutting measures, and branch closures have played a strong role in this area.

RBA figures show that the number of bank branches in Australia reduced by 1,918 between 1990 and 2000¹⁴. It is estimated that the annual savings resulting from the closure of a branch are of the order of \$500,000 per annum¹⁵ (excluding any one-off savings when the branch is first closed). This would equate to on-going annual savings to the banking industry of around \$1 billion per annum.

In addition to branch closures there have also been significant savings in moving from paper to electronic processing. The implementation by major merchants of EFTPOS terminals with on-line authorisation capabilities has meant that credit cards are also generally authorised on-line in Australia. This has had the effect of reducing credit card fraud and reducing paper handling costs. These savings must also be taken into account when analysing the cost structure of EFTPOS. The cost of credit card fraud in Australia (as a percentage of total

¹³ From statistical tables available on RBA web site.

¹⁴ From statistical tables available on RBA web site.

¹⁵ Estimate based on industry sources.

credit card sales) is around one quarter of that in the UK where authorisation is usually off-line with batch processing at the end of the day.

4.2 Efficiency

One of the major drivers behind reform of the card payments systems (credit cards, debit cards and ATMs) is to ensure that the Australian payments system is operating efficiently. In fact, the Payments System Board of the RBA has a mandate to promote efficiency and competition, and it was on this basis that the RBA “designated” the credit card systems in 2001.

One of the major concerns the RBA has had is that the current interchange arrangements for credit cards have been sending the wrong signals to consumers and has led to less efficient credit cards being used at the expense of more efficient and less costly debit cards. This was summed up by the RBA’s Payments Systems Board as follows:

“The weakness of normal market disciplines in card networks in Australia is producing a distorted form of competition, in which credit card usage has been encouraged to grow at the expense of other payment instruments, particularly debit cards and direct debits, that consume fewer resources. Cardholders are effectively being paid by card issuers to use a credit card as a payment instrument, but face a transaction fee for using a debit card (after a number of fee-free transactions). Since an average credit card transaction consumes around five times more resources than a debit card transaction for the same amount, the current pricing of card payment services, in which interchange fees play an integral role, is giving Australia a higher cost retail payments system than is necessary.”¹⁶

The following graph demonstrates the relative costs to merchants of the various retail payment methods and supports the RBA statement above. Given that costs incurred by merchants are inevitably passed on to consumers, this is a good measure of efficiency.

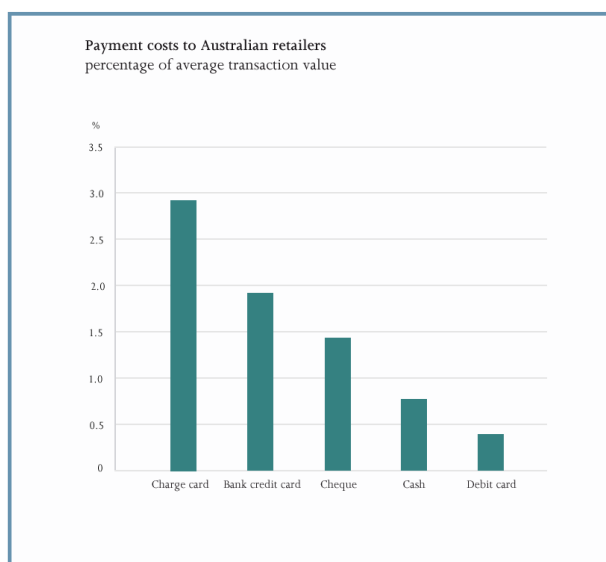


Chart 4 - Cost of Various Payment Methods to Australian Retailers¹⁷

¹⁶ RBA Payment Systems Board Annual Report, 2000 – Competition and Efficiency (this graph is based on data collected by the Australian Retailers Association).

¹⁷ RBA Payment Systems Board Annual Report, 2001 – Competition and Efficiency

This graph clearly demonstrates the relative efficiency, in economic terms, of debit cards compared to other payment methods in the retail environment. **Debit cards are already the most efficient form of payment at retailers.** On this basis, it would seem that the focus on improvements to the efficiency of our payments system should be focussed not on debit cards but on the other payment methods. That is not to say there is no room for improvement. The Canadian experience, for example, has demonstrated the benefits of open access to the debit system.

It is important to note that the impact of credit card loyalty programs is distorting the payments system. In its report on the reform of credit card schemes¹⁸, the RBA found:

“The pricing of credit card services is sending consumers a quite misleading signal about the cost to the community of different payment instruments, ...” (page vi)

and:

“The price signals are further distorted for credit cardholders in loyalty programs, who are paid a rebate to use credit cards in preference to lower-cost payment instruments.” (page 67)

This is supported by statistics on card usage. Debit cards showed strong growth throughout the 1990's and in 1995 EFTPOS transactions exceeded credit card transactions for the first time. However, the introduction of spend based credit card loyalty programs in the period from 1995 to 1997 began to increase credit card usage at the expense of debit card usage. In 1999, credit cards again became more frequently used than debit cards.

The RBA's findings have recommended that the cost of loyalty programs not be allowed as an “eligible cost” when calculating the level of the interchange fee. Now that the cost of loyalty is not to be included in the interchange fee for credit cards, then the price signals should return to normal. If the artificial incentives for customers to use credit cards are removed, then there should be solid growth in debit card usage. The relativity between debit card usage and credit card usage should return to the situation experienced before loyalty programs were introduced.

The message here is simple.

- The current interchange rates for credit cards have allowed credit card issuers to provide incentives to use their cards
- This sent the wrong message to consumers and adversely impacted debit card usage, where there were no such incentives
- Accordingly, this led to the use of a more costly and less efficient payment method.
- With the proposed changes to credit card interchange, the incentive to use credit cards should be removed and again the correct signals will be sent to consumers.

In other words, the cause of the wrong pricing signals (i.e. credit card interchange at levels which were too high) will be removed, correct pricing signals will be sent and efficiency in the card payment system will be restored.

¹⁸ “Reform of Credit Card Schemes in Australia – A Consultation Document”, Reserve bank of Australia, December 2001.

5. Process & Timeframes

The AIP has strong concerns about some elements of the process surrounding the review of EFTPOS and the interchange arrangements. The AIP's concerns have already been expressed to the RBA in a letter to the Governor. This letter is reproduced in Appendix 1. It is not intended to repeat all the arguments contained in this letter. However, it is worth summarising some of the main issues and concerns raised in the letter.

- The review must be independent, transparent and objective. The AIP does not believe these criteria are currently being met.
- All parties, including current members of the EFTPOS Industry Working Group, should be requested to make submissions to the review. These submissions should be public documents (except where commercial confidence applies) with access and time for all parties to review and comment on these submissions.
- The EFTPOS Industry Working Group is currently comprised of a sub-set of the key stakeholders in EFTPOS. The Working Group should be reconstituted to be representative of **all** stakeholders – specifically issuers, acquirers, merchants and cardholders. It must be remembered that 100% of EFTPOS transactions involve both merchants and cardholders.

The current structure allows an unrepresentative sub group to make recommendations to the Reserve Bank, with no certainty that these recommendations will be reflective of the views of all stakeholders. They are under no obligation to objectively consider any of the submissions and other parties have no chance to argue against their views. Further, their deliberations will be held behind closed doors which precludes any insight into the decision making process. **This process is neither objective nor transparent.**

- The current timeframes must be extended so that there is time for all participants to gain a full understanding of the issues and the implications of any changes. The current deadlines are not allowing the process to be completed with proper integrity. It is important to ensure the correct outcome is achieved rather than to fit with any preconceived timeframe.

The RBA and ACCC stated in their joint report¹⁹:

“The study has concluded that the interests of end-users of card payment services need to be more directly engaged in the pricing process and conditions of entry to card payment networks need to be more open than at present.”

It is time for this recommendation to be put in place and allow the end users, both merchants and cardholders, to be involved in the decision making elements of this process.

A complete timetable should be provided, detailing the anticipated next steps, key milestones and target dates and timeframes.

¹⁹ “Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access”, Joint Report by the RBA and ACCC, October 2000, page 5.

6. Scope of Review

The AIP wishes to make some comments on the scope of the review. Some of these issues have already been raised in the letter from the AIP to the RBA (refer Appendix 1). However, some further detail is presented on these issues here.

The focus of the EFTPOS Industry Working Group's Discussion Paper is on interchange. In fact the title of the document is "Discussion Paper: Options for EFTPOS Interchange Reform". We believe it neither sensible nor meaningful to look at interchange in isolation from other elements of EFTPOS. The Discussion Paper itself touches on some of these areas, such as access, but leaves other areas untouched.

In addition to interchange and access, there are two particular areas which we believe must be included in the scope of the current EFTPOS review. These are:

- the review must encompass scheme debit cards as well as domestic EFTPOS
- the relativity to other reviews (credit, Visa debit, ATMs) must be covered

These issues are covered in the following sections.

6.1 EFTPOS and Scheme Debit Cards

It makes no sense to review and make changes to EFTPOS without including the global scheme debit cards in the same review and making them subject to the same outcome.

In many countries around the world there is a trend to move from local proprietary debit cards to scheme branded debit cards such as Visa Debit, Visa Electron, Maestro and MasterCard Electronic. This is happening in a wide range of countries and regions, including Thailand, The Philippines, Brazil, UK and South Africa.

The interchange fees for scheme debit cards are inevitably higher than for the local debit cards and are often based on ad valorem charges similar to those for credit cards. In the UK, where scheme debit cards (Visa Debit) and local proprietary debit cards (Switch) are present in the market in roughly equal numbers, the Visa interchange fee is more than 50% higher than that for Switch (refer section on Overseas Schemes). This happens for a number of reasons. Firstly, the schemes themselves charge a range of fees including licensing fees, processing fees, etc. to both issuers and acquirers and these must be recovered. Secondly, the global schemes are dominated by card issuers. Under card scheme rules, a member must be an issuer but only a small percentage of members are acquirers as well. The issuers can increase their income under the positive interchange regime by simply increasing the interchange fee.

A further problem with scheme debit cards is that the interchange fee is generally, although not always, charged on ad valorem basis. Further, the debit interchange fee and/or merchant service fee is frequently charged at the same rate as the credit card interchange - often called "parity pricing". This happens, for example, in countries such as Germany, Singapore, Thailand and the Philippines. **There is simply no justification for debit card interchange being charged at the same rate as credit cards nor for it to be an ad valorem fee.**

However, the purpose of this section is not to provide a detailed description of the pros and cons of scheme debit compared to proprietary debit, simply to describe some of the high level differences and the impact they have on market prices. The higher interchange rates charged by scheme debit cards must be recovered in the market, leading to higher costs in the payments system.

The important point here is that the local EFTPOS cards could be converted to scheme debit cards fairly quickly should the review outcome distort the economic incentives against the current EFTPOS proprietary system in favour of alternative systems that may be less efficient in the Australian context. We are not suggesting this will happen, just that it is a possible scenario. Many EFTPOS cards already have scheme branding such as Maestro for overseas use - it would be relatively easy to convert these cards to domestic Maestro cards.

In the interest of efficiency of the payment system, the findings on EFTPOS interchange and access should apply to all debit cards.

6.2 Other Card Reviews in Australia

Three other card reviews have been taking place in Australia in recent times - credit cards, ATMs and the Visa debit product. While the final results of the credit card review have now been handed down, the ATM and Visa debit reviews are still underway. As outlined above, we believe that all debit cards should be incorporated in the current review, including the Visa debit product.

ATM interchange should also be investigated in conjunction with this review and not separately. As discussed earlier, ATM and EFTPOS interchange currently operate on the same negative interchange basis and both operate on a fixed fee per transaction basis rather than ad valorem charges. Further, "ATM cards" and debit cards are the same piece of plastic. Any review of ATM interchange should at the very least be linked to the EFTPOS review.

In summary, to enable retailers to understand the full impact of the collective changes to debit, ATM, Visa Debit and credit cards, it is crucial that all reviews occur concurrently and not separately, as is currently the case.

7. Overseas Schemes

The EFTPOS Industry Working Group has suggested that consideration of debit payment systems overseas “may provide a useful reference point for EFTPOS in Australia”. It is, however, necessary to look at the whole context of each country’s debit system, and not just focus on the direction of the interchange payment, which may be only a very minor factor in the whole situation. The history of each country also plays a large part in what lessons may be drawn.

Canada, the UK, South Africa, Germany, USA and New Zealand are briefly reviewed here, with the main relevant points highlighted for discussion. Issues of particular relevance to the oil industry are also discussed.

The information contained in this section is based on field research and data gathered by TransAction Resources over recent years.

7.1 Canada

Canadian service stations, and retailers in general, have seen their average cost per debit transaction fall over the last 5 or 6 years. Membership of the Interac²⁰ debit system was opened up to new entrants in late 1996 by the local Competition Bureau. As a result of this action, the number of Interac members has increased from 9 to more than 80. The membership now includes retailers, insurance companies and technology suppliers in addition to the traditional bank members.

The number of debit card terminals and of debit cards on issue have grown rapidly over the same period. Transaction and spend volumes have increased exponentially as merchant coverage has increased. Debit card transactions in Canada are now much cheaper for retailers than credit cards, even for low value transactions.

The Interac debit system has a zero interchange fee but members pay a small processing fee (less than C\$0.01) per transaction to the Interac Association to cover its costs of operating and managing the network.

Merchants now have a considerable number of alternative debit acquirers to choose from, and this increased competition, along with increased transaction volumes, has led to lower costs per transaction. The merchant fees for debit are a fixed price per transaction, not an ad valorem fee. This reflects the fact that the cost of processing a transaction through the network does not vary with its value.

As in Australia, the Canadian system is a PIN-based, on-line processing system with almost no fraud and no bad debt risk for the card issuers. This allows an Interac debit card to be given to anybody with a bank account.

Interac cardholders pay transaction fees of about C\$0.40 to the card issuer, though some customers are exempt from these fees if they have other bank relationships, such as mortgages, personal loans or investment accounts.

The Interac Association sets the technical standards for transaction processing between members. This means that the same computer software can be used to send transactions

²⁰ Interac is the name given to the Canadian debit card system.

to any other member. The effect of this is to keep front-end system costs to the minimum and to create a pool of software people who have a thorough understanding of the way it should operate. This leads to shared, lower system development, testing and maintenance costs for each member; currently a major cost for new entrants to the Australian debit system.

New Interac members buy a license to operate the processing software and are then faced with implementation costs for interfaces to any existing internal back-end systems.

As each Interac member has their own system in a distributed processing network, there is no single point of failure in the national system.

The original group of financial institutions which created the Interac scheme have had their control over the national debit payments system taken away from them, and operations have been opened up to public scrutiny. This has resulted in increased usage and lower costs for all parties.

The decision by the Canadian competition authority in 1995 to open up access to the debit system has resulted in a more competitive and more efficient debit payments system.

Key Findings

- The key to the success of the Canadian system has been the open access which has led to increased competition in acquiring which, in turn, has driven down merchant costs.
- The implementation of set standards has also made entry easier and has reduced costs.
- The access regime has led to an open transparent system.

7.2 United Kingdom

There are two major debit card schemes in the UK – Switch and Visa Debit. Both of these schemes have positive interchange where the acquirer pays a fixed fee to the card issuer. The Visa interchange fee of 7p is more than 50% higher than the Switch interchange fee of 4.5p.

There is a current proposal to convert most Switch cards across to MasterCard Europe, the new organisation formed from the merger of MasterCard and Europay (a small number of Switch banks have indicated they will convert their cards to Visa Debit). At present, the Switch cards have a Maestro logo on the back of the card, but this only applies when the card is used outside the UK. Under the new proposal, all the domestic debit transactions will be “scheme” transactions, mostly Maestro transactions processed on the MasterCard Europe system, EPSNet.

As for Visa, MasterCard receives a transaction fee for all debit transactions. It is feared that the current Switch acquirers will attempt to increase merchant fees for the Maestro cards if the interchange fees are increased to cover the overheads of the MasterCard Europe system.

Historically, debit card payments in the UK have been signature based, off-line transactions. This has resulted in relatively high levels of card fraud and bad debt risk for all the card

issuers. It has also resulted in central computer systems such as SwitchNet that are oriented around batch end-of-day processing and are completely incapable of handling large volumes of on-line transactions.

Even the on-line authorised transactions for debit cards such as Solo and Visa Electron, which are not permitted to operate in off-line mode, are processed for value in batches at the end of the day. Each card is effectively processed twice, once for an on-line authorisation and then once for value. This is neither efficient nor cost effective.

The high levels of fraud on the UK debit cards (currently running at around 0.1% of spend at merchants according to APACS figures) have led to a decision by the banks to implement a subset of the EMV standard on a chip known as the UKIS chip (UK Implementation Specification). Intervention by British retailers through the British Retail Consortium has now led to the adoption of PINs on these chips to get away from the slow and insecure practice of signature authorisation. The first version of the banks' UKIS chips did not have PIN capability. The majority of transactions for debit cards with the new chips will still be off-line however, without an account balance check.

British retailers, including service stations, are being asked to upgrade their card processing terminals to accept the new UKIS chip. There is currently a standoff with banks saying they will not issue chip cards until there are enough chip-capable terminals to make it worthwhile. Retailers say they will not upgrade their card terminals until there are enough chip cards in circulation to make the investment worthwhile. The total estimated cost to the card industry in the UK for the UKIS program, both banks and retailers, is around £1.1 billion (A\$3 billion).

The presence of a positive interchange model has certainly not helped the UK debit system to operate in an efficient manner. Their system has major problems that look set to continue for some time to come.

Key Findings

- The UK system is old, outdated and incapable of meeting modern debit card processing requirements such as on-line and/or PIN based transactions.
- This has occurred because the interchange arrangements provide no incentive for merchants or acquirers to invest in card processing infrastructure and the issuers, who receive the interchange income, see no benefit in doing so.
- The systems and procedures mandated by the banks have led to very high fraud rates and now the banks want the retailers to pay for this by paying for and implementing new chip based card processing systems.
- Both proprietary and scheme based debit cards exist in the UK with roughly equal market shares.
- The scheme based debit card system has a higher interchange rate than the local proprietary card system. The Visa debit interchange rate is more than 50% higher than the Switch interchange fee.
- Proprietary debit cards are being converted to scheme debit cards
- The last thing Australia should do is look to base any changes in our EFTPOS system on the UK debit model. It is outdated, inefficient, high cost and subject to high fraud rates.

7.3 South Africa

The interchange arrangements and flow of fees between issuer and acquirer in South Africa are of interest for this study, particularly in the service station environment.

In South Africa, credit cards are not allowed to be used for the purchase of petrol. To overcome the constraints imposed by this government regulation, the banks have developed debit card products specifically for use at service stations. These private motorist debit cards are called Petro Card or Garage Card, depending on the issuer. These cards were introduced in the 1980's when there were no general purpose debit cards in the market. Similarly, there are also bank issued fleet cards (such as First Auto and Stannic Fleet Card).

Petro and Garage cards access funds previously deposited by the cardholder or can be linked to the cardholder's cheque account in much the same way as a debit card in Australia. There is also now an option to link the card to a credit card account. However, in this case, because purchases are not allowed on credit, when a purchase is made a "cash advance" is transferred from the credit card account directly into the Petro/Garage account. This operates as though a cash withdrawal has been made which has then been immediately deposited into the Petro/Garage account. Accordingly interest is charged from the time of the "withdrawal".

These cards (Petro, Garage and Fleet cards) all operate on a negative interchange fee (often called a "processing fee" locally) in exactly the same way as Australian debit cards, i.e. a fixed transaction fee is paid by the issuer to the acquirer. These fees are R 0.50 (A\$0.091) for Petro/Garage cards and typically R1.60 (A\$0.30) for the fleet cards. Out of interest, these are by far the most commonly used cards for fuel purchases, with debit cards representing less than 1% of card sales at service stations.

It should also be mentioned that service stations pay no merchant service fees on these cards.

General purpose debit and credit cards in South Africa also involve a payment from the issuer to the acquirer. For these cards the typical scheme interchange fees apply – i.e. an ad valorem fee paid by the acquirer to the issuer. Out of interest, interchange fees for debit cards are negotiated bilaterally. In addition to the interchange fee arrangement, the issuer pays the acquirer an "authorisation fee". This is currently 35¢ (A\$0.065) for debit cards and 90¢ (A\$0.17) for credit.

The South African system recognises that there is a cost for the acquirer in providing an infrastructure and in processing the transaction and this cost should be able to be recovered by the acquirer. It should be noted that at least one major retailer has received payment from their acquirer in recognition of the investment that retailer has made in card processing infrastructure.

The bank card issuers are currently reviewing their acquiring costs and interchange levels for credit and debit cards and have contracted Edgar Dunn to assist them in this review. However, this is not an independent review and is being conducted by the banks based on guidelines set by the banks.

As in many other countries, many South African banks are converting their proprietary debit cards to "scheme" debit cards.

The diagrams below show the interchange and fee arrangements for each of the card types. As can be seen, there is a payment from the issuer to the acquirer in all cases.

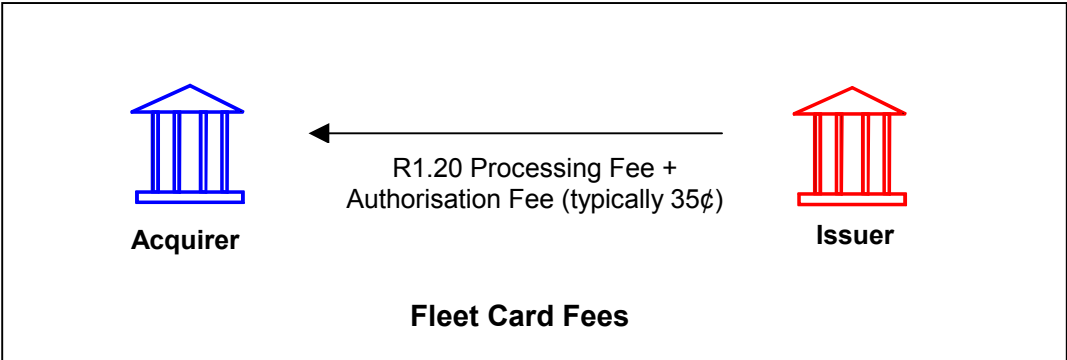
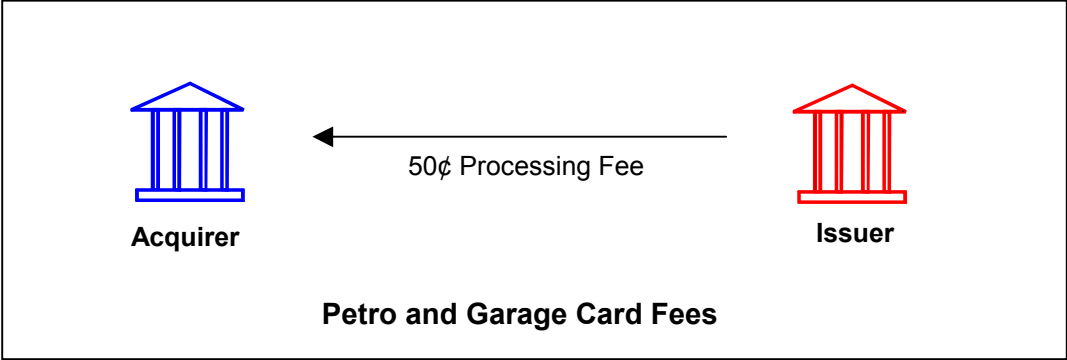
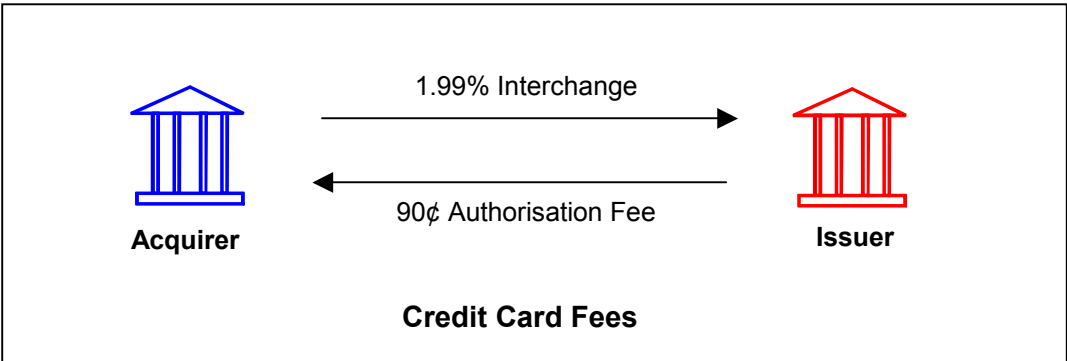
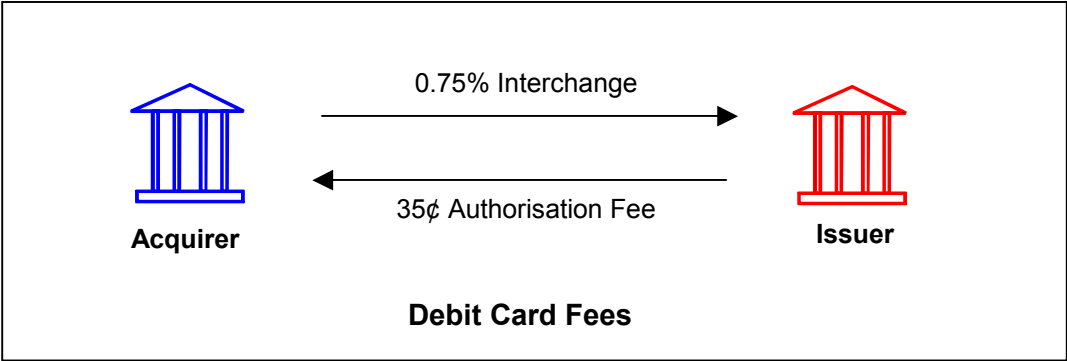


Diagram 1 - Interchange and Other Fee Flows in South Africa

Key Findings

- Service station specific debit cards have negative interchange
- While interchange for both “standard” debit cards and credit cards flows from the acquirer to the issuer, processing or authorisation fees are paid by the issuer to the acquirer for all card types in recognition of the costs incurred and infrastructure required.
- The processing fees range from R0.35 (A\$0.065) for scheme debit cards to R0.90 (A\$0.17) for credit cards through to R1.60 (A\$0.30) for bank issued fuel cards.
- Proprietary debit cards are being converted to scheme debit cards
- Most card transactions are not conducted on-line and there are consequently high fraud rates.

7.4 Germany

The debit card system in Germany operates nationally, including the former East Germany. The system operates with a number of competing transaction switching networks that supply card terminals and support services to merchants. Each network sends debit cards to one of four major bank authorisation centres, depending upon which bank or institution issued the card. Transactions are PIN based and fully on-line.

There are around 65 million “ec” or “eurocheque” debit cards (commonly known as ec-Karte), most of which may be used for payment at the point of sale. These cards may also be used at ATMs for cash withdrawal, and many also have a cheque guarantee function.

There are also a smaller number of scheme-branded debit cards, mostly Visa, which also exist in the same market.

The ec cards operate without interchange, but the Visa cards follow a positive interchange model. The ec cards are therefore much lower cost for merchants to accept and many merchants do not accept the Visa branded debit cards for this reason. The merchant service fee is the same for all Visa cards; whether credit, charge or debit cards.

The German merchants, outside the oil industry, pay a standard authorisation and processing fee of 0.3% for each ec debit card transaction.

The oil industry has a special merchant fee structure for ec debit cards as follows:

- | | |
|-----------------|---------------------|
| ▫ up to DM40 | 8pf per transaction |
| ▫ DM40 to DM100 | 0.2% of value |
| ▫ over DM100 | 0.3% of value |

On average, this oil industry fee was the equivalent of 0.22% of the purchase value at service stations in 1999.

As with debit cards, credit and charge cards (Visa and Europay/MasterCard) also have a lower interchange rate for the oil industry because government tax forms such a large part of the fuel price.

The oil industry in Germany pays lower merchant fees for both debit and credit products in recognition of the high proportion of government tax in the price of fuel. The credit card interchange rate for the oil industry is considerably lower than the default rate.

The German debit cards are linked to the cardholder's cheque account in most cases, and many of these allow access to an account overdraft. The interest rates on cheque account overdrafts are substantially lower than the APR rates on the outstanding balances for credit cards. For this reason, debit cards are more popular with cardholders than credit cards.

The majority of German credit cards operate like charge cards, with the account balance to be paid in full at each billing period. The introduction of true revolving credit cards was fairly recent and still exist in fairly small numbers today.

Between 1996 and 2000, the number of debit card transactions in Germany increased by almost 500% while the number of credit and charge card transactions increased by about 25% according to the Bank for International Settlements (July, 2002).

ec-Karte issuers tried to introduce an interchange fee (acquirer to pay issuer) in 2001, but the application to the Competition Authority was withdrawn when it is was indicated the application would be unsuccessful.

The ec debit cards, without interchange, have achieved the majority of the share of debit payments against scheme-branded debit cards with positive interchange. There is no indication that positive interchange has in any way allowed the Visa debit system to be more efficient than the ec card system. In fact, it is a higher cost system for merchants and has less coverage as a result of this.

Key Findings

- Both scheme and proprietary (ec-Karte) debit cards are issued, with ec-Karte dominating the market
- Visa scheme debit cards have the same interchange as credit cards; there is no interchange on ec-Karte.
- ec-Karte issuers tried to introduce an interchange fee (acquirer to pay issuer) in 2001, but the application to the Competition Authority was withdrawn when it is was indicated the application would be unsuccessful.
- Card usage is relatively low in Germany, but debit cards have far higher usage rates than credit cards.

7.5 New Zealand

There are two EFTPOS networks in New Zealand - ETSL and the ANZ network. These networks are interconnected.

New Zealand has negative interchange for debit cards. This interchange fee is paid by the issuer to either of the acquiring networks, ETSL or ANZ.

According to Reserve Bank figures, New Zealand has very high usage of debit cards with EFTPOS transactions in 2000 averaging 126 per capita²¹. This is more than double the usage of the next highest country (Canada in 1999 - 2000 figures are unavailable). Debit cards account for some 50% of retail sales. Debit transactions still outnumber credit card transactions by more than 2 to 1, despite the inroads made by credit cards in recent years due to associated loyalty programs.

²¹ "Payment and Settlement Systems in New Zealand", Reserve Bank of New Zealand, February 2002.

Like Australia, New Zealand has a very healthy EFTPOS system with high usage rates. Also, like Australia, it has negative interchange payable by the issuer to the acquirer.

Key Findings

- New Zealand has the highest usage of debit cards (compared to the 12 major countries tracked by the BIS)
- Debit cards operate on the basis of negative interchange

7.6 USA

Like many other countries, the USA has both “scheme” debit cards and local proprietary debit cards. The local debit systems tend to be regional and are usually on-line PIN authorised systems.

The most popular scheme debit cards are VISA Check Card followed by MasterCard's MasterMoney card. These are both off-line, signature authorised cards and have positive interchange on an ad valorem basis. In other words, the interchange operates in exactly the same way as credit cards. Typically merchants pay the same merchant service fee (MSF) for these debit cards as they do for credit cards. This averages around 2% of the purchase value. Visa and MasterCard also have on-line, PIN based products called Interlink and Maestro respectively, but these have a very limited market presence.

The major players in the on-line debit area are regional networks such as NYCE, MOST, TYME, HONOR and MAC and these transactions are all PIN authorised. There has been some consolidation of these regional networks in recent years as they attempt to gain economies of scale to compete with the international schemes. These EFTPOS networks also have positive interchange fees, but they are a fixed fee per transaction and are generally considerably cheaper than for the off-line scheme cards. A typical merchant fee for these cards is around US\$0.15 per transaction²².

This again illustrates the issue of scheme cards. The scheme cards are higher cost, more prone to fraud (no PIN, no balance checking) and less efficient. And yet the merchants, and consumers in the end, pay more for them.

There is currently a lawsuit underway (often referred to as the Wal-Mart case), launched by major retailers, which alleges that the card schemes are violating antitrust law. This is due to the “honour all cards rule” (HACR) which forces merchants who accept credit cards to also accept these high cost, high fraud off-line debit cards.

It is estimated there was 8.85 billion debit card transactions in the USA in 2001. Of that, 5.5 billion (62%) are signature based scheme card transactions and 2.85 billion (38%) will be on-line PIN based transactions operating on the regional switches.²²

In addition to interchange fees, networks charge switching fees. As mentioned in the Working Group's paper, these networks “are either bank-owned joint venture organisations or are owned by processing companies that operate the central switch facility”.

²² “Card associations face US legal double whammy”, *Cards International* 268 (Lafferty Newsletters), November 2001.

Key Findings

- USA has both scheme debit cards and proprietary cards
- The scheme debit cards are mostly off-line, signature based cards whereas the proprietary debit cards are on-line and PIN authorised.
- The scheme debit cards have a higher interchange fee which is ad valorem compared to the fixed fee per transaction for the proprietary debit cards
- The card schemes have enforced the “honour all cards rule” to ensure widespread acceptance of their cards, despite higher costs to the merchants. This is currently the subject of a law suit.

7.7 Lessons From Overseas

There is no indication that positive interchange payments contribute towards a more efficient debit payments system. On the contrary, the Australian debit system, with its negative interchange model, seems to compare very favourably. In general, the debit cards with the lowest overall cost for the merchant, seem to achieve wider acceptance and higher transaction volumes.

In Canada, the decision to open access to the Interac membership has resulted in more issuers, more merchants, more transactions and lower transaction processing costs. Regulatory, financial and technical barriers to entry have been removed, to great effect. The objective of a more efficient and safer debit payments system, seems to have been achieved. This open access has been the key to the success of the Canadian system. The implementation of set standards has also made entry easier and has reduced costs.

In the UK, the system is fraught with problems, and does not seem to be a model which offers any benefits at all when compared to the present Australian system.

The UK provides a good example of the impact of “scheme” debit cards - currently scheme debit and proprietary debit card systems run side by side. However, the Visa Debit interchange rate is more than 50% higher than the Switch interchange fee.

The UK is also a good example of what happens when there is no incentive for merchants or acquirers to invest in ensuring that the card processing infrastructure is modern, secure and able to adequately meet the demands made of it. The UK system is old, outdated and incapable of meeting modern debit card processing requirements such as on-line, PIN based transactions.

In Germany, the zero interchange ec debit cards are dominating against the positive interchange scheme-branded cards. The oil industry, with a very high proportion of government taxes in the retail price (around 70%), suffers from ad valorem merchant fees as taxes increase but retail margins do not. An ever-growing portion of the retail margin disappears as ad valorem fees increase in line with prices. The German card industry has recognised this issue, with lower interchange rates and transaction pricing for service stations. For low value transactions, the debit merchant fee is a fixed price per transaction.

In South Africa, the banks have developed debit cards specifically for use at service stations. These cards have a negative interchange fee. While interchange for both general purpose debit and credit cards flows from the acquirer to the issuer, processing or authorisation fees are paid by the issuer to the acquirer for all card types in recognition of the costs incurred and infrastructure required.

A low cost, efficient debit payments system must be secure. This means PIN based, on-line transactions to minimise fraud and bad debt costs to issuers. To deliver this requires a secure infrastructure capable of processing high volumes of transactions in real time. This infrastructure resides at each point of sale and at each transaction processor or acquirer. Such an infrastructure must be kept up to date as technology evolves (eg. EMV chip costs are very high).

Low fraud and bad debt costs, combined with open access and increased competition, seems likely to deliver the best outcome. The Australian interchange model has been extremely successful to date. However access to the Australian debit system should be improved and the system made more transparent. This would also be consistent with the approach being taken towards credit cards.

There is a trend emerging around the world where scheme based debit cards are replacing proprietary debit card systems (e.g. UK, South Africa, Thailand, Philippines, etc.). A feature of these scheme based debit programs is that they have higher interchange fees than the local proprietary systems. Further, they are not based on any methodology specific to that local market, but are based on global scheme rules which are designed to ensure that scheme issuing members are able to maximise their incomes.

Pre-tax petrol prices in Australia are generally the lowest in the world and to maintain this performance it is crucial to ensure that costs are kept to a minimum. It is therefore important to ensure the maximum cost efficiencies for card acceptance.

8. Interchange

Some of the broader interchange issues for debit cards have already been discussed in Section 4 – The Australian EFTPOS System. This is because the current interchange arrangements have been integral to the success of EFTPOS and no discussion of the Australian system would be complete without mention of interchange. This section will deal with some of the elements of interchange in more detail.

As was quoted earlier in this document by Manuel Rio²³ : “the negative interchange fees, and the reverse merchant fees, both bilaterally negotiated, adequately compensate, on a case by case basis, acquirers and merchants for their investments in infrastructure and the continuing modernization of the system.” He goes on to say: “The system works well as there are incentives for the network providers to develop and enhance the system and the customer interface.”

The current interchange structure, in fact, is the basis of the success of Australia’s EFTPOS system. We have a technologically advanced, secure system which provides for PIN based on-line authorisation of all debit transactions. This has been made possible because the major merchants, and in particular the oil companies, have invested significant amounts of money in developing, implementing and maintaining EFTPOS networks as well as marketing EFTPOS acceptance.

More than half of all EFTPOS transactions in Australia are conducted through terminals owned by merchants, particularly the major oil companies and the large supermarket chains.

The rationale for the current reverse interchange structure is logical and reasonable.

The acquirer provides a large-capacity fault-tolerant computer system with transaction switching and processing software. These acquiring systems are powerful and complex and are capable of processing very large numbers of transactions per second in real time. Each system also has a slightly smaller duplicate configuration at another location to act as a disaster backup system. The uptime of these acquiring systems is typically greater than 99.95%.

The acquirer must also maintain records and security data for each of the merchant terminals which it acquires for. There are many tens of thousands of these terminals located all over the country. Typically a Terminal Master Key, a MAC Key and a PIN Encryption Key (at minimum) must be maintained and managed for each terminal device connected to the acquiring system.

The acquirer also has the responsibility for certifying new acquiring applications put into the market by themselves or by any of the merchants they acquire for. This typically involves substantial testing resources and cost to ensure that all merchant systems are secure, reliable, and meet all required standards, including those contained in the *EFT Code of Conduct*.

Additionally, the Acquirer is responsible for the merchant relationship, including negotiation of commercial arrangements, reimbursement of card sales value, deduction of merchant service fees, provision of reports and statistics to the merchant, investigation of disputed

²³ “Australia’s EFTPOS”, unpublished submission to the European Commission Enquiry into the Visa MIF, Manuel Rio, Paris, March 30 1999.

transactions, etc. Providing these services to large merchants in particular can be a time consuming job.

A large investment is required to implement, upgrade and support such an acquiring capability. The issuers pay the acquirer a fee to recognise and compensate for the high level of investment required. **This is in line with normal business practice where the party providing the service is paid by the user of that service.** It is also in line with the interchange arrangements when a debit card is used at an ATM.

As a result, Australia has a number of high quality, sophisticated acquiring systems in a fairly small market, which otherwise would probably not exist.

The same logic prevails to allow those merchants who have invested in card processing systems to receive income from the acquirers. **These merchants receive income from acquirers in exchange for investment in payments system infrastructure the banks would otherwise have to provide themselves.**

This is the basic “user pays” principle - whoever provides the service should be able to charge for that service. The Reserve Bank itself uses the same principle. As stated in the BIS report on Australian Payment Systems, “the Reserve Bank charges explicitly for the banking services it provides and has supported moves towards appropriate and transparent pricing of payments transactions generally.”²⁴ On this basis it would seem logical that the Reserve bank supports the payments made by acquirers to merchants for the services provided.

In terms of costs, the joint review of card payments in Australia by the RBA and ACCC in 2000²⁵ found that the interchange fees exceeded the costs for all cards - credit cards, debit cards and ATMs. However, as the RBA said, the major problems with interchange fees lay with the credit card and ATM interchange arrangements, not the debit interchange.

“In summing up, the study found that interchange fees in all three card networks in Australia are higher than are needed to cover the relevant costs of financial institutions - and particularly so in the ATM and credit card networks”²⁶

There are two matters which are relevant to this statement.

First, it should be noted that the costs for debit cards did not include any costs incurred by merchants in providing card processing infrastructure and operating costs. For example, the cost of banks providing EFTPOS terminals was included in the calculations, but the costs of merchant provided terminals are not included.

Secondly, for EFTPOS interchange this statement is at odds with the findings of the RBA/ACCC report which said²⁷

“In debit card payment networks, interchange fees are negotiated bilaterally and are paid by the card issuer to the merchant’s financial institution (the acquirer). These fees have been justified as a means by which the acquirer can recoup the costs of the debit card infrastructure from cardholders. Acquirers earn revenues

²⁴ “*Payment Systems In Australia*”, prepared by The Reserve Bank of Australia & The Committee on Payment and Settlement Systems, Bank for International Settlements, June 1999.

²⁵ “*Debit and Credit Card Schemes in Australia*”, joint study by the RBA and ACCC, October 2000.

²⁶ RBA Payment Systems Board Annual Report, 2000 – Competition and Efficiency

²⁷ “*Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access*”, Joint Report by the RBA and ACCC, October 2000, page iv

from interchange fees of around \$0.20 per transaction, and revenues from merchant service fees of around \$0.12 per transaction. They incur costs of around \$0.26 per transaction, giving a mark-up of revenues over costs of 23 per cent. This mark-up is much lower than in credit card acquiring although infrastructure and procedures are very similar. The major reason is that large merchants have invested in their own acquiring infrastructure and have negotiated arrangements to share interchange fees with their financial institution.

This means the interchange fee (20¢) does not, in fact, cover the acquirer's costs (26¢), let alone any costs incurred by the merchant. If these figures are correct, then the above statement by the Payments System Board of the RBA²⁶ is not correct. The total income received by the acquirer does exceed the costs, but the interchange fee on its own does not.

The RBA/ACCC study found two main issues with interchange fees:

- anti competitive implications in the setting of multilateral interchange fees
- efficiency and cost issues (these have been discussed earlier in Section 4)

Both credit card and ATM interchange fees are set multilaterally by the very bodies who stand to benefit from higher fees and in March 2000 the ACCC decided that "the collective setting of credit card interchange fees was a breach of the Trade Practices Act 1974"²⁸. **However, it should be noted that debit card fees are set bilaterally and are therefore not subject to the same collective setting of the interchange rates.** The EFTPOS Industry Working Group itself has acknowledged the benefits of the current debit interchange arrangements in this area.

"The primary benefit of retaining a bilateral interchange fee regime is the element of market competition between EFTPOS participants in the setting of interchange fees, which at least in theory, should lead to economically efficient outcomes."²⁹

A further concern of the EFTPOS Industry Working Group (and the RBA and ACCC) appears to be that the interchange fees have not changed over time and that perhaps these fees should have reduced as the number of transactions have increased due to the economies of scale.

"Fees set through bilateral contracts have been rigid and appear to lack flexibility to change".³⁰

"Interchange fees for debit card transactions have hardly changed since they were introduced in the early 1990s³¹. Newer agreements appear to have been based on earlier agreements, without regard for changes in costs that may have warranted a revision to interchange fees."³²

While some costs have undoubtedly reduced from the effects of increased throughput, not all areas have benefited from economies of scale. While usage of EFTPOS has increased substantially, it has not increased at the same rate as the deployment of terminals. The

²⁸ Press release by the RBA, 12 April 2001.

²⁹ "Discussion Paper: Options for EFTPOS Interchange Fee Reform", EFTPOS Industry Working Group, July 2002

³⁰ "Discussion Paper: Options for EFTPOS Interchange Fee Reform", EFTPOS Industry Working Group, July 2002, Page 5

³¹ This date is not correct - EFTPOS interchange fees were introduced in the mid-1980s

³² "Debit and Credit Card Schemes in Australia", joint study by the RBA and ACCC, October 2000, page 63.

graph below demonstrates how the number of transactions per terminal has decreased over recent years. In 2000, the average throughput was only one third of the level 6 years earlier.

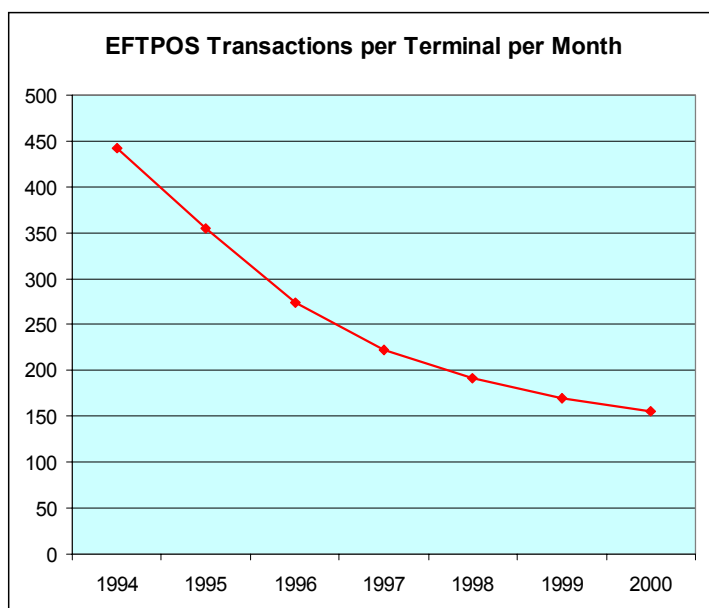


Chart 5 - EFTPOS Transactions per Terminal³³

It should also be noted that the interchange fees have in fact reduced in real terms as the value of the dollar is now considerably less than it was more than 15 years ago when interchange was introduced.

The benefits of the current EFTPOS interchange arrangements are clear:

- 1. They provide an incentive for investment in the EFTPOS infrastructure by both acquirers and merchants. This will allow Australia to remain at the forefront of card processing technology with resultant benefits in the efficiency of the payments system.**
- 2. The current interchange flow adheres to the commercially sensible "user pays" principle.**
- 3. It allows for fees to be set as the result of normal competitive processes.**
- 4. There are no anti-competitive or price fixing issues related to the collective setting of interchange fees.**

There is simply no evidence that there are any problems with the current EFTPOS interchange arrangements. In fact, to the contrary, there is much evidence that the system is a world leader and is the most efficient retail payment system in Australia. It would make no sense at all to make any significant changes and risk the benefits which are being shared by all Australians.

³³ Source: RBA statistics

8.1 Impact of Changes to Interchange

It is worth considering the impact any change to interchange rates would have on the various parties involved. For the purposes of this discussion, we will use the zero interchange position advocated by the RBA and ACCC in their joint report.

In simple terms, if there is no interchange fee the acquirers will lose income of 20 cents per transaction (for all not-on-us transactions). Assuming their current margin is currently set at a reasonable and competitive level, they now have to recover income of 20 cents per transaction from some other source. The only party they can recoup this from is the merchant. In turn, the merchant will need to recover this cost from the customer in order to maintain its existing margin. This can be achieved in three ways:

1. an increase in the price of retail goods, or
2. a specific debit card fee levied on the purchase
3. not accept debit cards at all

In the first two cases, there is an increased cost to the end customer. In the second case, we would be sending the wrong pricing signals. The customer would be faced with a zero fee if paying by credit card³⁴ which would lead to increased use of a higher cost, less efficient payment method. Under the third option, there would be reduced convenience and choices for the customer and a migration to more costly payment methods.

As can be seen, the merchants and the customers would both be worse off. The merchants will have to either raise the price of their goods, levy a fee on the purchase (both of which potentially result in reduced sales) or absorb the costs. On an overall basis, the major acquirers and issuers (i.e. the “Big Four” banks) will be neither worse off nor better off, although individual banks will be impacted to varying extents. This is because their issuing and acquiring market shares are roughly in balance on a consolidated basis.

The only group which would be significantly better off under a zero interchange scenario is the smaller financial institutions such as the building societies and credit unions. This group is very small in the acquiring arena but have a reasonably substantial number of cards on issue. Accordingly they are substantial net issuers and would benefit significantly from the elimination of EFTPOS interchange.

It does not seem sensible to embark on a reform process that provides a small benefit to a minority of stakeholders, yet effectively increases costs for merchants and customers, and puts the ongoing success and development of EFTPOS at risk.

8.2 Response to Working Group’s Options

The following section responds to the “perceived problems” with the existing system and the options put forward by the EFTPOS Industry Working Group to remedy these supposed problems.

³⁴ Assuming the merchant does not surcharge for the credit card purchase.

8.2.1 Perceived Problems with EFTPOS Interchange Arrangements

The basis for the proposed options by the EFTPOS Industry Working Group are the perceived problems with the existing interchange arrangements. The whole rationale for change seems to be dubious at best and the “potential concerns” are completely unsubstantiated. **In other words, there is no supporting evidence provided for any of these statements.**

The paper itself states that “some participants are satisfied with the current bilateral EFTPOS interchange arrangements, and some with at least the direction of interchange fees”.³⁵ Although the paper does note “other participants are convinced of the need for reform”, there is no evidence of a groundswell for any major reform.

Responses to each of the perceived problems are given below.

- **Fees set through bilateral contracts have been rigid and appear to lack flexibility to change**

The fact that the fees have not changed does not mean there is a lack of flexibility to change the conditions and the fees. **It should be noted that EFTPOS interchange fees have reduced substantially in real terms over the past 15 years** due to the impact of inflation and CPI increases.

In addition, whilst the fees may not have changed during that period, this is not market rigidity as there are many issuers and acquirers capable of providing the requisite services.

- **Direct network access is linked to successful negotiation of an interchange arrangement, which includes an interchange fee, with each counterparty issuer or acquirer**

This is a valid issue and it is possible some improvements could be made in this area. However, there are a number of issues linked to access beyond interchange and these are discussed in more detail elsewhere in the document.

- **This structure leads to difficulties and inefficiencies in negotiating bilateral interchange arrangements due to market and network structure**

We are unclear exactly what form the “difficulties and inefficiencies” take. Certainly the Working Group’s document does not list what these difficulties may be nor does it provide any supporting evidence to verify this claim.

If the structure referred to is the presence of bilateral negotiations on interchange fees, then there is no doubt this is more time consuming than a single multilateral fee that is imposed on everyone. That is the price that is paid for a free market, competitive negotiation process. We believe the current arrangements better conform to normal competitive commercial practice than any of the alternatives. Further, as previously stated in this submission, the current system is working very well and efficiently.

³⁵ “Discussion Paper: Options for EFTPOS Interchange Fee Reform”, EFTPOS Industry Working Group, July 2002, Page 5.

- **There is the potential for shifting of issuer and consumer incentives away from promotion and use of EFTPOS, particularly relative to credit cards**

This statement does not make sense on a number of fronts. Firstly, there is little evidence issuers are actively promoting EFTPOS usage currently. The focus of virtually all issuers in recent years has been on credit cards at the expense of EFTPOS.

Secondly, while there is an incentive for issuers in terms of interchange income for credit cards over debit cards, that has always been the case in Australia. In fact, in the wake of the RBA credit card enquiry, the credit card interchange rate is likely to reduce and the difference between the two interchange rates will be less than it has traditionally been. It is hard to see how this situation has “the potential for shifting of issuer and consumer incentives away from promotion and use of EFTPOS, particularly relative to credit cards”.

- **There is an apparent lack of consistency between EFTPOS payment interchange fees and those for other retail payment types**

If a debit card is used at an ATM, a fee is paid from the issuer to the acquirer. If the same card is used at a retail store, then surely the fee flow should be the same. If it is reasonable for the ATM owner to receive income to cover the cost of deploying and maintaining the ATM and its associated infrastructure, then surely the same principle should be applied for the EFTPOS terminal and infrastructure. This issue is discussed in more detail in Section 4 - The Australian EFTPOS System.

This perceived problem appears to represent a case of “selective arguing”. It is interesting to note that the card issuers did not raise this as an issue during the credit card enquiry. As the joint RBA / ACCC study pointed out:

“In Australia, interchange fees are unique to card networks; they do not apply when customers make payments by cheque, direct credit or direct debit. In those cases, financial institutions seek to recover their costs directly from their own customers.”³⁶

Under this perceived problem, as stated in the Working Group’s document, presumably the same issuers who contributed to the EFTPOS Discussion Paper would argue in favour of zero interchange for credit cards so that there would be consistency between credit card interchange fees and those for other retail payment types, such as cash and cheques.

8.2.2 Option 1 – Bilateral Interchange Arrangements

It is the AIP’s belief that the current bilateral interchange arrangements are working well. As discussed elsewhere in the document, we believe it makes no sense to make any major changes to a system which is already highly efficient and continues to deliver excellent value to the Australian economy.

The major issue in recent years has been the “distorted price signals” resulting from the incentives provided to customers to use credit cards in preference to alternative lower-cost payment methods. As discussed earlier (see Section 4.2 - Efficiency), now these signals are being removed, we should see this “distortion” removed from the market. Over time, we will see a return to stronger usage of debit vs credit.

³⁶ “Debit and Credit Card Schemes in Australia”, joint study by the RBA and ACCC, October 2000, p.i

It is interesting that in the three alternatives provided under “Option 1a - Circuit Breaker”, all three scenarios comprise a reduction in the level of the current interchange fee. If we move to a cost based methodology, then surely fees may increase, decrease or stay the same, depending on the outcome of the cost studies. This point alone demonstrates the thinking of the Working Group - the possibility of an increase in fees has not occurred to them, has not been put forward as an option and would not be countenanced by them.

It is the opinion of the EFTPOS Industry Working Group itself that the options they have put forward involve agreement between the participants on pricing and “could raise Trade Practices Act issues”.³⁷

By their own argument, there are no real positives and many potential negatives in modifying the existing bilateral arrangements. The points made by the Working Group include:

- the existing bilateral fee regime allows “market competition between EFTPOS participants in the setting of interchange fees”
- both options probably have competition implications (which do not exist with the current arrangement)
- there could be increased “administrative and implementation costs”.

We agree with these points. We can see no reason for changes and we can see no valid argument put forward by the Working Group that would justify implementing any such changes.

8.2.3 Option 2 – Multilateral Interchange Fees

There are two options provided here:

- Option 2a Standard multilateral interchange fee
- Option 2b Bilateral fee agreements with multilateral default rate

Both of these options have competition implications and would involve relevant parties setting fees from which they can potentially gain a benefit.

Overseas experience indicates Option 2b would be likely to lead to higher rather than lower fees. Typically a default interchange fee is the highest rate in the market and some parties negotiate lower rates bilaterally. Based on current interchange rates in Australia, this would lead to a default rate of around 25¢, with bilaterally agreed rates between some parties at lower rates.

While there is no over-riding objection to a multilateral fee, it does raise some problems. As outlined in the Working Group’s paper, these include:

- there are some competition issues which may require “ACCC authorisation under the Trade Practices Act”³⁸
- “significant costs could be incurred in the administration needed to establish a multilateral interchange fee”
- “Implementation hurdles would include the need to reach industry consensus on the methodology and ultimate fee levels adopted”

³⁷ *Discussion Paper: Options for EFTPOS Interchange Fee Reform*, EFTPOS Industry Working Group, July 2002, Page 9.

³⁸ *Ibid*, p.11

- there are “practical implementation issues, including any necessary technological changes”

As with Option 1, there is no strong case presented which would suggest it is worth abandoning a successful system in change of something with no real benefits.

However, an interesting point is raised under this option - the ease of access for potential new entrants. One of the benefits of the Canadian Interac scheme is that there is a standard set of software and standard message formats which all participants must use. This approach to standards does have value and merits further investigation.

8.2.4 Option 3 – No Interchange Fees

The rationale for this option is “to establish a ‘middle ground’ fee level (zero) with on-going simplicity of administration”.

First, there is no reason given as to why a zero fee is “middle ground”. The extremities that have been talked about in this paper range from the existing interchange fees (up to say 25¢ per transaction) to no interchange fee as advocated in the joint RBA/ACCC study. Surely middle ground is a fee of around 12¢ paid by the issuer to the acquirer.

Second, how can a zero fee be any easier to administer than a fee set at any other level? Why is a fee of 0 easier to administer than a fee of 12¢? There does not appear to be any justification for asserting that the existing fees are difficult or complex to administer.

It is also hard to understand why the Working Party believes that “A no-interchange option would most likely raise the least Trade Practice Act concerns and may or may not require ACCC authorisation”. If a group of parties who could benefit from the outcome are involved in making changes to the payment system which will almost certainly result in increased prices to consumers, there may well be competition implications.

The key issue here is highlighted by the Working Group themselves:

“A drawback of a no-interchange regime would be lack of flexibility if it were to be determined either now or in the future that issuers or acquirers should be compensated through a non-zero interchange fee. **This could have implications for the long-term sustainability of the network, and the need for continued investment in the existing secure EFTPOS network.**”

There is no evidence that any of the interchange options provided in the Working Group’s paper would lead to a better, more cost effective or more efficient payments system. We believe the existing interchange system is working extremely well. It has been demonstrated over a long period of time that the current system does provide incentives for merchants and acquirers to invest in a secure card processing infrastructure and delivers “long-term sustainability of the network”.

8.2.5 Multilateral Pricing Methodologies

If there is a move to a multilateral pricing methodology, then it is sensible that the prices be cost based. It is also sensible that **all** relevant costs be taken into account. Thus, we believe the first two models (Issuer costs only and Acquirer costs only) are completely inappropriate, as they only take account of a subset of costs.

Similarly, “Option C - Net of issuer and acquirer costs” should be rejected as it is not inclusive of all relevant costs. If an acquirer’s costs include the cost of, for example, deploying card terminals and PIN pads, associated development costs, the costs of communications, etc., then logically when these costs are paid by the merchant they should also be included.

Indeed, if we are to have an approach consistent with the “user pays” principle, as outlined in the Discussion paper, then the merchants’ costs must be included. The Working Group specifically states that under the “user pays” model the issuer would compensate the acquirer for “secure network access, cash-out services, and other services.” The same argument must allow for exactly the same situation to apply between the acquirer and the merchant.

The current EFTPOS arrangements already work on the “user pays” principle, with the actual level and flow of fees between issuers and acquirers and between acquirers and merchants being determined by normal market competition.

A final word must be said about the statement that “The rationale for this approach (*Option C*) would be that both cardholders and merchants receive benefits in the EFTPOS system”. While this is true, it should be understood that there are also significant benefits for issuers and acquirers from the EFTPOS system. As discussed earlier, the banks save on costs from branch closures, migration of payments to electronic processing, and receive many other benefits. If these parties did not receive any benefits from EFTPOS they would have exited long ago in the same way they have closed branches.

EFTPOS usage has continued to grow strongly and the banks continue to issue debit cards to customers without any income from interchange. In fact, according to RBA figures, the number of debit card accounts actually grew at a slightly higher rate than for credit cards between May 1994 (the earliest figures available) and May 2002. This is despite the impact of spend based loyalty programs in raising credit card numbers.

9. Access

The main focus of the paper from the EFTPOS Industry Working Group was on the level and direction of interchange fee payments. The subject of access was briefly raised as a potential area of discussion, but without much analysis.

The AIP believes that negative interchange is one of the key strengths of the Australian debit payments system, as discussed earlier. There appears to be no genuine argument for altering the present interchange arrangements, and indeed many arguments for retaining them.

There is however, considerable scope for future reform with the objective of improving the efficiency and safety of the national debit payments system, by improving access to the system for new and smaller entrants. Additional issuers, acquirers and processors should lead to increased competition and increased usage. Both of these factors should lead, in turn, to lower costs per transaction over time and lower prices for merchants and other users of the system. This has been clearly demonstrated in Canada (see above).

More open access to the debit system would also be more consistent with the approach taken by the Payments System Board of the RBA towards the credit card system, where new regulations are being put in place to remove barriers to entry, allow increased competition and greater transparency.

For merchants, the prospect of new acquirers being allowed to enter the credit card system, but not being allowed to also enter the debit card system, raises the probability of having to contract with different acquirers for credit and debit. For smaller merchants, this would be difficult to manage as most rent their card terminals from their acquirer, and cannot justify having multiple terminals for different card types. This is likely to generate an outcome where only larger Australian merchants could take advantage of the availability of new credit card acquirers.

It is an important principle that all benefits of card system reform should be genuinely available to all merchants and acceptors of card payments.

At present, "membership" of the debit card system is effectively restricted to Approved Deposit-Taking Institutions (ADIs). Even for ADIs however, it is a long lead time and expensive process to become a full and equal player in the system.

The current structure of bilateral commercial contracts requires new entrants to negotiate pricing, settlement and processing agreements separately with each of the other members. Existing participants can make use of this situation to delay and frustrate the aspirations of organisations that they may perceive as potential new competitors.

A further barrier to entry is the current array of technical interfaces required to implement interchange with the processing systems of other debit issuers and acquirers. While the AS2805 protocol framework has now been adopted by all card processors in Australia, the standard leaves plenty of scope for individual interpretation in implementation. This creates the necessity for some level of specification, development, testing and certification for each interchange link that is put into place.

It is recognised and accepted that only ADIs may take monetary deposits from individuals and operate their accounts. This does not mean that only these same institutions should be able to act as issuers or acquirers of debit cards.

If a non-ADI organisation were to operate as an acquirer of debit cards, without being an issuer, there is no requirement to hold or operate deposit accounts. If this acquiring organisation was subject to the same APRA regulation and oversight as proposed for specialist credit card acquirers, the risks would appear to be minimal. This would also simplify the procedures for admitting and auditing new entrants to the acquiring market, as one set of regulations and one oversight process would cover both the credit and debit systems.

For new acquirers to be encouraged to enter the Australian market, the ability to acquire both credit and debit cards is required for them to be genuinely competitive with other acquirers already in the market. If their acquiring activities are restricted to credit cards only, their offer to prospective customers is much weaker.

The potential also exists to allow non-ADIs to issue debit cards which access the accounts of cardholders held by ADIs. The cardholder would have to give the card issuer permission to access the account, on the same basis as merchants are today given permission for Direct Debit Authority for customer payments. The card issuer would be required to have each payment transaction authorised on-line by the account holding institution in order to check the account balance. This would help drive down costs by introducing an alternative access means to customers' accounts.

At present, within the Australian Payments Clearing Association, the group responsible for the Consumer Electronic Clearing System (CECS) is establishing a set of technical policies and agreed standards for the debit system. It may be possible to expand the role of this body to include commercial terms and to broaden its membership to include new entrants to the system.

Lastly, it will be important to move towards removing some of the technical barriers over time, to reduce the time and cost required to establish interchange links with all other acquirers, issuers and transaction processors. In addition to agreement on security measures such as key management, a standard implementation of the AS2805 protocol for debit processing and procedures for reconciliation and settlement, a body for conducting the testing and certification of new ATMs and card terminals could also be established. All these measures would lead to greatly reduced technical costs and shorter lead times for new entrants to become established in the market.

The success of the Canadian debit system since access was opened by the Competition Bureau in 1996 demonstrates the potential for such an approach in Australia. The AIP believes that improved access underlies the trend towards improvements in efficiency in Canada, and that a similar result could be achieved here. In Canada the improvements in usage and reduced costs flowed from changing the access arrangements, and lowering associated barriers to entry.

10. Recommendations

This section provides a brief bullet-point summary of the major recommendations of this report. The reasons and rationale for these recommendations are contained in the relevant sections of the body of the report. The recommendations are not listed in any particular order of importance.

- extend the timeframe of the EFTPOS review to allow proper consideration of all issues and the impact of any changes
- reconstitute the Working Group to make it representative of all stakeholders - specifically issuers, acquirers, merchants and cardholders
- expand the scope of the review to cover all debit cards, including international “scheme” debit cards, and broaden the focus beyond interchange
- ensure the review process is completely open and transparent, as has been the case with the credit card investigation
- investigate opening access to the EFTPOS system to non financial institutions for both issuing and acquiring
- implement standard software and interfaces to the EFTPOS system, as per the Canadian Interac model, to reduce barriers to entry
- do not conduct the review of ATM interchange in isolation to the review of EFTPOS - there are many inter-related issues
- ensure that all stakeholders’ costs are included in any economic evaluation of EFTPOS, not just those costs incurred by issuers and acquirers
- ensure all parties, including members of the EFTPOS Industry Working Group, make submissions and that time is given for analysis and response to these submissions
- under no circumstances should the “direct charging” model (as is being considered for ATMs) be considered for EFTPOS
- ensure the relativity to other reviews (credit, Visa debit, ATMs) is covered.
- ensure that no debit cards (either EFTPOS or scheme debit cards) in Australia are allowed to have ad valorem interchange fees
- do not change the existing EFTPOS interchange arrangements as they have been instrumental in providing Australia with a world class system and delivering long term sustainability of the EFTPOS network.

11. Appendix 1 Letter re Timeframes and Process

Below is a copy of a letter sent to The Governor of the Reserve Bank of Australia by the AIP.

30 August 2002

The Governor
The Reserve Bank of Australia
Martin Place
Sydney NSW 2000

Dear Mr MacFarlane

EFTPOS Interchange Reform

I am writing to outline the serious concerns of the Australian Institute of Petroleum (AIP) and its member companies over the process that has been adopted for consideration of EFTPOS interchange reform, and to recommend a restructure of the review process to address these concerns.

The Australian Institute of Petroleum is the industry association representing the interests of companies involved in the downstream petroleum products industry. Its members include:

- BP Australia Ltd
- Caltex Australia Ltd
- Mobil Oil Australia Ltd
- The Shell Company of Australia Ltd

Our member companies are major stakeholders in EFTPOS interchange. Oil companies were at the forefront of the introduction of EFTPOS to the retail sector, through their service stations. All the companies have invested many millions of dollars in the development of EFTPOS systems and the installation of EFTPOS terminals at service stations. As part of the justification for this investment, each of the companies has over time established contracts with the relevant acquiring bank, under which part of the interchange fee paid by the issuing bank to the acquiring bank was paid in turn to the retailer oil company, in recognition of capital and operating expenditures incurred by the company. I must stress that these are real costs, and of course need to be recovered.

The downstream oil companies are therefore major stakeholders in EFTPOS. They each contract with the relevant acquiring bank, in arms length negotiations, for the commercial arrangements underlying their EFTPOS investments and operations. These contracts are affected directly by EFTPOS interchange fee arrangements.

It was therefore with the utmost concern that AIP learnt at a very late stage that there was a process in place, apparently with the full knowledge of the Reserve Bank, to reach an agreement between banks over the reform of EFTPOS interchange fees. These concerns centre on:

- The apparent disregard of retailers as major stakeholders in the issue.
We understand that the EFTPOS Reform Working Group has been active since February this year. However, retailers were only briefed on 4 July 2002, with a deadline for comment by 31 July. While this has since been extended in our case to early September, after protest, retailer stakeholder views still are seemingly treated as little more than an afterthought.
- The lack of transparency in the review process.
The review process is being undertaken by a working group of financial institutions, whose common understanding of the issues could lead them to disregard the interests of other stakeholders such as consumers and retailers. Although there was one retailer included, at a late stage, this person was there in an observer capacity only.

Retailers are now required, at almost impossibly short notice, to make submissions to this working group, which the working group can choose to ignore, when making their recommendation. There is no requirement for the financial institutions to make submissions or to state their policy.

In practice, from the perspective of retailers, the review process allows just one of several parties to a commercial transaction to act as judge and jury on the interests of all parties, effectively without appeal.

- Competition issues.
The review process raises competition issues because arguably it could amount to an agreement amongst financial institutions to rearrange a market structure amongst themselves, in a way that can impact significantly and adversely on contractual arrangements with retailers and ultimately on the consumer.

It is widely understood that a major reason for the EFTPOS review was that smaller financial institutions, especially those that issued Visa Debit cards, considered that they stood to lose substantially from the proposed review of credit card fees, and wanted to recoup some or all of this loss from a review of EFTPOS interchange fees.

Such recoupment would be at the expense initially of some of the major acquiring financial institutions, which would need in turn to recover lost income from other sources. It may be the case that the acquiring institutions will try to recover these revenue losses from their customers – retailers, large and small – which must put upward pressure on prices to consumers. Overall, it is hard to conceive a positive outcome for consumers, and there is a real risk that benefits to the smaller financial institutions will ultimately be paid by retailers and their customers.

The Australian Competition & Consumer Commission (ACCC), with the Reserve Bank, has given an informal view of the future of EFTPOS interchange fees. AIP understands that the ACCC has also been advised of the EFTPOS review process, but has not authorized it. AIP reserves the right to alert the ACCC to its concerns, especially in regard to the potential effect of agreement between financial institutions on the commercial arrangements between banks and retailers and to the potential increase in costs which would need to be passed on to consumers.

AIP will be lodging a submission by the agreed deadline. However, AIP believes strongly that the EFTPOS review process is severely flawed. If it is to proceed, it must be restructured to remove the concerns outlined above.

Any such review process must be independent and transparent, with the outcomes reflecting an impartial balance of the views of the affected parties and the effects on the community. AIP recommends therefore the following process be put in place:

1. The Reserve Bank to take the direct lead role in the EFTPOS review.
2. All parties, including members of the working group, to be invited to make submissions to the Reserve Bank.
3. Submissions to be able to cover all related matters, including the potential for the replacement of current EFTPOS arrangements by scheme debit cards such as Electron and Maestro.
4. These submissions to be public documents, except where commercial confidence applies, with all parties able to comment on the views expressed in submissions.
5. Full recognition to be given to the effect on changes on EFTPOS/ATM arrangements on retailers and the consumer.

Given the short time frame before the deadline for submissions expires, we will be seeking to brief you personally on the issues outlined in this letter, and will contact your office in this regard.

Yours Sincerely

Bryan Nye

Executive Director