MasterCard International

Reform of Credit Card Schemes in Australia

FOR PUBLIC RELEASE

Response to the December 2001
Consultation Document
of the
Reserve Bank of Australia

MasterCard International Incorporated
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EXECUTIVE SUMMARY

The benefits of credit cards are widely acknowledged. The Consultation Document refers to the credit card system in Australia as being "world-class," as providing Australian cardholders a "range of services," and as being "convenient and widely accepted both in Australia and abroad." For merchants, it is noted in the Consultation Document that "credit card acceptance forms part of their competitive strategy of attracting sales from, or not losing sales to, rival merchants."

MasterCard is pleased that the Bank acknowledges that (1) "interchange fees play a pivotal role in determining the incentives for consumers to use, and merchants to accept, credit cards," and (2) "some minimum entry standards" for participation in a scheme "can be justified because credit card issuing and acquiring does generate risks" and that "reliance on prudential supervision by APRA may provide a cost-effective and objective screening device to determine eligibility for membership." MasterCard regards interchange fees as necessary to the existence of four-party credit card systems and membership eligibility restrictions as necessary to minimising the risk inherent in issuing and acquiring. As such, both interchange fees and membership eligibility standards serve the public interest and are of benefit to cardholders and merchants.

MasterCard welcomes any measures that improve the competitiveness and efficiency of payment systems. MasterCard believes however, that the proposals of the Bank in the Consultation Document will have a significant adverse impact on the four-party credit card schemes operating in Australia. As a result, the benefits of credit cards referred to in the Consultation Document will be severely eroded and the proposals will actually decrease the competitiveness and efficiency of the Australian payments market, impacting badly on consumers and merchants alike.

The Public Interest Test

The public interest test is at the heart of the obligations imposed on the Bank, and its proper application is essential to a meaningful consideration of the proposals. The central notions of efficiency and competition underlying the public interest test as a guiding principle for Australian competition policy originate with the Hilmer Committee (1993). They also inform the work of the Wallis Committee (1997), carry over into the Joint Study of the Bank/ACCC (2000) and find their way into the 2001 Consultation Document where they are transformed into a set of competition benchmarks for the purposes of applying the public interest test to the Bank's proposals.

Unfortunately, the five competition benchmarks set forth by the Bank as "underpinning the public interest test in the payments system" are seriously flawed. They do not correctly reflect the general principles on which the public interest test is based. In fact they are incomplete, misleading and inconsistent with basic economic principles. Their use would give rise to a misapplication of the public interest test to the operation of four-party credit card schemes and seriously prejudice the future viability of these schemes with consequent adverse effects on both cardholders and merchants. These benchmarks are a main reason why the proposals in the Consultation Document will not achieve the desired objectives of the public interest test.

MasterCard, therefore, does not believe that the Bank's proposals are in the public interest and that indeed, in several major respects identified in this Response, they are directly contrary to the public interest and, on that basis alone, should not be implemented.

Additionally, MasterCard maintains that the Bank's consultation obligations have not been satisfied, because all of the information that is necessary in order for MasterCard to make informed comments on the proposed regime and standards have not been made available. As such, the Bank should not proceed until the further information identified in the body of this Response has been made available and interested parties have had a reasonable opportunity to comment on that further information.

Competition in Payment Systems

A key theme of the Bank's analysis is that competition is not working in the payments market in Australia, especially with regard to four-party schemes. The Bank's position, as presented in its Consultation Document, reflects a lack of appreciation of the dynamism, complexity and intensity of competition within the four-party schemes and between four-party schemes and other payment service providers.

The four-party schemes operate with several levels of competition simultaneously. The schemes compete against each other. The issuers, within the same scheme as well as between the schemes, compete against one another. Similarly the acquirers compete against one another. The members of the four-party schemes also compete with the three-party schemes, private label store cards, debit cards, cheques, direct entry and of course cash. In fact MasterCard's total share of the payments market properly defined is less than 2%. There should be no doubt therefore that substantial competitive pressures are faced by MasterCard and the other four-party credit card schemes.

The Cost of Cash

Another serious flaw in the Bank's analysis and proposals is its inadequate consideration of the true cost of cash. The cost to merchants of handling cash is high. For example, the Prices Surveillance Authority of Australia has reported that, "the security and administrative costs to merchants of holding cash means that cash transactions are not necessarily less costly than credit or charge card transactions. Myer Stores and the Retailers Council of Australia submitted that costs of cash sales (in-store collection from cash registers, counting in the back office, security transport services, inaccuracies, etc.) were only marginally less than the costs associated with credit cards (merchant fees, chargebacks, costs of authorisation and delay in cash reimbursement)." Moreover, the Bank completely fails to consider the societal costs of cash which by some estimates could be as high as 5%.

Is Debit Better?

The Bank's stated preference for online debit cards contradicts its own stance of encouraging more competition in the payments market in Australia. By definition, issuers of debit cards must be banks with savings deposit accounts to service the debit cards. Given the relatively homogenous nature of debit card products (compared with the varieties of service configurations and features of credit cards), it is clear that large banks with their economies of scale will be able to compete most effectively and with regard to debit cards. By contrast, smaller institutions, by offering cards with features their cardholders want, can effectively compete for credit card business. Some of the largest credit card issuers in the US today were relatively small banks when they entered the credit card business. So the Bank's stated preference for debit cards is actually a competition restricting preference.

Australia's Interchange Rates are Amongst the Lowest In the World.

While the question of whether the interchange fee is too high in Australia cannot be answered without understanding the respective net benefits to the cardholders and the merchants, who are the customers of the four-party credit card schemes, some insight can be gained by comparing Australia's interchange fees with those other countries. Australia's rates are lower than in most countries, including significantly larger countries like the United States, the United Kingdom, Germany, and Japan.

Inadequate Consideration of the Closed Schemes and Store Cards

Four-party payment card systems were developed to overcome the limitations inherent in three-party systems. In a four-party system, cardholders can use their cards at any and all merchants acquired by any financial institution in the system, and merchants can accept cards issued by any financial institution in the system. Four-party systems can easily expand (by signing up additional financial institutions), even globally, allowing for the exploitation of economies of scale on a level that few three-party systems can match. In addition, four-party systems create a level of competition, intra-system competition, that cannot exist with three-party systems. These are the things that gives rise to the efficiencies of four-party systems and the lower cost of operating such systems.

Four-party systems, therefore, have many benefits when compared to three-party payment systems, including:

- Widest possible issuance and acceptance at low transaction costs;
- Intra-system competition in each of the issuing and acquiring functions;
- The ability of smaller banks to participate in global payment systems and therefore remain competitive with larger banks in their local banking market;
- Access to global payment systems by smaller merchants who otherwise could not offer their customers the same payment options as larger merchants; and
- Global brands, which create value for consumers, especially travellers.

But, as noted, four-party systems require interchange fees in order to function. Thus, the benefits of four-party systems would be lost if interchange fees were set too low, that is, below the level that allows four-party system issuers to recover a significant portion of their costs from merchants. Such a scenario is likely to lead to small issuers exiting the business entirely and large four-party issuers/acquirers migrating their businesses to the more expensive and less efficient closed systems (since closed system operators can recover a share of their costs from merchants without the need to set interchange fees), a bad result for cardholders and merchants alike.

The Impacts of the Proposals

The Bank erroneously believes that by making four-party systems less attractive to cardholders, debit cards will become the preferred payment option in Australian retailing. In fact, the more likely outcome is that three-party credit card offerings will replace four-party scheme offerings.

The Bank erroneously believes that, if four-party scheme acquirers were forced to drastically cut their merchant service charge, three-party system operators would have to follow suit. This is a naive view of the market. When faced with a situation in which government intervention forces four-party scheme issuers to raise their prices to cardholders, three-party system operators will do everything possible to take business away from them. This means that, instead of adjusting their merchant service charges downward as the Bank believes, they will use their greater ability to collect revenue from merchants to fund superior cardholder programs.

Since three-party systems are less efficient, more expensive, less competitive, than four-party systems, the mandating of lower four-party scheme interchange fees for the four-party schemes, by as much as the Bank effectively proposes, will most likely lead to higher fees and a reduction of benefits. This can be demonstrated by considering the four possible responses of four-party scheme issuers to a mandatory reduction in interchange fees:

1. Do nothing in response to the reduced interchange fees.

2. Attempt to recover lost interchange fees through higher cardholder fees.

3. Attempt to recover lost interchange fees through bilateral interchange fee agreements, and

4. Attempt to recover lost interchange fees by charging merchants directly – that is, large issuer/acquirers becoming three-party system operators.

The first scenario of doing nothing is highly unlikely given that, based on the Bank's own numbers, the amount of interchange fee revenue that credit card issuers stand to lose under the Bank's proposals exceeds the entire profits of the industry.

The second scenario of raising cardholders' fees would actually be worse than the do nothing scenario. Given the empirically demonstrable high elasticity of cardholder demand and the ability of cardholders to switch to cheaper three-party credit cards, issuers will lose so much business if they raise cardholders' fees that they will actually be worse off than if they do nothing. This dramatic result underscores how quickly an otherwise efficient and low cost four-party scheme could be unraveled in a scenario of arbitrary government intervention. In addition, smaller issuers, which typically have a higher proportion of the "interchanged" (as opposed to the "on us") transactions will suffer most. As they exit the business, credit card issuance will become concentrated in the hands of a few large banks.

The third scenario of issuers relying on individually negotiated bilateral interchange fee agreements will likely not work, since it would undermine the "honour all cards" rule, one of the pillars of four-party payment systems. Even if bilateral interchange fee agreements were possible, the likely result would be higher merchant service fees. A leading European economist, Professor Carl Christian von Weizsäcker states in his analysis of the economics of credit cards that *"merchants are likely to pay more under conditions in which interchange fees are set bilaterally."* Moreover, the significant transactional costs that would be incurred in each bilateral process, and the large number of bilateral agreements that would be needed, would make a structure of bilateral agreements extremely costly to implement and maintain.

The fourth scenario emerges to be a most likely one over time. After solidifying their position by acquiring the businesses of their smaller issuer-only rivals, large four-party issuer/acquirers could start operating their own three-party systems. Professor von Weizsäcker has concluded in his analysis that this is likely to occur should four-party interchange fees be eliminated or severely reduced as a result of government regulatory intervention, and MasterCard believes that the level of reduction effectively sought by the Bank would likely have this effect. In this scenario, as the weakened four-party schemes lose market share, three-party schemes will gain market share at their expense. The three-party systems in Australia charge, on average, merchant fees more than 50% than those charged by MasterCard member banks. Hence, merchants will be worse off under this scenario. Moreover, the resulting reduction in competition and increase in the costs of credit cards cannot possibly be in the public interest.

Credit Cards and Levels of Consumption

The Consultation Document states that increased consumption as a result of credit availability is a one time only increase – that it is a simple inter-temporal substitution of consumption in which consumers spend today instead of what they plan to spend in the future. This is a claim that defies even the most basic understanding of macroeconomics.

Elementary economics informs that there is a special case under which a temporarily induced increase in aggregate demand would not have a permanent positive impact on the economy. This is the case in which all available production resources (capital, labour, land, and others) are fully engaged. Thus, if the Bank is seriously suggesting that an increase in consumer liquidity due to the use of credit cards does not have sustainable positive impacts on the Australian economy, then the Bank must be saying that there are no idle and under-utilised economic resources in Australia.

It does not take specialised expert knowledge to reject this assertion. As long as there are resources not yet fully utilised in Australia, an increase in consumer demand, via the line of credit available on Australians' credit cards, will bring into production previously idle, or under-utilised, resources. This will in turn create new investment and business opportunities, followed by new employment opportunities, followed by higher consumer incomes – the well known "multiplier effect." Higher consumer incomes will allow consumers to spend more than they would without their initial increase in credit card-funded spending. Thus, the initial spending does not have to be a substitution for future spending if it stimulates increased utilisation of idle or under-utilised resources.

The Treasurer recently was quoted as saying Australia's healthy economic growth has been helped by strong retail spending in late 2001. Retailers reported in December that their strong sales were fuelled by credit cards. It is an indisputable fact that Australia's consumption-driven economy is buoyed by the ready availability and responsible usage of credit cards.

Restrictions on Merchant Pricing (the "No Surcharge" Rule)

The Consultation Document takes the position that permitting surcharging is necessary in order that merchants can pass along to their customers the allegedly higher costs of accepting credit cards. The Bank overlooks the fact that MasterCard does not prohibit merchants from offering cash discounts. Cash discounts enable merchants to recoup, if they wish, the cost of credit card acceptance, while protecting cardholders from price gouging and the other negative consequences of merchant surcharging. The experience in those countries in which surcharging is allowed is that few merchants actually do it, which is consistent with MasterCard's view that, by accepting MasterCard credit cards, merchants receive a valuable service at a fair price. Surcharging (but not cash discounting) is also inconsistent with the "honour all cards" rule, since surcharging can be used to discriminate against cards that merchants have agreed to accept.

Contrary to the Bank's assertion, there is no reason to believe that surcharging leads to a general reduction in consumer prices, or that forbidding surcharging leads to distorted "price signals." Rather, it is surcharging that leads to price distortions since it means that some cardholders end up paying more than the posted or advertised price for goods and services. It is also noteworthy that the European Commission recently approved the Visa "no surcharge" rule.

The Bank's Proposed Access Regime

The Bank's suggestion that MasterCard's membership eligibility rules and policies erect entry barriers is unfounded. MasterCard notes that the Bank's proposal regarding access to the four-party schemes is essentially consistent with MasterCard's current membership rules and policies. Under the Bank's proposal, any new member would have to qualify as a financial institution (under proposed amendments to the Banking Act) and be supervised by APRA. This is essentially what MasterCard's rules require. However, the Bank's proposals are incomplete – for example, APRA has told MasterCard that it has not even begun to draft the prudential standards that such new financial institutions would have to meet. Therefore, MasterCard cannot comment effectively on the Bank's proposed access regime, and no action should be taken in this regard until this failure of the Bank to meet its consultation obligations under the PSA Act has been rectified.

MasterCard is concerned with the Bank's proposal to permit so-called "self-acquiring. Self-acquiring is inconsistent with the obligations of the acquirer to enforce merchant compliance with scheme rules and to take such steps as may be necessary to insulate the scheme from the risk of merchant failure. The recent collapse of such large merchants as Ansett Airlines proves the importance of this concern. The Bank has indicated that the four-party schemes would be permitted to enforce policies to minimise the risk of self-acquiring and this should be specified in the proposed access regime.

MasterCard is also concerned with the Bank's proposal to abolish the so-called "net issuer" rule. As the smaller of the international credit card schemes in Australia, MasterCard fears that this could lead to members devoting most of their resources to issuing the other brand's cards, and to limit their involvement in the MasterCard scheme to acquiring. This would be bad for competition generally and for cardholders in particular.

Specific Comments on the Consultation Document

The Consultation Document is riddled with unsubstantiated assertions, internal contradictions and inaccurate statements. While too numerous to summarise, a few of the most egregious errors are described briefly below.

The setting of interchange fees is <u>not</u> *prima facie* anti competitive, as the Bank asserts. Interchange fees have been determined not to be anti competitive by the U.S. federal courts, and no court anywhere in the world has ever held to the contrary. Moreover, the competition laws of most developed nations recognise that certain types of cooperative price-setting behavior, even among competitors, may be allowed. Moreover, the Bank neglects to mention that the collective setting of prices by joint ventures is specifically permitted in most market economies and is specifically recognised in Australia's *Trade Practices Act*.

The Bank alleges that MasterCard's interchange fees have not been reviewed by on the basis of a formal methodology. This is incorrect. MasterCard's Australian members engaged Edgar Dunn & Co. in 1996 to undertake an interchange cost study of credit cards. This study, which used the MasterCard interchange fee cost-based formula (which measures the cost of the payment guarantee, processing costs and the interest free period), indicated that the rates as they stood then in Australia were slightly below measured cost for electronic transactions, and slightly above measured cost for standard transactions. The members chose not to adjust the rates at that time. Due to the subsequent rapid growth of electronic transactions as compared to standard transactions, the average effective interchange fee would actually have been higher today had members adjusted the rates according to the results of the 1996 Edgar Dunn study.

The Bank states that Baxter's analysis does not establish that interchange fees would be set at an economically efficient level if it were set collectively by a scheme. What the Bank fails to mention is that Baxter also says that, if it were not set collectively, it would "almost certainly produce chaotic results, such as higher fees and instability within the card systems" (as quoted in the Commissioned Report by Professor Katz at p.25).

The Bank states that the claim that "people spend more on credit cards" is not supported by data provided to the Bank by the Australian Retailer's Association and some major retailers. However the claim is supported by the Bank's own Transaction Cards Statistics Collection data. The Bank needs to explain why it prefers to rely on others' data over its own.

Professor Katz is cited to support the Bank's opinion that the collective setting of interchange fees may lead to excessive use of credit cards. Professor Katz argues that merchants willingness to accept cards is a poor measure of the effect of card acceptance on merchant welfare. In other words the Bank and Professor Katz, without providing any supporting material, suggest that merchants do not act rationally. In fact merchants are always seeking to maximise sales and minimise costs, and as such, would not be willing to accept credit cards were it not adding to their total welfare. Recent studies show merchant sensitivity to increases in merchant service fees leads to a dramatic alteration of merchant behaviour. Indeed the fact that American Express and Diners Club have lower acceptance than MasterCard in Australia is a testament to the price sensitivity of merchants.

The Bank's argument that there is insufficient competition in the credit card business relies on the assumption that merchants have no choice but to accept cards at the prevailing merchant service fees. The fact is that the major merchants have driven down the margins of acquirers' on credit cards to extremely low levels MasterCard understands that Coles Myer is paying merchant service fees that are only about 10 basis points higher than interchange rates and in some instances is paying merchant services fees that are equivalent to the interchange rates.

The Bank's draft Wholesale Fees Standard lacks the necessary information which is needed in order for MasterCard to be able to make informed comments on it. No definition is even provided of what is a "credit card," yet the standard is supposed to apply to interchange fees in respect of credit card transactions. Communications with the Bank suggest that what is a "credit card" is what the schemes and its members currently recognise as "credit cards". This response belies the complex nature of this matter, the fact that there is no standard for defining a credit card. A comprehensive definition of "credit card" is required to be included, and such definition must be flexible enough to accommodate new products and the normal competitive process.

MasterCard's concern that surcharging could lead to price "gouging" of credit card users by merchants is dismissed by the Bank without regard to the evidence and with a shocking lack of concern for consumer well-being. For example, the Bank's states, incredibly, that taxis in Australia are not exploiting their customers when they impose a 10% surcharge for use of credit card because the taxi industry is simply "protecting its own" payment system, Cabcharge. Cabcharge imposes a 10% surcharge on its own proprietary charge card as well as on all other cards, including debit. It is troubling that the Bank apparently believes that it is permissible for an industry to overcharge the customers of a competing payment system in order to protect their own.

In dismissing concerns over issuer risk on the grounds that these are generally fairly predictable, the bank overlooks the fact that issuers must be vigilant in monitoring the performance of their portfolio and matching risk management carefully with marketing and portfolio expansion efforts so that they do not find themselves assuming more risk than they previously anticipated. In addition, issuers must monitor prevailing economic conditions and other factors that could result in otherwise unanticipated increases in default levels. The history of the credit card business is replete with examples of issuers that found themselves in financial difficulty because they did not properly manage credit risk.

The Bank's suggestion that credit cardholders currently pay nothing for the use of credit cards is erroneous. Annual fees in Australia can range from zero (for non-interest free days cards), to approximately $300 for a Platinum MasterCard. The typical fee is approximately $40, late payment fees in the range of $30 are typical, and 80% of cardholders who at one time or another use the credit facility pay interest charges ranging from introductory rates as low as 3.5% to standard rates approximately 17% per annum. In fact the low interchange rates in Australia are reflected by the fact that credit card holders are typically asked to pay more. In the United States and UK for example annual fees are uncommon.

The Bank's comments on the impact of the proposals on small credit card issuers are puzzling and troubling. MasterCard would have thought that the Bank would be endeavouring to encourage those smaller banks to stay in the credit card business. This is particularly the case because the ability of a financial institution to issue a credit card could be an important factor in a person's decision as to which institution will be their bank. Apart from the Bank's lack of concern over the fate of smaller financial institutions and the long-term effect that this might have on competition in the Australian banking industry, the Bank's analysis is flawed because it is inconsistent with the Bank's obligation under the Payment Systems (Regulation) Act to act in a manner that promotes competition and the public interest.

Critique by Professor von Weizsäcker of Economists Cited in the Consultation Document

MasterCard invited Professor Dr. C Christian von Weizsäcker to critique Professor Michael Katz's *Reform of Credit Card Schemes in Australia II* report commissioned by the RBA. Professor von Weizsäcker holds a chair in economics at the University of Cologne and is the director of its Institute of Energy Economics. Among others he is a member of the academic advisory board to the German Economics Ministry and until recently was the head of the German Monopoly Commission. Professor von Weizsäcker has an international reputation in the fields of industrial economics and antitrust economics and has published widely on the subject.

Following is a summary of Professor von Weizsäcker's main observations:

The models cited by Professor Katz in his Commissioned Report (a) neglect to accommodate Gresham's law and price coherence and (b) assumes that the number of competing payment systems is exogenous. It is very risky to do a public interest analysis with models that are not able to generate fairly basic phenomena of real business life. Policy conclusions concerning payment systems should be based on models that are sufficiently rich as to generate results consistent with "price coherence" and to take into account the possibility that government intervention may actually reduce the number of competing payment systems. If Professor Katz is prepared to rely on models with only two payment systems, credit cards and cash, he should at least agree with those who believe that all payment systems are in the same relevant market.

Professor Katz' is concern about externalities and the possibility that credit card acceptance is a zero-sum game between merchants overlooks the fact that, as in any competitive market, consumers (and society) still benefit from a choice of payment schemes even if merchants do not. The arguments put forward in the Katz paper to show that there may be excessive use of credit cards are unlikely to hold in more realistic, "richer" models of the payment process.

No-surcharge rules imposed by credit card associations ensure that the quoted price is the maximum price that a given customer will be charged. This rule benefits consumers as they can still benefit from a price decrease if they pay cash and are protected from being charged excessive surcharges in situations of limited choice of payment means.

Professor Katz' (and some other commentators') argument that credit card associations and their price setting should be regulated to improve social welfare fails to consider the ability of regulation to improve social welfare in this area. It is not possible for government intervention to internalise every possible market externality. Their attempting to do so in an area as complex as payment systems is likely to have adverse consequences.

Competition between payment systems without price regulation is likely to lead to better results.

Purchasers are highly selective in their choice of payment systems and therefore competition among payment systems for cardholders is fierce. With merchants: even if there are many payment systems available they will find it in their best interest to accept quite a few of them. Under competitive conditions, we therefore expect a large part of the cost of payment systems to be covered by merchants. Decisions taken by purchasers and merchants about the number of payment systems are interdependent. If the annual fee and the transaction fee of purchasers is driven down by competition, then the number of payment systems of which the representative purchaser becomes a member rises. The more cards the purchaser carries around the lower is the pressure on merchants to accept additional payment systems, since the purchaser with many cards is more likely to hold a card which the merchant accepts even if the merchant does not accept all cards. If payment systems were forced by government decree to raise the proportion of revenue obtained from cardholders, this would mean that price competition on the cardholder side would suffer. But higher prices for cardholders implies a reduction of the average number of cards purchasers hold, making it more difficult for merchants to avoid acceptance of any given payment system. This declining choice for merchants could lead to higher merchant fees. If the intention of the government is to reduce the cost of payment systems to merchants, such a government decree could be counterproductive.

Regulating interchange fees without a realistic view of the consequences of such regulation may lead to the demise of open (i.e., four-party) systems. They are likely to be replaced by closed (three-party) systems, which are not exposed to interchange fee regulation. These closed systems may be more expensive for the economy because their acquisition cost of merchants and cardholders are likely to be higher: The end result could be more expensive payment systems.

The services a payment system provides on the occasion of its use in any particular transaction are two linked services: As we know from economics, it is not possible to isolate the separate costs of two outputs which are of necessity produced in fixed proportions. Therefore it would be a mistake to try to decompose the set of all activities of the operator into 1) the set of those activities of the operator that create costs for the service to the cardholder and 2) the set of those activities that create a service to the merchant.

Moreover, the activities of issuers tend to be more costly than the activities of acquirers. For example, the issuing bank bears the cost of the payment guarantee, *i.e.*, the costs of default and fraud, as well as of the interest-free period. The issuing bank also has larger administrative and processing costs than the acquiring bank: The turnover effected by a credit card system spreads over many million cardholder customers and only over a number of merchants which – as indicated by research on the United Kingdom – may be in the order of 100 times lower. Hence, a four-party credit card system under competitive pressure can only work if reimbursements of some of the costs of issuers occur out of the fees obtained by acquirers from their merchants. Since a fallback interchange fee is indispensable for the working of a four-party credit card system, a multilateral agreement to implement such a fee is not price fixing.

Professor Katz apparent view that government regulation of the interchange fee is desirable and that the regulator should try to ascertain “legitimate” costs and set a maximum interchange fees accordingly or, alternatively, determine the ”best” formula for setting interchange fees and require all four-party systems to use the formula, is too simplistic. Government is not in a position to find the socially optimal level of the fallback interchange fee. Given that there is competition between payment systems and that markets are dynamic, not static, it is not at all clear that the current costs of operating the system are a good guideline for the interchange fee. A system that wishes to expand may need to increase interchange fees to encourage issuers to invest more in the system or it may need to lower interchange fees to encourage wider acceptance or greater merchant investment in the system. Given all this Professor von Weizsäcker finds it highly implausible that a government regulator of interchange fees can do better for the public interest than the competition between payment systems which we observe in the real world.

INTRODUCTION

1. MasterCard's Response to the Consultation Document

This Response is provided by MasterCard International Incorporated ("MasterCard") in response to the document released for public comment by the Reserve Bank of Australia (the "Bank") on 14 December 2001 entitled "Reform of Credit Card Schemes in Australia – A Consultation Document" which includes draft standards and a draft access regime also released by the Bank on that date ("Consultation Document"). This Response is also provided in an attempt to respond to the Notice published by the Bank in the *Gazette* on 14 December 2001.

The benefits of credit cards are widely acknowledged. The Consultation Document refers to the credit card system in Australia as being "world-class" (at p.1) and having benefits for cardholders in providing a "range of services" as well as being "convenient and widely accepted, both in Australia and abroad" (at p. i). For merchants it is noted that "credit card acceptance forms part of their competitive strategy of attracting sales from, or not losing sales to, rival merchants." (at p. i)

MasterCard welcomes any measures that seek to improve the competitiveness and efficiency of payment systems. MasterCard is also pleased that the Bank acknowledges that "interchange fees play a pivotal role in determining the incentives for consumers to use, and merchants to accept, credit cards" (at p. iii) and that the Bank also acknowledges that "some minimum entry standards" for participation in a scheme "can be justified because credit card issuing and acquiring does generate risks" and that "reliance on prudential supervision by APRA may provide a cost-effective and objective screening device to determine eligibility for membership" (at p. vi). MasterCard regards interchange fees as necessary to the existence of four-party credit card systems and membership eligibility restrictions as necessary to minimise the risk inherent in issuing and acquiring. They are not features of four-party credit card schemes which have the purpose of restricting competition.

As will be explained in this Response, however, MasterCard believes that the proposals of the Bank in the Consultation Document will have a significant adverse impact on the four-party credit card schemes operating in Australia, including the scheme operated by MasterCard. As a result, the benefits of credit cards referred to in the Consultation Document may be severely eroded and the proposals will actually decrease the competitiveness and efficiency of the Australian payments market.

MasterCard, therefore, does not believe that the proposals are in the public interest and that indeed, in several major respects identified in this Response, they are directly contrary to the public interest and, on that basis alone, should not be implemented.

Further, in several important respects (as identified in this Response) MasterCard believes that the information provided by the Bank upon which the public, including MasterCard, has been invited to comment, is deficient. The proposals should not proceed at least before the further information identified has been made available and subject to public consultation.

This Response is divided into three parts:

- In **Part A**, MasterCard addresses, in the context of the public interest criteria which are required to be considered by the Bank, the theoretical and empirical evidence upon which some of the major aspects of the Bank's proposals are based.
- In **Part B**, MasterCard provides a more direct and detailed response to statements made by the Bank in the Consultation Document.
- In **Part C** there is a report that MasterCard commissioned specifically for this Response from Professor Carl Christian von Weizsäcker, an economist with considerable experience and expertise in payment systems. The report analyses the economics of credit card payment schemes and critiques the report by Professor Michael Katz, "Network Effects, Interchange Fees and 'no-surcharge' Rules in the Australian Credit and Charge Card Industry (August 2001)", on which the Bank relies to arrive at many of its conclusions.

Attached to this Response are a number of annexures of documents referred to. These documents are:

- Annexure A – C. Christian von Weizsäcker, "Economics of Credit Cards – Expert Report on behalf of MasterCard International Incorporated and Europay International SA" dated 23 January 2002
- Annexure B – [Confidential]
- Annexure C – [Confidential]
- Annexure D – [Confidential]
- Annexure E – [Confidential
- Annexure F – [Confidential]
- Annexure G – [Confidential]

This Response should be read in conjunction with MasterCard's previous submission to the Bank of June 8, 2001. Many of the points made by MasterCard in its June submission have not been properly considered in the Consultation Document and remain relevant for the purposes the Bank's proposals.

2. Legal framework

2.1 Determination of Proposed Standard No.1 and Standard No.2 and the Proposed Access Regime

The *Payment Systems (Regulation) Act 1998* (the "PSR Act") allows the Bank:

- to designate a payment system[1];
- to determine *standards* to be complied with by participants in a *designated payment system*[2]; and
- to impose an *access regime* on those participants[3].

In considering whether to designate a payment system, to determine a standard, or to impose an access regime, the Bank must have regard to whether it is in the *public interest* to do so. What constitutes the "public interest" for these purposes is dealt with in Section 2.3 below. In considering whether to impose an access regime, the Bank must consider not only the public interest but also the interests of the current and future participants in the designated payment system.

On 12 April 2001, the Bank purported to invoke section 11 of the PSR Act to designate the "credit card systems" asserted by the Bank to be operated by MasterCard[4], Visa and Bankcard.

Before determining a standard or imposing an access regime, the Bank is required by notice in the *Gazette,* to advise of the proposed action and summarise its purpose and effect. The PSR Act also requires that the Bank notify the public and seek comments in connection with a proposed standard or access regime, as part of the consultation process mandated by the PSR Act[5].

The Bank published a Notice in the *Gazette* on 14 December 2001, stating that the Bank proposed to:

- impose an access regime on the three "designated" credit card systems (the "Proposed Access Regime");
- to determine a standard to be complied with by the three "designated" credit card systems relating to the calculation of wholesale fees (commonly called "interchange fees) paid by credit card acquirers to credit card issuers ("Proposed Standard No.1"); and
- to determine a standard to be complied with by the three "designated" credit card systems relating to the ability of merchants to recover the costs of accepting credit cards from cardholders (commonly called "surcharging") ("Proposed Standard No.2", and, together with Proposed Standard No.1, the "Proposed Standards").

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1 Section 11 of the PSR Act

2 Section 18 of the PSR Act

3 Section 12 of the PSR Act

4 On this point, and in this Response, MasterCard makes no admission that the "MasterCard system" or the "MasterCard network card system" is a "payment system" within the meaning of the PSR Act or that any proposed access regime or standards could validly apply to those alleged systems.

5 Section 28 of the PSR Act

2.2 Consultation Obligations

The Bank's obligations to consult in respect of the Proposed Access Regime and the Proposed Standards is specified in section 28 of the PSR Act. Under section 28(2) the Bank is obliged to:

- cause a notice to be published in the Gazette
    - ➢ advising of the proposed action
    - ➢ summarising its purpose and effect
    - ➢ inviting people to make submissions on the proposed action within a specified time, and
- consider any submissions that are received within that time.

It is against this background, and pursuant to the purported "consultation process" established by the Bank, that MasterCard provides this Response.

MasterCard maintains that the section 28(2) consultation obligations have not been satisfied in respect of Proposed Standard No. 1 because all the information that is necessary in order for MasterCard to make informed comments on this standard has not been made available. The information that has not been made available is further described in the comments on Chapter 2 of the Consultation Document which are provided in Part B of this Response.

MasterCard also maintains that the section 28(2) consultation obligations have not been satisfied in respect the Proposed Access Regime because all the information that is necessary in order for MasterCard to make informed comments on this regime has not been made available. The information that has not been made available is further described in the comments on Chapter 4 of the Consultation Document which are provided in Part B of this response.

The proposed action identified in the Notice and in the Consultation Document (even assuming, contrary to MasterCard's position, that the Bank has validly designated any payment system operated by MasterCard under section 11 of the PSR Act) should not proceed until the further information identified has been made available and interested parties have had a reasonable opportunity to comment on that further information.

2.3 Public Interest Test

As stated above, in considering whether to require the participants in the three designated payment systems to comply with the Proposed Standards or the Proposed Access Regime, the Bank must have regard to whether it is in the public interest to do so[6].

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6 Sections 12(2)(a) and 18(1) of the PSR Act

Consideration of the public interest requires, at a minimum, that the Bank must have regard to:

- the desirability of payment systems being:

  (i) financially safe for participants;

  (ii) efficient; and

  (iii) competitive; and

- the proposals contained in the Consultation Document not materially contributing to increased risk to the financial system[7].

As explained in this Response, in several important respects the proposals contained in the Consultation Document are not in the public interest. Furthermore, if the proposals are allowed to proceed they are in several respects directly *contrary* to the public interest.

Further, for the reasons explained below and in Part A, Section 2.3 and the comments in Part B, Chapter 2, MasterCard believes that the Bank has selected benchmarks to evaluate the public interest that are designed to meet its own objectives and that those benchmarks are inadequate to evaluate the full list of matters which should be considered under the PSR Act.

The public interest test is at the heart of the obligations imposed on the Bank under the PSR Act and its proper application is essential to a meaningful consideration of the Proposed Access Regime and the Proposed Standards. The central notions of efficiency and competition underlying the public interest test as a guiding principle for Australian Competition policy originate with the Hilmer Committee (1993). They also inform the work of the Wallis Committee (1997), carry over into the Joint Study of the Bank/ACCC (2000) and find their way into the 2001 Consultation Document (at Chapter 1.5) where they are transformed into a set of competition benchmarks for the purposes of applying the public interest test to the Bank's proposals.

Unfortunately, the five competition benchmarks that are set forth by the Bank as "underpinning the public interest test in the payments system" are seriously flawed. They do not correctly reflect the general principles on which the public interest test is based. In fact they are incomplete, misleading and inconsistent with basic economic principles. They give rise to a misapplication of the public interest test to the operation of four-party credit card schemes and seriously prejudice the future viability of these schemes with consequent adverse effects. In effect, these benchmarks are the main reason why the proposals in the Consultation Document will not achieve the desired objectives of the public interest test, namely to promote stability and efficiency of Australian payment systems and also to promote competition among payment services to the benefit of consumers and merchants.

MasterCard does not dispute the general principles of the public interest test applied to payment systems as set out in the PSR Act (section 8) whereby payment

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[7] Section 8 of the PSR Act

systems should be: (i) financially safe for use by participants; (ii) efficient; and (iii) competitive, and not cause or contribute to any increased risk to the financial system. Nor does MasterCard dispute that some elements of this test under the PSR Act are broadly consistent with the general objectives of Australian Competition Policy. In fact, MasterCard welcomes the explicit linking of the regulatory basis for any intervention by the Bank in the Australian payments market with the general economic principles of competition policy as set out in the Hilmer Report.

Hilmer distinguishes between three dimensions of efficiency – allocative, productive and dynamic - that should be the focus of competition policy. Together with the recognition that competition is a dynamic process capable of supporting these objectives, they are the key to the proper application of competition policy to the market for payment services. If the regulatory policy of the Bank were to follow correctly these principles and apply them in their competition benchmarks then MasterCard is confident that the correct conclusions regarding the operation of the schemes, so far as relevant to application of the public interest test, would be reached.

However, the consistent translation of these general principles into the operational benchmarks in the Consultation Document has not happened.

The three dimensions of efficiency do not all find their way into the competition benchmarks although they are of central importance. No mention, for example, is made of any benchmarks that are capable of assessing the *productive efficiency* benefits of four-party payment schemes over three-party schemes and other forms of payment. No mention either is made of a competition benchmark that captures the *dynamic efficiency* benefits that competition among payment schemes can bring to consumers. These two omissions are serious and are discussed further below.

a) Productive efficiency

It is a well established proposition in economics that effective "competition is the enemy of sloth" and that "the best monopoly profit is a quiet life" (Caves[8], quoting the Hicksian dictum). Ineffective competition due to market power or anti-competitive cooperative agreements results in managerial slack (X-inefficiency), strategic manipulation of costs[9] and more generally is associated with excessive costs[10]. Explicit recognition of the productive efficiency criterion as a competition

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[8] Caves, "Industrial organisation, corporate strategy and structure", *Journal of Economic Literature*, March 1980, pp 64-92.

[9] Vickers, "Delegation and the Theory of the Firm", *Economic Journal Supplement* (Conference Papers), 1985, pp. 138-147. Hart, O.L., "The Market Mechanism as an Incentive Scheme", *Bell Journal of Economics*, Vol. 1, 1983.

[10] See, including for empirical studies, Caves, and Barton, D.R., *Efficiency in US Manufacturing Industries*, MIT Press, Cambridge, Mass., 1990. Caves, R. et al. "Productivity dynamics in manufacturing plants; comments and discussion", Brookings Papers on Economic Activity 1992, pp. 187-267.

benchmark would have forced the Bank, for example, to confront the relative cost advantages that four-party payment systems have over three-party systems.

The productive efficiency benchmark would also have suggested dealing explicitly with the decentralised manner in which global acceptance of credit cards is secured by the acquiring activities of thousands of banks worldwide. Another fact that would have become apparent from the explicit consideration of a productive efficiency benchmark is that in Australia the intense competition between two international credit card schemes and one traditional domestic scheme have allowed member banks to evaluate comparative performance of each scheme and impose performance controls on the respective managements of the schemes. This ability to monitor and control the performance of three different schemes is likely to enhance the productive efficiency of four-party schemes against three-party schemes. Finally, the Bank has been presented with evidence from MasterCard's Australian members demonstrating the steady reduction in merchant service fees in Australia which indicates the successful pursuit of costs savings rather than the pursuit of the quiet life of the lazy and unchallenged Hicksian monopolist.

b) Dynamic efficiency

Dynamic efficiency, the other missing efficiency related benchmark, is defined as the optimal trade-off between current consumption and investment in technological progress. Or as quoted by the Bank itself on page 11 from the Hilmer Report, the dynamic efficiency dimension "*reflects the need for industries to make timely changes to technology and products in response to changes in consumer tastes and productive opportunities*". An explicit recognition of dynamic efficiency in the competition benchmarks of the Bank would have focussed attention, for example, on the heavy investments in technology (fraud control) and innovation that credit card schemes and their banks make.

Dynamic efficiency considerations are also fundamental to the appreciation of how competition interacts with the incentives to undertake R&D. It is recognised that in some instances competition in technological innovation leads to reduction in costs or improvements in quality but may lead to an increase in concentration[11]. A dynamic efficiency benchmark would have forced the Bank to consider whether it is indeed appropriate to seek to influence the structure of the payments market by denying four-party schemes their ability to use their network advantages in competing with three-party systems and other forms of payment. Three-party schemes are generally smaller in scale, particularly proprietary store card schemes. There may be more of them, but they do not necessarily create a more dynamic and innovative payment services industry. In fact, the economics would point to a contrary effect. (See specific comments below). For example, some of the innovations of four-party payment systems and/or their members, include new payments products (such as global ATM cards, co-brand cards, direct debit cards, commercial cards, person-to-person payment transactions), card and cardholder security features and systems (such as tamper proof signature panels, card authentication holograms, card validation codes, real-time cardholder (PIN) validation, fraud detection and reporting

11 von Weizsäcker, C.C., "A Welfare Analysis of Barriers to Entry", *Bell Journal of Economics*, Vol. 11, 1980, pp. 399-420.

systems), remote transaction services (such as address verification services, e-commerce security systems), transaction processing products and services (such as cardholder-activated terminals, card-related documentation imaging), and global interoperability and standards (such as global chip card operating system standards, merchant category codes, global financial message formats).

c) Allocative efficiency

Not only are there two major omissions from the list of efficiency criteria quoted by the Bank, there is also the imprecise and misleading "operationalisation" of the allocative efficiency criterion when the Bank argues for pricing by financial institutions to consumers that reflects costs and demand conditions (the first benchmark on p. 11 of the Consultation Document). The Bank's quote from Hilmer on p. 11 is more helpful in pointing out that allocative efficiency *"is achieved where resources are allocated to their highest value uses (ie those that produce the greatest benefit relative to cost)."* This means that, as long as the marginal willingness to pay for a payment service is greater than its costs, more efforts (and resource costs) should be put into the production of the service. Allocative inefficiency would result if no additional resources were spent leading to unsatisfied demand. No accusation of unfulfilled demand has been made concerning credit card schemes. Nor has the Bank shown that the marginal willingness to pay is lower than the additional resources required.

In layman's terms allocative efficiency requires that relatively more is produced of what people want and are willing to pay for. Understood this way, it becomes clear that the "allocative efficiency" that the Bank hopes to cause four-party credit card schemes to achieve is related mostly to what the Bank believes is the optimal allocation of transactions between one type of payment instrument and another (chiefly, debit vs credit cards) and very little about what consumers actually want.

There are a number of instances in the Consultation Document where the Bank makes statements as to an alleged distortion of the choices between payment instruments and the costs that they impose without acknowledging that the users of credit cards typically pay a substantial portion of the costs of the four-party payment system through interest on outstanding balances, annual fees and other charges (e.g., late payment charges). The notion that the costs of four-party credit card systems is borne by merchants who then pass on these costs to users of other payment instruments is strongly argued but wrong and empirically illfounded.

[Confidential]

With 75% of outstanding balances being revolved most cardholders make a significant contribution. Pure transactors who never revolve would also contribute through annual fees to the costs of the system. Note that pure transactors are much less than the 25% who pay off their outstanding balances at any one time. It can safely be assumed that there are a fair amount of occasional revolvers who may pay off their balances most of the time but not all of the time. This means that they pay some interest and late fees in addition to annual fees.

The failure to apply correctly the criterion that prices must reflect cost and demand conditions is in fact at the heart of the failure of applying the allocative efficiency criterion to payment systems in general and the role of the interchange fee in credit card systems in particular. As is further elaborated in other parts of this submission, in a situation involving joint costs of providing a service to two sets of customers, the requirement for cost-based pricing can only be met with regard to the sum of both prices (merchant and cardholder prices). It is not possible to have cost-based prices for merchants and cardholders separately. The right test therefore is to review whether total costs of a scheme are reflected in the prices charged to merchants and cardholders. Viewed this way, of course, the interchange fee is not the relevant variable but only one of several elements of a scheme. In fact the interchange fee is a cost-allocation mechanism that shifts costs to acquirers and away from issuers. In itself the interchange fee does not directly determine the prices to merchants and cardholders. The interchange fee does this only indirectly. Because costs of acquirers are higher due to the interchange fee the merchant service fee is likely to be higher too. And because the interchange fee lowers the costs of issuers, the issuer price charged to cardholders will be lower. As a cost-shifting device the interchange fee does not raise overall costs. It merely balances costs.

The benchmark on cost reflective pricing to consumers is not clear and unhelpful as an elaboration of the requirement of allocative efficiency. Moreover it is misleading as it leads to the belief that the interchange fee can be charged in line with some notion of cost for a specific service. (See specific comments below). It is more helpful to focus on the way in which the resources required for the provision of credit cards provide benefits for consumers and merchants and how these two customer groups share in the remuneration of these costs within an environment of effective competition and choice between different methods of payments and issuers of credit cards.

PART A COMMENTS ON SOME MAJOR ASPECTS OF THE BANK'S PROPOSALS

1. MasterCard's Position Regarding the Bank's Consultation Document

MasterCard is in general agreement with the Bank's stated objectives of improving the efficiency of Australia's payments system and increasing market competition.[12] MasterCard believes that a well functioning payments system is critical to attaining these objectives.

In the Consultation Document, the Bank states that its proposals are meant to facilitate the working of the market mechanism, and that objections to it amount to a vote of no confidence in the competitive process in Australia.[13] However, as is demonstrated below, the Bank's proposals will seriously distort the working of the free market mechanism in Australia, undermining its competitiveness. Specific comments referred to in Section 2 below will also show that the competitive process in the payments industry is working and functioning well in Australia today, and that the Bank's proposals will achieve results opposite from its stated objectives because the proposals are, by and large, an arbitrary market intervention without due regard to the nature of four-party payment systems or competitive forces that are already at work in Australia. Thus, the Bank's very "reform" proposals are in themselves a vote of no confidence in the competitive process in Australia and a potentially dangerous experiment which puts the Australian payments system at risk.[14] The Australian economy can ill afford the consequences if MasterCard's concerns about the proposed reforms are realised.

A key underlying theme of the Bank's analysis is that competition is not working in the payments market in Australia, especially in the market segment of four-party schemes. The Bank's position, as represented in its Consultation Document, reflects a lack of appreciation of the competitive intensity as well as the complex and dynamic competition among and within the four-party schemes.

The four-party schemes operate with several levels of competition simultaneously. The schemes compete against each other. The issuers, within the same scheme as well as between the schemes (if the memberships are different between schemes), compete against one another. Similarly the acquirers compete against one another.

In Australia, the competition between the three four-party schemes is intense. MasterCard has been increasing its investment in brand building in Australia in recent years.[15] [Confidential]

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12 While another stated objective is to improve community welfare, MasterCard has a concern with the nebulous notion of improving community welfare where this is frequently used to support objectives that are decidedly anticompetitive and uneconomic.

13 p. ix, Consultation Document

14 The Bank's proposed reform is the only known instance of a central bank attempting to intervene directly in the pricing of a payments system in all the developed free market economies.

15 These investments do not include investments in technology and new products and services.

MasterCard also competes for the business of card issuers by providing its members with financial support for the development and launch of new products and the growth of their cards business. [Confidential] Millions more has been spent by MasterCard in Australia to develop and maintain its Australian Processing Centre (APC), for the purpose of giving it a competitive edge in processing and switching credit card transactions in Australia.

Competition also manifests itself in the charging structure for both issuers and acquirers, and other criteria such as value added services, transaction processing times, reliability, points of acceptance, customer service and fraud control. Competition between the MasterCard scheme and others is particularly fierce for so-called marginal customers. Gaining an additional set of merchants or cardholders makes the network more valuable to existing users. At the same time, losing a group of merchants has a negative feedback effect on the value of the network. Losing the marginal customer to a competing network amplifies this effect and forces the card networks to be even more competitive. It is not surprising, therefore, that relative acceptance levels and number of cards issued are important market parameters. They reflect the intensity of competition for additional customers on both the acquiring and issuing side.

The competition among members of the four-party schemes is a unique and dynamic feature that does not exist in the three-party schemes. [Confidential][16]

In Australia, competition between members of the four-party schemes has rendered profit levels low. As is shown below with reference to the Bank's analysis of profitability in Figure 4.1 of the Consultation Document, the profits generated on the issuing side only take into account the direct costs of the issuing business. With a volume of over A$80 billion, issuing banks require a strong asset base as risk capital on which they have to earn an adequate return. In their detailed review of key Asia Pacific markets in 2000, Morgan Stanley concludes that returns on assets in the credit card business are just reasonable, at or below average; and the relatively protected and small market in Australia has failed to attract new entrants in the business.[17]

Competition between issuers is also closely linked to the merchant acquiring side, as pointed out by Professor von Weizsäcker.[18] Competition between issuers keeps cardholder fees down, which, given cardholders' high price elasticity of demand, boost the growth of cards issued. More cardholders and more cardholders with multiple cards means it's easier, everything else being equal, for merchants to avoid accepting any given payment system as there are now fewer customers who cannot shift their mode of payment. Increasing choices to merchants in turn means intensified competition in the acquiring side of the business, leading to lower merchant fees.

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16 [Confidential].

17 "Global Credit Cards – Industry Overview." Morgan Stanley Dean Witter. December 2000. A similar finding is also reported by Lafferty Research, which concludes that the four largest Australian banks only earn average to below average returns from credit cards. "Exploring Asia Pacific Growth Markets," by Brian Purtell & Rebecca Taylor. Lafferty Research. January 2002.

18 "The Economics of Credit Cards", *Annex. A*.

Thus, the four-party schemes have built-in competition dynamics that are absent in other payments systems. This has encouraged competitive pressures to build even in a relatively small market like Australia. And this is consistent with Morgan Stanley's observation that the four large Australian banks' returns on their credit card business is only average or below average, which is a strong indication of the intensity of market competition.

While acknowledging evidence that the average merchant service fees have declined, the Bank states that "The existence of declining merchant service fees is not per se evidence of vigorous competition. The test of a competitive market is that participants over time earn only normal profit, taking into account of both revenue and costs." (p.88, Consultation Document). MasterCard believes that the assessments by industry analysts, together with the Morgan Stanley research referred to, and coupled with evidence of decline in merchant service fees, point to exactly a situation of "normal profit", a result of vigorous competition between and within the four-party schemes. The Bank has pointed to no evidence to the contrary.

The Bank states that "competition policy seeks to promote efficiency and enhance community welfare through the encouragement of effective competition and the protection of the competitive process."[19] Nowhere in the Bank's Consultation Document is there an assessment of the state of competition existing today between and within the four-party schemes, and in contrast with the three-party schemes. This makes it impossible to understand how the Bank's proposals could protect the competitive process that is there today, and how more effective competition could be further encouraged. By ignoring the competitive process that is already in place and functioning in Australia, the Bank's proposals are likely to, at minimum, create unnecessary and undesirable market distortions, and, at worst, undermine the existing competitive process.

As this foregoing discussion indicates, the market for payment systems is highly competitive and, as is described in Section 2.1 below, the MasterCard scheme and the four-party schemes do not possess the necessary market power to give rise to concerns sufficient to warrant the type of market intervention proposed by the Bank in the Consultation Document.

2. Specific Comments

2.1 The Relevant Market

The Consultation Document contains no analysis of what constitutes the relevant market in which credit cards compete. Yet this analysis is highly relevant in order to understand the competitive dynamics within which credit card schemes operate within Australia and to be able to evaluate the proposals contained in the Consultation Document.

The choice of relevant market should reflect the commercial reality of the situation. Issuers in the MasterCard scheme cannot compete between themselves on either

[19] p.11, Consultation Document, *ibid*.

an intra-scheme or inter-scheme basis for the provision of MasterCard services to acquirers. The individual (MasterCard) transaction defines the acquirer and issuer who are obliged to complete the transaction on behalf of their respective customers. In a literal sense, this cannot be a relevant market. The appropriate way to analyse the market is to recognise that acquirers and issuers are offering a joint service in competition with other payment services in a downstream payment systems market (i.e. to merchants and cardholders, respectively). Neither issuers nor acquirers operate independently. As indicated, there is intra-scheme competition as between issuers in issuing cards to cardholders and as between acquirers in providing services to merchants.

The inescapable conclusion is that the appropriate focus for any analytical framework concerning the relevant market is the downstream market for payment methods. Competition exists between a payment system's acquirers in the provision of banking services to merchants, but the most important point to note is that the success of the network is dependent on its acceptance by a large number and a wide range of merchants. Attempting to charge excessive merchant service fees and running the risk of merchants "taking the sign down" thereby depressing transaction volume would be inconsistent with success. This is particularly true given the relatively elastic nature of cardholder demand and competition from other payment systems. [Confidential]

There is powerful evidence that the relevant market in which the MasterCard scheme competes includes credit cards, charge cards, debit cards, cheques and cash. [Confidential]

The final conclusion as to the appropriate relevant market within which credit cards compete is supported by Professor von Weizsäcker:

> "There is then no doubt that other payment systems impose substantial competitive pressure on credit card systems. To use a term from competition law, the 'relevant market' of credit card systems comprises other card systems and cash … cash is as close a substitute for credit cards as are debit cards."[20]

2.2 Truncated Analysis #1 – Not Adequately Considering the Cost of Cash

The Bank does not adequately consider the cost of cash in its analysis. As MasterCard has described in Section 2.1 above (and as it previously indicated in its June 8, 2001 Submission to the Bank (Part A, Section 1 and part c, Question 10), the "relevant market" for an analysis of the four-party schemes is the payments market, which includes cash, cheques, payment cards (including pre-paid, debit and store cards), the three-party payments schemes and the four-party payments schemes. By not adequately considering the cost of cash, the Bank presents a truncated analysis that leads to fallacious conclusions.

Based on these considerations of what constitutes the relevant market, downplaying the cost of cash is counter-intuitive as well as counter-factual. It is counter-intuitive as the entire history of the evolution of non-cash payments systems, from the

[20] See C. Christian von Weizsäcker, Annex. A., paragraph 32.

introduction of letters of credit to the invention of cheques, is driven by the high costs and inefficiency of handling cash.[21] It is also counter-factual.

The cost of handling cash is very high from the perspective of the society. An estimate made in 1998[22] of the cost of moving and distributing cash in Australia, under the Centralised Cash System Scheme, shows an annual cost of 5% of the total cash in circulation for cash distribution (costs of insurance, carrier company, handling fee). This is only the cost of moving and distributing cash, and does not include the costs of printing notes and minting coins. There are also the costs of cash related to the "black economy" and tax evasion on which governments expend huge amounts in trying to combat.[23] These are costs that are borne by the government, which are eventually paid for by all Australian taxpayers.

Credit cardholders, by shifting an increasing proportion of their transactions to a cashless basis, are reducing the amount of cash needed in daily circulation. In doing so, they are actually making a significant contribution to society at large in reducing the social cost of handling cash.

There are also high costs to merchants in handling cash. For example, the Prices Surveillance Authority of Australia has reported that, "the security and administrative costs to merchants of holding cash means that cash transactions are not necessarily less costly than credit or charge card transactions. Myer Stores and the Retailers Council of Australia submitted that costs of cash sales (in-store collection from cash registers, counting in the back office, security transport services, inaccuracies, etc.) were only marginally less than the costs associated with credit cards (merchant fees, chargebacks, costs of authorisation and delay in cash reimbursement)."[24]

As stated in Section 2.1, MasterCard believes that the relevant market analysis must encompass, at minimum, cash, cheques, debit and credit card transactions.

The Australian Retailers Association ("ARA") has reported the cost of cash to the merchants being only 12 basis points. The Bank relies heavily on the ARA study to support its own arguments. MasterCard does not believe that the ARA's estimate is credible. Unlike merchant service fees which are explicit payables for the merchants, the merchants' costs of handling cash is not the kind of information that is readily available and therefore obtainable through a member survey as ARA has done.

A number of studies have been conducted in the northern hemisphere into the costs of cash. Most of these have been undertaken in the context of assessing the true

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21 Peter Bernstein, The Power of Gold – the History of an Obsession. 2000. New York: John Wiley & Sons. David Evans & Richard Schmalensee, Paying with Plastic – the Digital Revolution in Buying and Borrowing. 2000. MA: MIT Press.

22 "The cost of Handling Cash: Cash Handling Strategies for Asia", The Asian Banker Journal. July 1998.

23 A major benefit of credit card usage in this regard is that they are generally not associated with tax evasion or the "black economy" due to the records which credit card usage generates.

24 p.120-121, "Inquiry into Credit Card Interest Rates," Prices Surveillance Authority of Australia, 1992.

cost of cash in comparison to other payment methods. All the studies have identified that their measures do not include all the costs associated with the use of cash.

Each of the studies appears to discount or disregard significant costs associated with the acceptance of cash by retailers. Even the study by the ARA, which claims to include all of the retailers costs appears to have disregarded some costs.

MasterCard believes retailers incur a number of costs which relate to the acceptance of cash. These include:

- Cash handling costs such as the need to collect, count and deposit receipts;
- Transaction costs associated with the need to withdraw and deposit receipts with their financial institution;
- Staff costs for the time involved in undertaking the transaction and providing correct change;
- Security costs for the prevention of theft and loss, this may include insurance and other measures to minimise or prevent loss of receipts;
- Opportunity costs associated with the need to have cash on standby with the retailer. These costs may include the cost of an overdraft to fund the retailers “float” or the interest income forgone.

MasterCard does not believe this list is exhaustive but rather is indicative of the costs incurred by retailers which are often not included when estimating the relative cost of various payments methods. For example, the ARA study appears to have excluded from its estimates of costs associated with accepting cash:

- Security costs; and
- Opportunity costs.

Each of the other studies within the table appear to suffer from similar exclusions. For example the study conducted in the Netherlands expressly excludes staff costs associated with undertaking the transaction. There is little consistency in the costs included and excluded by the various studies other than the universal exclusion of opportunity costs.

It appears that both retailers and researchers overlook these additional costs as they are not explicitly linked to the provision of cash. This has led to a mistaken belief that these costs either do not exist or are not part related to the use of cash as a payment medium.

The impact of these externalities on the costs of cash are significant. In the UK the opportunity cost of cash alone was estimated to be UK£1.5 billion in 1993[25]. The additional costs of handling cash were estimated to be in the region of UK£3 billion in the same study. This additional UK£4.5 billion impost on the economy equated to

25 Van Hove, L (2000) "Leo Van Hove's review corner: The price of cash - on a report for a Dutch retail association" in the *Electronic Payment Systems Observatory- Newsletter*, No. 2, October 2000, http://epso.jrc.es/newsletter.

0.75% of the UK's GDP. A similar study in Belgium concluded that the social cost of cash equated to between 0.35% and 0.56% of the nation's GDP.

The exclusion of these costs sees cash with an intrinsic advantage in any review of the costs of various payments instrument as few of the costs associated with its use are borne by consumers or retailers. Instead the costs of cash provision are internalised by the participants in the payments system. A study of the Norwegian payment systems estimated that in 1988 only 20% of the costs associated with cash were borne by users. In 1998 this had risen to 60%, a figure the authors claim was well above that of other nations[26].

A more accurate and credible approach to assess the merchants' costs of handling cash typically requires the development of a sound research methodology, with the research preferably carried out by external consultants to ensure objectivity. There is no evidence that the ARA member survey data are based on such carefully designed research studies. In addition, as addressed in the comments on Chapter 2 in Part B below, ARA's statistics regarding average credit card transaction sizes are inconsistent with data shown on the Bank's own website. This casts further doubts on the reliability of the ARA assessments.

(a) Implications for the Claims of Consumers Subsidising Cardholders

The Bank claims that the consumer subsidises the cardholder because the merchant passes on the cost of accepting credit cards to all customers. This claim is based on an implicit assumption that handling cash is cost-free to the merchant. Yet, were the cost of cash to be properly identified, then the entire "cross-subsidy" issue can be shown to be greatly exaggerated. As indicated above, most of the studies on the cost of cash are incomplete and do not take into account all relevant costs. If all the relevant costs were factored in it is likely that there would be little net savings to be had in accepting cash, and thus marginal net costs in accepting credit cards that the merchant has to pass onto all customers. Thus there is quite possibly little or no cross-subsidy.

Further, as indicated in Section 2.7 below, evidence would indicate that most merchants do not impose a surcharge on credit card transactions in those places where they are permitted to do so. Neither do most merchants offer a discount for cash. The implication of this is that merchants derive net benefits in encouraging and accepting credit cards after taking into account the costs of handling cash and the incremental benefits conferred by accepting credit cards. If the cost of credit cards were significant compared to the cost of cash, it is expected that there would be a greater incidence of surcharging (in those places where it is permitted) or offers of discounts for cash. In any event, if as the Bank asserts, 35% of retail transactions are made by credit and charge card and the average merchant service fee is 1.8%, and assuming that any level of surcharging in Australia would be similar to that in countries where currently it is permitted (at most, 10-15%), the impact of the "no surcharge" rule on retail prices would at most be in the order of only 0.1%.

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26 Ibid.

In ignoring the social costs of cash, the Bank is also violating its own public interest test. The public's interests must be defined in terms of both costs and benefits to the society. This omission therefore has built into the Bank's entire analysis a strong bias, rendering its conclusions inaccurate and untenable.

In addition, as has been explained by Professor von Weizsäcker, an undue reduction of interchange rates in a four-party system could be expected to contribute to the growth of three-party systems.[27] Three-party systems, however, do not have the efficiencies of the four-party systems and, if credit cards do not disappear from the payments system altogether (which appears unlikely), merchants will be subject to higher merchant service fees under the three-party schemes[28]. Accordingly, the end result may well be that a more expensive payment system becomes the dominant system. This would not lessen any perceived issue with consumers subsidising cardholders – indeed, it has exacerbated it. For the reasons explained in Part B in the comments on Chapter 5, any expectation that merchants may be able to negotiate lower merchant service fees with the three-party schemes seems, at best, illusory.

(b) Implications for Debit versus Credit Cards

After not adequately considering the cost of cash, the Bank uses debit cards as the benchmark of comparison for credit cards. This approach is seriously flawed. As explained in Section 2.1, cash is an integral part of the relevant market in analysing the four-party payments schemes. Both debit and credit cards have their roles in replacing cash as determined by their respective costs and benefits to merchants and their customers.

By downplaying the costs of handling cash, however, the Bank is able to selectively compare debit with credit cards, and draw the conclusion that credit cards are "over-used" because the debit card is a "cheaper" alternative.

This claim can be substantiated if and only if (i) cash is costless to the society and to the different agents involved in the payments market; and (ii) debit and credit cards are equally acceptable for consumers for all categories of purchases. Point (i) is dismissed as argued above - handling cash entails significant costs to both the society at large as well as to the different agents involved in the payments market. Point (ii) can also be shown to be untenable.

[Confidential]

The Bank's own data also shows a similar pattern in Australia. From 1995 to 2001, while there was significant overlap in credit and debit card usage in respect of a range of transaction sizes, the average transaction size of credit cards hovered around the A$90 to A$110 range, in contrast with the average transaction size of debit cards in the A$50 to A$60 range.[29]

27 [Confidential]

28 The ARA study cited in the Consultation Document showed it to be approximately 2.8%

29 Bank's Website: Payments Statistics. The Bank's own data contradicts the data submitted by the ARA. But in the Consultation Document, the Bank chose to use the ARA data, citing them on p.21, Table 2.3 This is highly unusual. Since the Bank's data are collected over several

Consumer preference for the different payment methods, reflecting their costs and benefits in different levels of purchase, is clearly more complicated than the Bank's simplistic assumption that because debit and credit can be used interchangeably by consumers for all categories of purchases, the cost of one of them should be the benchmark for determining the cost of the other.

The Bank's stated preference for debit cards contradicts its own stance of encouraging more competition in the payments market in Australia. By definition, issuers of debit cards must be banks with savings deposit accounts to service the debit cards. Given the relatively homogenous nature of the debit card product (compared with the varieties of service configurations and service features of credit cards), it is clear that large banks with their economies of scale will be able to compete most effectively and with regard to debit cards. By contrast, smaller institutions, by offering cards with features cardholders want, can effectively compete for credit card business. Some of the largest credit card issuers in the US today were small banks when they entered the credit card business, for example: Capital One (formerly Signet Bank), MBNA (formerly Maryland Bank), Metris (formerly Fingerhut Bank), People's Bank and Providian. So the Bank's stated preference for debit cards is actually a competition restricting preference.

Implications for the Public Interest Test

In not adequately considering the cost of cash from both the perspective of the society (social cost) and the perspective of merchants (private cost), the Bank's analysis has failed to meet the "productive efficiency" prerequisite of the public interest test. Productive efficiency is achieved "where firms produce goods and services at minimum cost." The Bank's proposed reforms could not possibly be based on any knowledge of what the minimum cost is, in comparing the different payment methods, when the cost of cash is effectively ignored.

In implicitly downplaying the cost of cash, the Bank has created a phantom cross-subsidy between the consumers and the cardholders. This has distorted the analysis of public interest. The Bank alleges that there is a need to protect the public interest where no such need exists.

The Bank's stated preference for debit cards is in direct contradiction with its stated objective of promoting competition in the payments market in Australia. The ability to issue debit cards is limited to banks since the debit card requires a savings deposit account to service it. Thus, non-bank issuers are automatically excluded. And, among banks, large banks will have economies of scale advantages over smaller banks.

2.3 Incorrect Interpretation of the Economic Rationale of the Interchange Fee

The Bank adopts a purely cost-based approach to determine the "right" level of interchange fees. The Bank then selectively approves of certain cost categories while rejecting others. The resulting "formulae" is then said to produce the "right"

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years, and are meant to be the "official" data, we have chosen to use the Bank's data instead of the ARA data.

level of interchange fee. For reasons explained below, not only is this approach circular, it is deeply flawed.

Based on this flawed approach, the Bank then conveniently proceeds to:

- suggest that competition is not working in Australia because interchange fees are higher than can be justified by using the Bank's interchange fee formula,

- argue that the higher than "necessary" interchange fees are the mechanism through which credit cardholders are "subsidised" by non-credit cardholders, which purportedly results in credit cards being "over-used", and then

- conclude that the solution is for the Bank to selectively determine what should or should not be included as costs in the setting of interchange fees.

Not only is this approach circular, it ignores the well established economic rationale for an interchange fees in a four-party payments scheme – an interchange fee is in fact both an internal transfer charge and a balancing mechanism which supports a complex arrangement between scheme issuers and acquirers. It is a means to internalise the network externalities and also a means to balance the cost and revenues of issuers and acquirers. Far from restricting members' individual freedom in deciding their own pricing policies, the interchange fee is the means by which scheme members not only compete with other payment systems' issuers, but are also able to compete with each other for the business of cardholders and merchants.

The approach of the Bank also overlooks the need to incorporate considerations of both costs *and* benefits to all the participants in the scheme in determining the appropriate level of interchange fees. This is of fundamental importance to both the justification of the interchange fee as well as allowing the four-party schemes to function efficiently in a competitive environment in which they must compete with each other, three-party schemes and other means of payment.

In focusing on costs alone, the Bank only presents half the picture. As such, the Bank has failed to establish a sound basis for considering how costs should be charged to the different participants in a four-party scheme. This distortion is further compounded by the unduly restrictive approach the Bank has adopted as to the costs which can be taken into account. Presenting the full picture means taking into account both costs and benefits to all participants. As informed by elementary economics, how the costs of the system should be charged to the participants in such a situation is best determined by their respective demand conditions.

A consequence of the Bank's approach in focussing on costs has been to place the burden upon MasterCard and its members to establish that the MasterCard interchange fee is set at a level which is not "excessive". This is an unnecessary and largely meaningless task. As stated by Professor von Weizsäcker (Annexure A), there is no reason to believe that the MasterCard interchange fee has been set at an excessive level. Moreover, under the PSR Act, the burden lies squarely with the Bank to demonstrate that any regulation is in the public interest. MasterCard believes that it is not. The task set by the Bank is made more difficult by the absence of any indication as to why the Bank considers the current level of the

MasterCard interchange fee to be excessive other than by pointing to certain cost elements typically considered by the MasterCard scheme when it establishes interchange fees. In the absence of an established benchmark of what is appropriate, and given the role of the interchange fee as a balancing tool, MasterCard is unaware of how the Bank could have concluded that the level of the MasterCard interchange fee may be excessive.

The Bank's intention to reallocate the recovery of certain costs from the merchant to the cardholder displays a fundamental misunderstanding of the role of the interchange fee. In particular, it fails to recognise that the MasterCard interchange fee cost formula acts only as a proxy. Any attempt to recover costs from cardholders (by, for example, imposing transaction fees) will deter the growth of the MasterCard network since cardholders tend to be very price sensitive. [Confidential] Moreover, as noted by Professor von Weizsäcker *"the fact that specific costs of the joint credit card system are located in one part of the system (mainly issuers) does not mean that the revenues have to be allocated in exactly the same way. On the contrary, on the basis of my analysis, I expect that merchants will carry a large part of the costs of the payment systems and means of payment that they accept."*[30]

Professor von Weizsäcker has pointed out that there exists an asymmetry between the demand conditions of the cardholder and the merchant.[31] The cardholder is "sales transaction saturated" – for any category of goods or services that the cardholder wants to purchase, there is a firm ceiling on how much he/she would purchase given his/her liquidity constraints, his/her allocation of income to different purposes, and prevailing prices. In contrast, the merchant is "sales transaction hungry" – the merchant normally welcomes any additional sales as long as there is a net profit margin in doing so. This asymmetry means that typically the cardholder does not compete for merchants, whereas the typical merchant competes for cardholders.

This asymmetry also means that it is typically the cardholder who chooses the payment method, being very sensitive to each alternative payment method's costs and benefits to him/her. This is, not surprisingly, "sales transaction saturated" behaviour. The merchant, on the other hand, being "sales transaction hungry", is inclined to accept most payment methods as long as there is a net benefit in so doing[32]. This means the cardholder has a much higher price elasticity of demand[33] than the merchant when it comes to choosing any particular payments method.

Accordingly, the appropriate way to charge for providing a joint product – and, in this regard, the payments service facilitated by the four-party scheme is a joint product to both the cardholder and the merchant - is to take into account the respective

30 See C. C. von Weizsäcker. Annex A , paragraph 93.

31 See C.C. von Weizsäcker, Annex A

32 Although merchants are not compelled to provide the means of accepting all payment methods and, in making their choice, will be influenced by the fact that cardholders typically carry more than one payment method. Merchants do have the ability to influence a cardholder's payment choice by, for example, offering a discount if payment is made by cash rather than a credit card or asking if payment can be made using a debit card or different credit card. See von Weizsäcker, Annex A at p. 24

33 [Confidential]

benefits obtained by both, as reflected in their different price elasticities of demand. This would in turn entail that the merchant be allocated a significant portion of the total cost of the payment system, even though the costs of acquirers are lower than the costs of issuers. Apportioning costs in this manner optimises net benefits to all participants. Failure so to optimise means that the system does not reach economically optimal size and, if interchange fees are set too low, that the system ceases to exist.

In ignoring the benefit side of the equation, therefore, the Bank is not in a position to properly address the issue of whether the current interchange fee is too high, and whether the merchant is bearing a disproportionately high share of the total cost of the four-party scheme.

Given that the four-party schemes do not have substantial market power in the payments market (see Section 2.1), and that the payments market is highly competitive (see Section 1.0), the fact that more Australians are using credit cards for more of their purchases along with more Australian merchants accepting credit cards, is a strong indication that the four-party payments schemes are generating real net benefits to both cardholders and merchants. It is inappropriate for Bank to use its regulatory powers under the PSR Act to set the level of the MasterCard interchange fee. In doing so, the Bank not only makes certain incorrect assumptions about competition at the retail payments level but is effectively acting, at least de facto, as a price regulator, when it is generally recognised that the setting of prices should be left to the market.[34] Further, due to the adverse effect that this regulation will have on four-party systems, as explained in this Response, the regulation will also effectively amount to product regulation. This was not the intent of the PSR Act.

Implications for the Public Interest Test

In setting forth the “competition benchmarks” for the public interest test for the payments industry, the Bank wrongly applied the three dimensions of economic efficiency cited by the Hilmer Report[35] as prerequisites to setting the benchmarks. The first, and perhaps the most important, of the three is allocative efficiency. As argued above in the Introduction, Section 2.3, allocative efficiency in the presence of joint costs has to take into account the costs and benefits of both sides of the market, that for merchants and consumers. Moreover it is paramount to ensure that any pricing arrangement achieves the “greatest benefit relative to cost” in allocating resources. The Bank’s cost-based approach to the interchange fee, which ignores the benefit side of the equation, thus fails to meet a critical prerequisite in its own public interest test.

Further in setting the benchmarks the Bank appears to have selected them, and stated them, for the purposes of being able to justify the conclusions it wishes to reach (see further the comments in Part B on Chapter 2 below). The first

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[34] There are, of course noted exceptions to this general principle in fee market economies. However, they relate to natural monopolies and other essential service providers where the legislature has expressly established a price-setting regime and given the government the power to regulate prices. This is not the case with the PSR Act.

[35] p.11, Consultation Document

benchmark stated on p. 11 of the Consultation Document, namely, that "relative prices charged by financial institutions to consumers who use payment instruments should reflect the relative costs of providing these instruments as well as demand conditions" does not make any reference to merchants. For the reasons explained above, the benefits obtained by both cardholders and merchants should be taken into account. The comments in the Introduction, Section 2.3 are also relevant to in this regard.

2.4 Is Australia's interchange fee too high? An international comparison

While the question of whether the interchange fee is too high in Australia cannot be answered without understanding the respective net benefits to the cardholders and the merchants who participate in the four-party scheme, some insight can be gained by comparing Australia's interchange fees with those other countries. The following provides this information with regard to MasterCard data and shows that Australia's fees are amongst the lowest in the world. This provides further support for the belief that the Bank's concerns about Australia's interchange fees being excessive is unfounded.

[Confidential]

2.5 Truncated Analysis #2 – Inadequate Consideration of the Three-party Schemes and Private Label Cards

Looking back at the roots of modern payment cards, and how they have developed over time, sheds an interesting light on some of the basic and fundamental issues of this matter. Regulating the four-party interchange fee must be considered in the context of long standing competition between private label cards ("PLCs") and four-party system bank-issued credit cards which have marked the history of payment card competition and evolution throughout the past century.

The manner in which payment cards emerged, and subsequently evolved, adds significant strength to a number of points made in this Response:

- four-party scheme cards represent real benefits to merchants;
- the MasterCard interchange fee formula, and its cost components used to calculate the level of the interchange in the MasterCard scheme, are fully justified;
- the interest of small versus large merchants are clearly different and the former would severely suffer if Proposed Standard No. 1 were to be introduced.

PLCs were successfully launched in the US decades before bank-issued credit cards, and dominated the credit card industry for most of the 20th century. These cards were conceived in order to provide a credit service, confer status, stimulate high-volume purchases as well as provide a convenient bookkeeping tool. PLCs evolved into a 'mass' payments instrument in the 1920's.

The first bankcards were issued by Bank of America in 1958. However, PLCs accounted for the vast majority of cards throughout the 1960s. It was only after a decade of fierce competition that bank cards gained significant acceptance and popularity among consumers and merchants. Initially, many merchants, particularly large merchants, refused to accept bank cards. Smaller merchants were the first to accept bank cards in large numbers, for several reasons: most could not afford their own PLCs; smaller retailers benefited the greatest from the ability to offer customers a credit line, thereby expanding their customer base; and speciality stores were benefited from being able to offer credit to travellers and other shoppers who only visited their stores occasionally.

From the 1990's, the growth of PLCs stagnated. In this same period, larger merchants – who had previously resisted bank cards – began to accept them. The ascendance of bank cards was best symbolised when JC Penney, a large US retailer, finally began accepting the Discover credit card which was developed by its arch-rival, Sears.

As illustrated from the above, the issues raised in the Consultation Document must be considered in the context of a long standing rivalry between large merchants, who had the most to lose from the success of bank cards, and the purveyors of the four-party systems, the banks.

MasterCard would like to underline the importance of the origin and nature of this conflict. It bears directly on the force of arguments made in submissions of retail trade organisations dominated by large merchants. It also highlights the potential harm of regulatory intervention into the payments market.

The four-party payment credit card system was developed in 1966 against the backdrop of increased consumer mobility. The three-party, travel and entertainment card systems that were formed in the 1950s by banks, came together to form four-party systems. The critical difference between three and four-party systems lies in the separation of card issuing and merchant acquiring activities between two different banks. Under the three-party or "on us" model, a single entity issues all cards and signs up all merchants and, of course, it charges its cardholders and merchants for the services it provides. Any allocation of cardholder and merchant revenue between the issuing and acquiring sides of its card business is done internally.

Early three-party payment card systems had several important disadvantages compared with modern four-party systems: (1) the growth of issuance, acceptance and usage was curtailed because cardholders could only use their cards in a limited geographic area and at a limited number of merchants within such area (i.e., those that signed an agreement with the issuer of the cards); (2) there was duplication and inefficiency created by each entity having to sign up and acquire other financial institutions' merchants (which, because of the cost, seldom occurred except in the case of very large merchants) – much to the disadvantage of smaller merchants; (3) any merchant that wanted to accept multiple brands of payment cards needed to accommodate the rules, systems and other requirements of multiple issuers (again, something that only large merchants could even consider doing); and (4) because of these geographical limitations and system inefficiencies, competition for cardholders' and merchants' business among operators of three-party system programs was limited. The various inefficiencies resulting from three-party payment systems have caused them to be significantly more expensive than four-party systems, as demonstrated by the fact that they generally charge higher merchant service fees than four-party system acquirers.

Four-party payment card systems were developed to overcome the limitations inherent in three-party systems. In a four-party system, cardholders can use their cards at any and all merchants acquired by any financial institution in the system, and merchants can accept cards issued by any financial institution in the system. Four-party systems can easily expand (by signing up additional financial institutions), even globally, allowing for the exploitation of economies of scale on a level that few three-party systems can match. This is what gives rise to the efficiencies of four-party systems and the lower cost of operating such systems[36].

In addition to overcoming the limitations inherent in three-party systems, four-party systems significantly increase competition, since each member can offer the same basic benefits under the same brand, that is, every issuer can offer cardholders the same acceptance network and basic level of service, and every acquirer can offer merchants the same card base[37]. Thus, the members of the system compete with other members for the business of cardholders and merchants.[38]

The development of four-party payment systems created the separate businesses of issuing and acquiring cards. Whereas three-party system operators must develop and maintain both their issuance and acceptance at levels that makes their payment services attractive to both cardholders and merchants, some members of four-party systems (especially smaller ones) can focus on the issuing side of the business and rely on other members' efforts (typically larger ones) with respect to acquiring. One of the consequences of this is that more financial institutions can be involved in the payment card business via four-party systems than if they had to operate a three-party system[39]. This further increases competition, to the benefit of cardholders and merchants.

By involving more banks, four-party credit card schemes allow cardholders to find acceptance in many more locations, and allow merchants to broaden significantly

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36 See C. C. von Weizsäcker, Annex A, paragraph 79.

37 At the same time, issuers and acquirers can customise their respective service offering, thereby further enhancing intra-system competition.

38 This is explained by one industry analyst as follows: "*For starters, there's a big difference between the way American Express and Discover cards are issued, and how Visa and MasterCard cards are. Visa and MasterCard are associations that basically franchise the name to member banks, which seek customers by offering cards with various interest rates and incentives. American Express and Discover issue their own cards. They don't go through banks or institutions, at least not domestically, which means there isn't competition at the bank level… In terms of the economics of the business, this means two important things: American Express and Discover collect the full merchant fees charged to businesses during transactions. This gives American Express a double leg-up since the discount rate (the fee it charges merchants) is roughly 1.2% higher per transaction on average than the merchant fee for Visa/MasterCard… This distribution system, in a sense, eliminates a layer of competition for American Express and Discover. So, banks issuing MasterCard or Visa cards must compete against one another for card members, whereas if you want an American Express card or a Discover card, there's only one place to go*". Meeting American Express' Competition, Richard McCaffery, www.fool.com (16 March, 2001).

39 This is especially important for acquiring, since acquiring is mostly a processing business in which achieving scale economics is critical to success.

their customer base. In this way, the scheme can take optimal advantage of the "network externalities" inherent in payment card schemes, ie. the value of the scheme to merchants increases with the number of cardholders using its cards, and the value of the scheme to consumers increases with the number of merchants accepting its cards. These externalities benefit both merchants and consumers.

As explained above, in the 1970s and 1980s, national four-party systems, in the U.S., Europe and elsewhere, came together under the MasterCard and Visa brands, to create truly global payment products. Advantages included making it easier for travellers to make purchases and obtain cash abroad, and making it easier for merchants to do business with foreign visitors.

The intense competition both between and within four-party schemes clearly spurs competition. This explains why four-party credit card schemes evolved from being simply a mechanism to provide cardholders and merchants with the benefits of easy access to credit facilities to become, via the development of global interoperability standards, electronic transaction processing and global networks, a convenient payment method in direct competition with other payment alternatives. This has led in turn to the creation, by four-party systems and their members, of a large number of beneficial innovations such as real-time cardholder validation (via PINs), ATM services, debit cards and corporate cards[40].

Four-party systems, therefore have many benefits when compared to three-party payment systems, including:

- Widest possible issuance and acceptance at low transaction costs;
- Intra-system competition in each of the issuing and acquiring functions;
- The ability of smaller banks to participate in global payment systems and therefore remain competitive with larger banks in their local banking market;
- Access to global payment systems by smaller merchants who otherwise could not offer their customers the same payment options as larger merchants;
- Global brands, which create value for consumers, especially travellers.

2.6 The Perverse Competition and Efficiency Effects of Selective Intervention in the Operation of Four-Party Schemes

The Bank has completely misunderstood the three-party schemes in its analysis. As indicated in Section 2.1 above, the relevant market of payments systems encompasses cash and all the payments methods that offer an alternative to cash by virtue of higher efficiency, convenience, and added benefits. Charge and credit cards provided by the three-party schemes and PLCs offered by retailers are clearly part of the relevant market for the purposes of this analysis even if they impose on average higher fees on merchants.

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[40] As explained below, these innovations have largely been possible as a result of multilateral interchange fee arrangements. In addition, the interchange fee has led to greater investment in Chip/PIN technology and is an important element in e-commerce initiatives.

Given the Bank's fixation on the cost-based approach, it is instructive to cite data from the ARA (also quoted in the Consultation Document) showing that while the cost per transaction of using a credit card is higher than a debit card, the average cost per transaction of using a charge card is 53% higher than the cost of using a credit card.[41] The merchant service fee charged by the charge cards is also higher.

By not properly including three-party payment systems in its analysis, the Bank overlooks the most likely effect of its proposals – that the competitive and efficiency benefits of four-party payment systems will be lost as they are likely to be replaced by more expensive and less valuable three-party systems in Australia.

The Bank erroneously believes that, by making four-party systems less attractive to cardholders and less expensive for merchants, debit cards will become the more preferred payment option in Australian retailing.

Indeed, this selective intervention can be shown to have serious anti-competitive consequences. As Australian financial institutions now issue American Express credit cards and receive a commission based on total cardholder volume, the Bank's selective intervention, focusing exclusively on the four-party scheme, will have a direct impact in tilting the playing field in favour of the three-party schemes.[42]

The Bank erroneously believes that if four-party schemes were forced to drastically cut their merchant service charge, the three-party schemes would have to follow suit (Chapter 5.3, p.121). This is a naive view of the market. When faced with a situation of regulated pricing of four-party schemes leading to higher cost faced by cardholders, three-party schemes will take advantage and exploit the opportunity to offer attractive rates in competition with four-party schemes. They will benefit more from their newly found competitiveness and will not feel obliged or forced to adjust their merchant service charges as the Bank believes. The battle in the market for payment services is at least as much for cardholders as for merchants.

Lowering the interchange fees for the four-party schemes through regulatory decree by as much as the Bank effectively proposes will inevitably lead to higher fees to cardholders and a reduction of benefits provided to them. There are four possible and mutually exclusive scenarios of how such a situation may unfold. The first is that issuers do nothing in response to reduced interchange fees. The second is that issuers attempt to recover lost interchange fees through higher cardholder fees.

41 Unlike the ARA's data on the cost of cash, merchants' costs of using credit, charge, and debit cards can be readily obtained from a member survey with credible results.

42 Professor M.L. Katz acknowledges the de facto interchange fees in this arrangement: "American Express does not have a formal interchange fee. However, American Express and its issuing partner, AMP, have an agreement that links AMP's economic compensation to the merchant fees collected by American Express. *This compensation is the economic equivalent of an interchange fee*." M.L. Katz, "Reform of Credit Card Schemes in Australia", August 2001 (emphasis added). It has also been reported that Aussie Home Loans will start offering American Express cards: "The company will use a common strategy to get customers to swap their old credit cards for the Aussie Home Loan Amex cards. New clients will be offered a very low rate on their transfer balance…" A. Kahler, "How to Choose the Best Credit Card," *Australian Financial Review*, Weekend Edition, February 9-10, 2002. If the Bank is of the view that the intersystem pricing mechanism is an acceptable substitute for explicit interchange fees, let it say so and allow MasterCard and the other four-party schemes to adopt them.

The third is that issuers attempt to recover lost interchange fees through bilateral interchange fee agreements. And the fourth is that large issuer-acquirers attempt to recover lost interchange fees by dealing directly with merchants – effectively creating their own three-party schemes.

The first scenario of do nothing is highly unlikely, given that the amount of interchange fee revenue that credit card issuers stand to lose under the Bank's proposals exceeds the entire profits of the industry. One would surmise this by taking a look at the profits of the major issuers and acquirers of credit cards in Australia. A recent Australian Financial Review article[43] suggested the collective profit arising from credit cards for the four major banks in Australia was approximately A$380 million. A reduction in interchange by the specified amount will lead to losses of A$500 million to the industry, resulting in the evaporation of the purported profits currently being made.[44]

The second scenario of raising cardholders' fees would be worse than the do nothing scenario, however. Given cardholders' empirically documented high price elasticity of demand[45], issuers will face stiff competition from the unregulated three-party schemes if they raise cardholders' fees. In addition, issuers with a higher proportion of the "interchanged" transactions (as opposed to the "on us" transactions[46]) will suffer most. And these are typically smaller issuers.

[Confidential] This is a very dramatic result, which underscores how quickly an otherwise efficient and low cost four-party scheme could be unraveled in a scenario of arbitrary government intervention. What commences as ostensible price regulation will result in effective, and unwarranted, product regulation if four-party credit cards are, through the proposed reforms, deprived of their network efficiencies and benefits and, as a consequence, disappear from the Australian payments system. This is described in further detail in Section 2.1 above and in [Confidential].

The third scenario of individually negotiated bilateral interchange fee agreements will result in a very cumbersome and costly system. The "honour all cards" rule will be likely to be undermined in such a scenario as well. Merchants in the end will also pay more as bilateral interchange fee agreements replace the four-party interchange

43 Australian Financial Review, 9-10 February 2002, "How to Choose the Best Credit Card" by A. Kahler

44 This is based on the cost estimate for authorisation, processing and fraud costs in the Joint Study which were a total of $0.28 per transaction. On an average transaction of A$100 (referred to in the Joint Study) this a decrease of 67 bp from the current interchange fee level of 95 bp also reported in the Joint Study. Based on the estimated value of domestic credit card transactions in 2001 of $76 bill. (being derived from the Bank's data on the value of credit card purchase transactions for the year ending November 2001 being $81.7 bill. and the value of domestic transactions being estimated by the Australian Bankers Association as comprising 93% of those transactions) the decrease in the interchange fee revenue would be approximately $509 mill.

45 [Confidential]

46 "On us" transactions refer to those in which the cardholder and the merchant deal with the same card issuer/acquirer. All three-party schemes are "on us" transactions by definition. Portions of the four party schemes are also "on us" transactions. Indeed, the efficiency of a four party scheme can be assessed in terms of its ratio of interchanged transactions to "on us" transactions. The higher the ratio, the more efficient the system.

fee structure. f it were possible to have bilateral interchange fee agreements without a default interchange fee (which MasterCard does not consider to be the case) it is clear that this would have negative effects on the level of interchange fees agreed. As stated by Professor von Weizsäcker in his paper "*merchants are likely to pay more under conditions in which interchange fees are set bilaterally*"[47]. The significant transactional costs that would be incurred in each bilateral process, and the large number of bilateral agreements that would be needed, would make a structure of bilateral agreements extremely costly to implement. MasterCard estimates that bilateral arrangements are less efficient than multilateral arrangements as soon as the number of issuers and acquirers rises above five.

The fourth scenario emerges to be a most likely one over time. After solidifying their position by acquiring the businesses of their smaller issuer-only rivals, large issuer-acquirers currently in the four-party system could start operating their own three-party systems, focusing on "on us" transactions. Professor von Weizsäcker has concluded in his analysis that this is likely to occur should the four-party interchange fees be eliminated as a result of government regulatory intervention, and MasterCard believes that the level of reduction effectively sought by the Bank would likely have the same effect.[48] In this scenario, as the weakened four-party schemes lose market shares, three party schemes will gain market shares at the expense of the four-party schemes.[49] As Professor von Weizsäcker states:

> *"I have shown above that prohibition of an interchange fee would lead to the replacement of four-party credit card systems by three-party systems which are not likely to be more efficient and therefore cheaper (section F). I have also shown that the competitive process implies that a large part of the revenue of a credit card system will be obtained by value based merchants' fee (section D). Therefore prohibition of the interchange fee would raise rather than lower merchants' fees for credit card systems."*[50]

Market analysis in the UK has demonstrated that not only could this occur, but it would also mean massive losses of market share by the four-party schemes.[51] A few new three-party schemes will likely emerge in this scenario, dominated by the largest issuer-acquirers in the four-party schemes.[52] Their services will be more expensive and less competitive than the four-party schemes that they are replacing. Smaller issuers, cardholders and merchants will all be disadvantaged in this scenario.

Thus, of the four possible scenarios outlined, only the fourth scenario is likely to be a viable one. But it is also a highly undesirable scenario, entailing net losses of social welfare across the entire payments system.

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47 See C. Christian von Weizsäcker , Annex A, paragraph 66.

48 "The Economics of Credit Cards", *ibid*.

49 [Confidential]

50 p.88, C.C. von Weizsäcker, Annex A

51 [Confidential]

52 The only way that the existing global schemes could remain viable in Australia under the Bank's proposals might be to align themselves with one of the surviving three-party bank programs, effectively turning them into the systemic equivalents of those three-party systems.

The Bank's selective and arbitrary intervention in focusing exclusively on the four-party schemes will result in a reduction in the efficiency of the payments market in Australia as the three-party schemes, which have higher overall fees and lower network benefits, will reap a competitive windfall against the four-party schemes.

In MasterCard's June 8, 2001 Submission to the Bank (in Part A, Section 1.1 b), the consequences which may ensue if interchange fees are set too low were pointed out: "A self-reinforcing cycle could be set in motion that could eventually lead to the whole system unraveling: interchange fees set too low, leading to issuers charging higher fees to cardholders, leading to diminished cardholders network, leading to fewer merchants acquired, leading to the need to further lowering of the interchange fee, and so on. This could be characterised as a 'death spiral' process."

The Bank has not in the Consultation Document made any attempt to address this major concern. Given that MasterCard has now presented empirical evidence of its likelihood, perhaps the Bank will now take it into consideration before making its final decision.

In Asia Pacific, the situation described by Professor von Weizsäcker is actually illustrated by the prevailing conditions in the Korean and Japanese payments markets.[53]

	% of on us transactions	**Average [Range] Interchange Fee**	**Average [Range] Merchant Fee**
Korea	99%+	2.9%	3.2%
Japan	91%	[Up to 5%]	[1.5% - 8%]
Australia	24.6%	0.95%	1.78%

(Data excludes international transactions, based on estimates by Edgar, Dunn & Co.; and Australia's % of on us transaction based on MasterCard 2000 data).

The very high percentage of "on us" transactions in Korea and Japan mean that merchants are required to negotiate and sign individual agreements with each card company whose cards the merchant wants to accept, which is very inefficient and costly. The resultant interchange fees are not only much higher, but the process of setting them is significantly less transparent than that of the four-party schemes. High interchange fees mean that card companies are not motivated to compete in acquiring. For those who are willing to acquire, they tend to set the merchant fees as high as possible to maintain their profitability. Contrary to the Bank's contention that merchants could negotiate down the merchant service fees in dealing with three-party schemes, evidence from Korea and Japan shows the opposite – dominance by three-party schemes has led to extraordinarily high merchant service

53 This is an issue raised by MasterCard in its Submission to the Bank, June 8, 2001. There is neither acknowledgment nor adequate response by the Bank in its Consultation Document.

fees. The result is to be expected, given that three-party payment systems do not have intra-system competition.

In addition, “on us” transactions strongly favour large issuers-acquirers. If the four-party schemes are weakened by arbitrary government intervention as a result of the Bank’s proposed reform measures, then the biggest banks in Australia are in the best position to dominate the credit card business after the smaller banks’ are squeezed out, leading to severely diminished competition in the credit card market.

Implications for the Public Interest Test

The Bank’s failure to take into account the three-party schemes in its analysis violates at least two of its own benchmarks. The first of these two states that “prices of payment instruments should be transparent.” Yet, the Bank has chosen to exclude the three-party schemes in its deliberations, even though the pricing decisions in these schemes, as well as the relationship between fees charged and the costs within the three-party schemes, lack any semblance of transparency. In contrast, the four-party schemes have well established methodologies for estimating their interchange fees[54].

And, in excluding the three-party schemes, it is impossible to imagine how the Bank’s proposals could achieve results described by the second of the two benchmarks – “competition within the market for a payment instrument, and between different payment instruments, should be open and effective.” The Bank’s proposals will intervene in the operations of the four-party schemes, critically affecting the setting of fees and related operational parameters, and thus their overall competitiveness. Meantime, an acknowledged higher cost product, the three-party schemes, will be able to do what they wish, unimpeded by regulatory constraints. This will be a situation exactly opposite from “open and effective” competition.

Further, the incremental competitive and efficiency benefits that the Bank hopes to achieve with the Proposed Access Regime are expected to be swept away as a result of the implementation of the interchange fee proposals. The returns will not be such as to encourage many (if any) new entrants into the business of credit card issuing.

2.7 Surcharging and Cash Discounts

The Bank claims that the “no surcharge” rule suppresses market signals, and hides the “true” costs of the four-party schemes from the customers. This claim can be shown to be incorrect both conceptually and empirically.

From a conceptual point of view, the economic equivalent of surcharging in Australia today is actually possible through cash discounts. Under MasterCard’s rules, merchants accepting MasterCard cards for payment in Australia are free to offer cash discounts now, which is equivalent to surcharging. Thus, from a conceptual as

[54] MasterCard offered to assume the responsibility for setting interchange fees for its members in Australia using the same methodology as it employs in the U.S. and globally, and notes that the Bank refused that offer out of hand.

well as practical perspective, merchants can pass onto the customers exactly the cost of accepting credit cards should they wish to, and there will be no "suppression" of price signals. If the price signals are "suppressed", it is not because of the "no surcharge" rule, but because of merchants choosing to suppress them. The real and relevant question is, why?

From an empirical perspective, available evidence points overwhelmingly to the conclusion that merchants do not offer cash discounts, and even when they are free to surcharge, they typically choose not to do so, because they do not perceive it to be in their best interest to do so. Merchants in the UK have been free to surcharge since 1991. [Confidential][55]

Similar evidence is available from the Netherlands and Sweden. In the Netherlands both surcharging and cash discounts are allowed. A survey[56] conducted there in 2000 shows the following findings:

Merchants that do not surcharge	89%
Merchants that do not cash discount	91%
Cardholders that do not approve of surcharging	74%
Cardholders that do not approve of cash discount	49%

A similar survey[57] conducted in Sweden in 2000 show the following findings:

Merchants that do not surcharge	95%	Key reason for not surcharging is the worry of losing sales
Merchants that surcharge	5%	Do so only when the purchase amount is very small
Merchants that do not cash discount	99%	Key reason given is that the card payment system is regarded as safe and efficient and they would like to encourage customers to use credit cards

The evidence is clear – merchants' decision on whether they choose to offer a cash discount (when they do not have the option of surcharging) or to surcharge (when they have such an option) is based on their business judgement on whether there is net benefit in doing so. The Bank's attempt to cast doubts on these survey findings is unconvincing. Contrary to the Bank's contention, fundamentally such a decision does not have anything to do with whether they have the option to surcharge or not. If a merchant decides that the benefit of accepting credit cards does not outweigh the cost, then he/she could, and would, offer a cash discount to encourage customers to pay with cash, even if the option of surcharging is not there.

55 [Confidential]

56 Study Regarding the Effects of the Abolition of the No-Discrimination Rule in the Netherlands. ITM Research, conducted on behalf of the EC Competition Director General, March 2000.

57 Study Regarding the Effects of the Abolition of the No-Discrimination Rule in Sweden. IMA Research, conducted on behalf of the EC Competition Director General, February 2000.

So there is no suppression of price signals. The price signals are always there, except that the Bank chooses to disregard them. Indeed, [confidential] the Netherlands and Sweden shows unambiguously that the merchants' price signals indicate a preference for credit cards because of the implicit costs of handling cash and the net benefit derived from accepting credit cards.[58] Accepting credit cards both increases sales for merchants as well as reducing their costs of handling cash to such an extent that they gain significant net benefits after paying for the explicit associated costs in accepting credit cards (merchant service fee, costs of authorisation etc.)

And this is the competitive process at work.

Thus, there appears to be only one sensible answer to the question of why merchants do not, to any significant extent, offer cash discounts today in Australia. Merchants derive significant net benefits in encouraging and accepting credit cards, after taking into account the costs of handling cash and the incremental benefits conferred by accepting credit cards. Whereas, to offer a cash discount for a cash payment is to discourage customers from using credit cards, which is contrary to their self-interests.

From the point of view of retail prices, given that there is a cost to the merchant associated with every payments method, then retail prices should have always reflected this cost. Long before the introduction of credit cards, merchants had to factor in the cost of handling cash, which was just part of the operating costs. With the range of payments options available today, the only change is that the merchant has to factor in an average cost of the payments methods, however estimated, into the final retail prices. Viewed this way, it is nonsensical to suggest that retail prices are higher today because of prevalence of credit card use. Retail prices had always reflected the cost of accepting payment, regardless of the specific payments method involved. If the merchant's cost of accepting a credit card is marginally higher than the cost of accepting cash, then this margin is more than compensated by the increased sales made possible by credit card use, which reduces the merchant's cost of accepting payment on the basis of per unit of sales. This leads to, everything else being equal, retail prices lower rather than higher as a result of wide spread credit card usage.

In the paper included in Part C (in Section C of that paper) Professor von Weizsäcker gives the example of opening hours of shops. If a law is passed or a cartel is formed to reduce the weekly opening hours of shops, this may have little impact on total sales of shops. Customers adapt and do their shopping at the time the shops they want to buy from are open. If now the law is rescinded again the first shops increasing their opening hours will win additional business away from the other shops. This is an indication that consumer benefit has increased, even if total expenditures of consumers in shops have not increased. But shopping convenience has increased for the customers. Under competitive conditions we then expect most shops to increase their shopping hours again, thereby providing additional shopping convenience for customers. Yet total shopping volume may not have changed at all. Nevertheless, in economic terms society benefits.

58 [Confidential]

If the Bank insists on allowing merchants to surcharge, then the proper and logical way to do this is to ensure that merchants surcharge on *all* payment methods according to exactly the costs that they incur. A scrupulously honest merchant will therefore surcharge x% for cash, y% for credit card, z% for debit card, and w% for cheque, each calculated exactly according to the real in-store costs incurred in accepting each of these payments methods. How this is to be implemented is beyond imagination. Equally unimaginable is how the Bank is going to ensure that the handful of unscrupulous merchants who face less than effective competition won't use surcharging as a way of further gouging their customers.

Implications for the Public Interest Test

Merchants' ability to offer cash discounts in Australia today meets the competition benchmark of "merchants should be free to set prices for customers that promote the competitiveness of their business." The fact that most merchants are unwilling to offer cash discounts reflects their business judgement that there is a net benefit to them, particularly in promoting the competitiveness of their businesses, in accepting credit cards. Allowing surcharging will not result in anything more than that a few merchants will use it as a way of over-charging their customers.

2.8 Credit Cards and Levels of Consumption

The Bank states that increased consumption as a result of credit availability is a one time only increase – it's a simple inter-temporal substitution of consumption in which consumers spend today instead of what they plan to spend in the future. This is a claim that defies even the most basic understanding of economics.

Elementary economics informs that there is a special case under which a temporarily induced increase in aggregate demand would not have a permanent positive impact on the economy. This is the special case in which all available production resources, capital, labour, land, and others are fully engaged. Thus, if the Bank is seriously suggesting that an increase in consumer liquidity due to the popularity of credit cards does not have sustainable positive impacts on the Australian economy, then the Bank must be saying that there are no idle and under-utilised economic resources in Australia.

It does not take specialised expert knowledge to reject this assertion.

As long as there are resources not yet fully utilised in Australia, an increase in consumer demand, via the line of credit available on Australians' credit cards, will bring into production previously idle, or under-utilised, resources. This will in turn create new investment and business opportunities, followed by new employment opportunities, followed by higher consumer incomes – the simple "multiplier effect". The higher consumer incomes will allow consumers to spend more than they would without their initial increase in credit card funded spending. The net result is that the initial spending does not have to be a substitution for future spending if it stimulates increased utilisation of under-utilised resources.

Recent retail and growth figures in Australia have shown the significant impact credit cards have on driving economic growth in a consumption based economy. For example, a press release by the Federal Treasurer on 7 March 2002 said the following,

> *"Australia's economic growth rate of 4.1 per cent over 2001 compares with an OECD average of less than 0.5 per cent over the same period. Amongst the G7 economies, the strongest growth rate over 2001 was the UK at less than 2 per cent, with the remaining members below 1 per cent .*
>
> *Economic growth was underpinned by strong growth in household consumption of 1.3 per cent in the December quarter. This follows solid growth in the June and September quarters and household consumption was 4.2 per cent higher through the year to December"*

This report followed recent newspaper articles specifically about retail spending in the December quarter. One such report (28 December 2001 Herald Sun) said,

> *"The Christmas consumer spending spree reaffirmed Australia's love affair with credit cards. Despite the terrorism incidents in the US in September 2001, Australians shrugged off thoughts of economic woe and raced to restore the fortunes of retailers. In December 2001, Australian retail spending is expected to top A$17.54 billion. Indicators suggest that retail spending increased 4.5% on the figure for 2000, another sign of the confidence Australians have in their job security and in the strength of the local economy"*

Indeed, available analytic evidence suggests that an easing of liquidity constraints as a result of increased use of credit cards produces significant impacts in increased aggregate demand. An analysis[59] of a massive data series covering the 1995 – 1998 period in the US, consisting of 231,644 monthly observations of credit card accounts, concludes that:

(i) Every $1,000 increase in credit limit generates a temporary average increase of $130 in the outstanding revolving balance per account, with 80% of the increase realised in two months. This allows cardholders to use the line of credit to smooth spending in spite of their sometimes lumpy incomes (for the self-employed), and in anticipation of rising incomes.

(ii) While each 1% increase in interest rates leads to a drop of $110 in outstandings per account over a nine month period (64% of the drop happens in the first two months), a 1% decrease in interest rate induces a $380 rise in outstandings per account over a nine month period (70% of the rise happens in the first two months).

The aggregate impact on the macroeconomy could be very significant, especially when there is a combination of credit expansion and lower interest rates.

MasterCard finds it hard to understand, and more than a little disturbing, that a central bank such as the Bank, would hold such a view, given that one of the basic

[59] David G. Gross and Nicholas S. Souleles, June, 2001. "Do Liquidity Constraints and Interest Rates Matter for Consumer Behavior? Evidence from Credit Card Data." National Bureau of Economic Research.

tenets of macroeconomics is that one of the surest ways of stimulating growth is by increasing borrowings.

Implications for the Public Interest Test

The popularity of credit cards and its growing transaction volumes are consistent with two of the three dimensions of economic efficiency identified by the Hilmer Report which is referred to by the bank in the Consultation Document: allocative and dynamic efficiency. The use of the line of credit provided by credit cards in increasing aggregate demand, bringing into productive use of unutilised and under-utilised resources to raise overall economic output and income, meets the prerequisite of allocative efficiency. With rising aggregate demand creating new business and productive opportunities because of the easing of consumers' liquidity constraints, credit cards are also contributing to the economy's dynamic efficiency. Accordingly, to the extent that the Bank's proposed reform will negatively impact on allocative and dynamic efficiency, MasterCard believes that the reforms are not in the "public interest" as that term is defined in section 8 of the PSR Act.

2.9 Affect on Tourism

Tourism now accounts for over 5% of Australia's GDP, and is one of the fastest growing sectors, with high employment and income multiplier effects. Small retail merchants account for the highest portion of employment generated by the tourism industry (27%), followed by accommodation (18%), and cafes and restaurants (9%). If a surcharge is imposed on international tourists using credit cards, the result is likely to be harmful to the hospitality and retail industries that cater to international tourists with a negative affect on tourism in Australia. As we have discussed above, the demise of four-party systems, and their transformation into three-party systems as a result of the proposed reduction on interchange fees will lead to higher merchant fees, and fewer small merchants accepting cards. This coupled with surcharging at the fewer merchants that continue to accept cards, will have undesirable impacts, which will be most apparent in regional and rural areas of Australia. These areas rely heavily on tourists for their economic survival. The potential inconvenience to tourists will lead to making Australia a significantly less desirable holiday destination, resulting in a reduction in tourism to Australia, the impacts of which are painstakingly obvious.

PART B SPECIFIC COMMENTS ON THE CONSULTATION DOCUMENT

In this Part of MasterCard's Response, specific comments are provided on each of the Chapters of the Consultation Document. Our comments are ordered according to the specific paragraphs on the specific page of the Consultation Document. A part of a paragraph appearing on a page is treated as a paragraph for the purposes of the numbering convention adopted in this Part. A bullet point or sub-paragraph is treated as being part of the paragraph of which it forms part.

Chapter 1 – Background to reform

1. p.1	The Bank's failure to include the proportion of cash transactions gives a distorted view of the role of credit cards in the Australian payments market in Table 1.1. Assuming the accuracy of the information contained in Table 1.1, if cash were included in the relevant market, the percentage of transactions accounted for by MasterCard (on its own) and four-party payment systems (taken together) would fall to about 8.1% and 32.8%, respectively. Even without including cash in the calculation, based on the information contained in Tables 1.1 and 1.2, MasterCard's share of non-cash payments is only in the order of 5% (22% of the credit and charge card market, which is itself 24% of the non-cash payments market). There is no reliable data demonstrating the volume of cash payments in Australia, however it is reported from the United Kingdom that "Cash payment volumes were some 25.6 billion in 1999 accounting for three-quarters of all payments."[60] Also taking into account that MasterCard's volume share in Australia is significantly lower than its share of total cards, if cash were included the percentage of MasterCard transactions would drop to approximately 1-2%. Despite this, somehow the Bank is convinced that the interchange fee setting practices, "no surcharge" rule and membership eligibility rules and policies of a credit card system that represent only 5% of non-cash payments and only 1-2% of total payments, is distorting competition and undermining the efficiency of the Australian payments market, and that radical government intervention is warranted.
2. p.2	Assuming that the Bank's 25% figure is correct, the large majority of transactions are not done for purely transactional reasons but also in order to use the credit facility. This means that cardholders pay for a substantial portion of the cost of credit cards in the vast majority of cases. In fact, based upon figures cited in the ACCC-RBA Joint Study, interchange make up only about one-third of issuers' revenues.

[60] http://www.apacs.org.uk/

	Hence, the implication that cardholders get a free ride from consumers who pay by other means is inaccurate. In relation to Figure 1.1, more recent data published by the Bank suggests that the gap between debit and credit card payments was closer than is suggested in this diagram, with debit growing strongly in 2001 at a similar rate to credit.[61]
3. p.3	Table 1.2 suggests that the relevant market may only comprise the four-party schemes and the three-party schemes. For the reasons indicated in Part A, Section 2.1 and in MasterCard's Submission to the Bank of June 8, 2001 (Part A, Section 1) the market should include other payment instruments such as cash, cheques, debit cards and store cards. Once the market has been correctly defined, the indicated shares for the four-party schemes would be significantly reduced.
4. p.4, para 1	The increasing similarity between the three-party schemes and the four-party schemes, as illustrated by the release of a credit card by American Express, highlights a major deficiency in the reforms proposed in the Consultation Document in not including the three-party schemes in the reforms. This point is explained further in Part A, Section 2.5.
5. p.4, para. 2	The Bank asserts that the rules and regulations of the four-party schemes are determined collectively by the financial institutions that compete with each other as issuers and acquirers. This is not an accurate description of the manner in which MasterCard's rules and regulations are generally established. All major rules and regulations are approved by the MasterCard Global Board, which is comprised of senior executives of banks from around the world. While some MasterCard directors work for banks that compete with each other, this is not true of the majority of the Global Board.
6. p.5, para. 1	For the reasons explained in the preceding paragraph, with regard to MasterCard, it is incorrect to state that members of each scheme collectively determine the criteria for membership or impose the so-called "no surcharge" rule.
7. p.5, paras 2, 3 and 4	It is not correct that the setting of interchange fees is *prima facie* anti competitive. Interchange fees have been determined not to be anti competitive by the U.S. federal courts (in *National Bancard Corp. v. Visa U.S.A., Inc*.,[62] "*NaBanco*"), and no court anywhere in the world has ever held to the contrary. Moreover, the competition laws of most developed nations recognise that certain types of cooperative price-setting behaviour, even among competitors, may be allowed. Thus, joint ventures of competitors routinely set the prices of their goods and services with no fear of running afoul of competition law. Similarly,

[61] http://www.rba.gov.au/Statistics/Bulletin/C02hist.xls
[62] *779 F. 2d 592* 1986

	collective price-setting by competitors is permitted in industries as disparate as telecommunications, sports sponsorships and music licensing. Interchange fees have never been held to be anti competitive under the Trade Practices Act. In fact, the Australian Competition and Consumer Commission ("ACCC") discontinued its action against National Australia Bank ("NAB") before the issue was ever ruled upon in court. In Annexure A, paragraphs 71 and 72, Weizsäcker provides an analysis as to why the MasterCard interchange fee does not constitute price fixing. Moreover, the Bank neglects to mention that the collective setting of prices by joint ventures is specifically permitted in most market economies. This exception to prohibition of competition laws is specifically recognised in Australia's *Trade Practices Act* in section 45A(2), and similarly mentioned in the European Commission's Guidelines on Horizontal Co-operation (see [Confidential]). MasterCard regards the MasterCard system as being a joint venture between issuers and acquires to deliver a joint product – namely, the MasterCard credit card system. The nature of credit card systems as being that of a joint venture has been specifically recognised by U.S. legal authority (in *Nabanco*). Further, authorisation is not a mandatory requirement under the *Trade Practices Act* and MasterCard does not regard its system to have contravened, or as risking a contravention, any competition law such as would require authorisation to be sought. The approach of the Bank here, and at other points in the Consultation Document (including at pp. 6-7) is infected by the incorrect assumption adopted by the Bank (which appears in this respect to have been influenced by incorrect views of the ACCC) that the MasterCard credit card scheme is in breach of the *Trade Practices Act* and requires authorisation. The Bank appears to take the approach that the mere existence of a multilateral agreement means that there is a restriction of competition, although no analysis or support for this is given. This leads MasterCard to be concerned that the Bank has failed to understand the central role of interchange fees in four-party payment systems. If it did understand this role, it might be less inclined to intervene in the setting of interchange fees.
8. p.6	The Joint Study cited by the Bank, which it co-authored with the ACCC, contains many of the same unsupported and erroneous conclusions as the Consultation Document. The seeds for the misunderstanding of the efficiency criteria under the public interest test were sown with the Joint Study where it is argued that: • interchange fees are higher than justified by costs; • there are no incentives to bring prices in line with costs;

	• only when incentives reflect demand and cost conditions can consumers make well-informed purchase decisions and choose cheap and efficient schemes over more expensive or less efficient ones. It is noted that MasterCard raised significant reservations concerning conclusions reached in the Joint Study – which were dealt with in MasterCard's submission to the Bank dated June 8, 2001 – and most of which have not been addressed by the Bank in its Consultation Document. There is the overwhelming impression that the RBA takes on board the erroneous view of the Joint Study and perpetuates the myth of inefficient and expensive credit card schemes. There is no factual basis for the RBA to find that four-party credit card schemes are expensive and inefficient. On the contrary: • cardholders make use of credit card charges (75% of outstanding balances carry interest), knowing and appreciating the revolving credit facilities that they offer (unlike debit cards); • as the Bank states (p.2) loyalty programs have contributed to the success of credit card schemes, which implies that cardholders recognise and appreciate these benefits.
9. p.7, para . 2	MasterCard does not agree in principle with the Bank's contention that when consumers can make well-informed choices, it would be expected that lower cost and more efficient payment instruments would thrive at the expense of the more expensive or less efficient ones. This argument assumes that consumer demand is driven only by pricing considerations, and that consumers disregard the non-price benefits that a particular consumption choice may offer. With respect to payment systems, these other benefits may include convenience, security, refund entitlements if paid goods or services are not delivered, and the benefit of following consumption patterns through monthly statements. The Bank's contention is not supported by the evidence – despite the offer of discounts by merchants for cash sales, there has been no significant increase in cash payments by consumers over recent years. Nor is it consistent with the experience in most other industries. If it were, there would be no such thing as luxury goods, designer fashions or highly-paid professionals. In other words, consumers do not always prefer the cheapest product. Even accepting the Joint Study's conclusion that Australia's credit card systems and issuers encourage the use of credit cards at the expense of other payment instruments (which of course is exactly what they are required to do under competition law), this of itself does not mean that the incentives in an economy fail to reflect demand and relative cost conditions. Rather, the most likely explanation is that consumers

	prefer them. In addition, the Bank's contention that Australia has a higher cost retail payment system than necessary does not give adequate regard to the cost of cash (as explained in Part A, Section 2.2) and, also assumes that pricing considerations only dictate an optimal level of resource expenditure for payment systems, and again fails to appreciate the demand for non-price related benefits offered by particular payment instruments. Further, although the Bank approaches this issue from the perspective of "consumers" making well informed choices, its analysis is, as described in Part A, Section 2.3, based upon the cost and efficiency of payment systems to a merchant, rather than the consumer, and ignores the respective benefits to both merchants and cardholders.
10. p.7, para. 4	Although MasterCard was not directly involved in discussions with the ACCC concerning the possible authorisation process, it appears to MasterCard that the ACCC did not provide the banks with which it was dealing with adequate opportunity, despite considerable effort by the banks to reach agreement with the ACCC regarding an appropriate basis on which authorisation would be sought for changes to the credit card systems which would satisfy all of the ACCC, the banks and credit card schemes. Instead, the ACCC commenced (in a blaze of publicity) court proceedings on 31 August 2000 against one bank but not against MasterCard. Many other parties, including MasterCard, were later joined in those proceedings as cross-respondents by that bank. In April 2001, the ACCC discontinued the primary proceedings so that there was no opportunity for the Court to test the assertions of the ACCC that there was any breach of the *Trade Practices Act*. There were also no admissions by any of the parties that the ACCC's court action was at all justified. Instead the ACCC, by preventing the Federal Court from testing its assertions, referred the matter to the Bank to be dealt with under the PSR Act. It is highly self-serving, therefore, for the Bank to cite this referral by the ACCC as a reason for the need for regulation of banks or of credit card schemes generally.
11. p.8, para. 1	MasterCard notes that by letter dated 26 March 2001, the Governor of the Bank wrote to MasterCard advising that it was considering whether to designate the Australian credit card system. That letter stated that "the Bank is happy to consult with interested parties, over a two week period beginning 26 March." In view of the seriousness of the matter being considered by the Bank, MasterCard regards the very limited time afforded by the Bank for consultation on this matter as being unreasonable and inconsistent with the requirements of the PSR Act. Further, as already noted (and as previously advised to the Bank), MasterCard does not admit that the "MasterCard system" or the "MasterCard network card system" referred to in the purported designation by the Bank is a "payment system" under the PSR Act. MasterCard does not accept that the Bank has validly designated under the PSR Act the credit card system operated by MasterCard.
12. p.8,	For the reasons described in Part A, Section 2.5, MasterCard believes

para. 2	that a significant flaw in the Banks regulatory approach is that it did not seek to regulate the three-party schemes. MasterCard maintains that, as a result, the public interest test is not satisfied in respect of the reforms proposed in the Consultation Document. As noted in Part A, Section 2.5, three-party schemes employ their own pricing mechanisms when they allow other institutions to conduct business under their brand. These mechanisms are significantly less transparent, and usually result in higher costs to merchants, than the interchange fees of four-party systems. The Bank's reliance on the fact that the three-party schemes do not have rules that "discriminate on the grounds of institutional status" is laughable. Three-party schemes deal only with those other institutions that they choose and, generally, they exclude virtually every other institution from participation. This is the factor that distinguishes them as three-party schemes. The Bank states in this paragraph that it "confirmed that any decision it took about restrictions on merchant pricing in the public interest with respect to the designated credit card systems would also apply to the three-party card schemes". However, Proposed Standard No 2 does not achieve this; nor could any proposed standard achieve this until three-party credit schemes have been designated.
13. p.8, para. 3	The Bank fails to note that the European Commission recently upheld the Visa "no surcharge" and "honour all cards" rules. The Bank further fails to note that the Commission announced its intention to approve a Visa interchange fee methodology that appears to be very similar to that employed by MasterCard in the U.S. and that MasterCard offered to the Bank to adopt in Australia. Nor does the Bank mention that the U.S. Department of Justice, after conducting several extensive investigations in the past several years, has never challenged MasterCard's interchange fees or "no surcharge" rule.
14. pp.8-9	As noted in Section 2 of the Introduction, MasterCard does not admit that the Bank has the power to designate it under the PSR Act.
15. p.9, para.4	MasterCard disagrees with the Bank's statements concerning the matters on which it may determine standards. MasterCard maintains that the intention behind the section 18 power under the PSR Act to make standards relates to matters concerning the operation of payments systems and that any regulation of interchange fees should be by way of an access regime under section 12 of the PSR Act. "Access" is defined in the PSR Act to mean "the entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable". MasterCard maintains that interchange fee arrangements (assuming that they can be regulated pursuant to the PSR Act) more appropriately fall within such "terms" under section 12.

16. p.9, para.5	In relation to the consultation process, MasterCard refers to its comments in Section 2.2 of the Introduction, as well as in Chapter 2, paragraph 63, and the introduction to Chapter 4 below.
17. p.10, paras.3, 4	Comments on the inappropriateness of the Bank tainting current interchange setting arrangements with the imputation of illegality have been made above at paragraph 8. The suggestion about the regulatory framework established by the schemes for credit cards being unique is incorrect. The Bank (as indicated at paragraph 7 above) overlooks the nature of a credit card scheme as being a joint venture. Arrangements made by MasterCard are in keeping with the joint venture nature of its credit card scheme. Other industries where such arrangements exist include various financial trading systems and utilities. It is inappropriate for the Bank to state that credit card scheme members act collectively to set wholesale prices, prohibit merchants from passing on these prices and restrict entry to the market in a way that substantially lessons competition. As the Bank is aware, "substantially lessens competition" is the relevant test under several anti-competitive provisions of the *Trade Practices Act 1974* ("TPA"). A person may only be judged to have acted in a manner that substantially lessens competition by a Court of Australia in proceedings for breach of the TPA (and only after affording the person an opportunity to present their case). Moreover, it is widely recognised, and the Bank admits (at p(iii)), that interchange fees are an integral part of four-party payment systems that, far from lessening competition, make possible significant inter- and intra-system competition that would otherwise not exist. As such interchange fees are clearly in the public interest and any conclusion by the Bank to the contrary is both logically and legally unsustainable.
18. p.11 para 1	Although MasterCard recognises that producing a framework which conceptualises notions of competition and efficiency is a task which should not be oversimplified, the Bank's approach is not easily discernible. Further, while the Bank equates its approach to the public interest test with the broad objectives of competition policy in Australia, MasterCard is concerned that the Bank does so at the expense of those specific public interest factors (which, under the PSR Act it must consider) which do not relate to competition policy, namely the financial safety of payments systems and the risk to the financial system. Further, in relation to the access regime, as indicated in Section 2.1 of the Introduction, the Bank must also consider the interests of current and future participants in the system.
19. p.11	The Bank states that "the payments system in Australia needs to give

para 3	maximum rein to the workings of the price mechanism". As the Bank acknowledges (at p (ii)), interchange fees are an integral part of four-party payment systems. However, the Bank's proposed reforms will determine interchange fees arbitrarily, in complete disregard to the workings of competition and the price mechanism. The Bank sets out several competition 'benchmarks' it views as underpinning the public interest test. Whilst MasterCard generally welcomes benchmarks to the extent that they can be applied to promote competition and efficiency in *all* payment systems, MasterCard believes that the Bank has set benchmarks in a manner designed to serves its own objectives. MasterCard's criticism of these benchmarks is provided in Section 2.3 of the Introduction. For example, the Bank refers to productive efficiency in the context of the three dimensions of economic efficiency identified in the Hilmer Report, and yet productive efficiency is not reflected in the benchmarks. As has been referred to extensively, the four-party schemes have major advantages over the three-party schemes in terms of network efficiencies. As pointed out in Part A, Section 2.5, a major concern which MasterCard has with the proposed reforms is that they encourage the growth of the three-party schemes. These schemes do not have the productive efficiencies of four-party schemes. It appears that the Bank may have been reluctant to set a benchmark relevant to productive efficiency for fear that its proposals would not satisfy that benchmark. Also, the Hilmer Report refers to dynamic efficiency, and yet there is no benchmark which reflects this. In Part A, Sections 3 and 4 of MasterCard's June 8, 2001 Submission to the Bank, MasterCard identifies adverse consequences from the reform proposals for Australia's drive to become a knowledge based economy as well as consequences for e-commerce initiatives. Again, it appears that the Bank may have been reluctant to set a benchmark relevant to dynamic efficiency for fear that its proposals would not satisfy that benchmark. MasterCard makes the following further observations with respect to the benchmarks set by the Bank: • *relative prices charged by financial institutions to consumers who use payment instruments should reflect the relative cost of providing these instruments as well as demand conditions.* MasterCard agrees that, in a competitive market, prices will generally reflect costs, including risk costs and the cost of capital. But if, as the Bank's proposals with regard to interchange fees suggest, the Bank means by this that interchange fees must be strictly cost-based, MasterCard respectfully disagrees. Moreover, MasterCard asserts that any interchange fee setting methodology based on such a view will not only harm four-party payment systems but will result in higher costs and lower levels of service to both cardholders and merchants. As pointed out in Section 2.3 of the Introduction, in a situation of joint

	costs of providing a service to two sets of customers, the requirement for cost-based pricing can only be met with regard to the sum of both prices (merchant and cardholder prices). It is not possible to have cost-based prices for merchants and cardholders separately. The right test therefore is to review whether total costs of a scheme are reflected in the prices charged to merchants and cardholders. Viewed this way, of course, the interchange fee is not the relevant variable but only one of several elements of a scheme. In fact the interchange fee is a cost-allocation mechanism that shifts costs to acquirers and away from issuers. The benchmark on cost reflective pricing to consumers is not clear and is unhelpful as an elaboration of the requirement of allocative efficiency. Moreover it is misleading as it leads to the belief that the interchange fee can be charged in line with some notion of cost for a specific service. • *merchants should be free to set prices for customers that promote the competitiveness of their business* As the Bank is aware, MasterCard's rules do permit a merchant offering a customer a cash discount. Accordingly, merchants are free to set prices which take into account the cost of different forms of payment so far as credit cards are concerned. With respect to surcharging, this benchmark is appropriate to the extent that competitive conditions ensure that any surcharge imposed by merchants reflects the merchant service fee. It may not be appropriate where, due to an absence of competition, for example because of geographical isolation, a merchant is able to gouge cardholders by setting a surcharge that is significantly higher than the merchant service fee. • *prices of payment instruments should be transparent* Pricing decisions by competitors, especially with regard to wholesale prices, and the various costs upon which they are based, are in many case kept confidential. This is true of even the most competitive markets. MasterCard does not understand why its credit card scheme should be subject to different treatment. Under the Bank's proposals, all of its competitors will know its interchange fees, and certain of its key costs of doing business. MasterCard, however, will not have the same information about most other payment systems. Moreover, it is difficult to understand the basis of the Bank's belief that transparent interchange fee pricing will produce, or even contribute to, efficient and competitive conditions in the payment systems markets. Merchants already know the cost of accepting credit cards and, unless they have made no effort to inform themselves, they also know the level of interchange fees. Nevertheless, MasterCard is prepared to accept that there should be more transparency with interchange fee setting, as long as the cost of such transparency is not MasterCard's loss of freedom to set interchange fees at levels that will assure the success, or at least the survival, of its four-party credit card scheme in Australia.

	• *any restriction on the entry of institutions to a payment system should be the minimum necessary for the safe operation of that system* MasterCard agrees that entry restrictions should be the minimum necessary to protect the legitimate interests of four-party payment systems, and that safe operation is one of these. MasterCard is pleased that the Bank has acknowledged, consistent with MasterCard's existing membership rules, that prudential regulation and supervision of members is a necessary minimum requirement for membership. There are other restrictions which may be important, however, for example, the ability to conduct one's business without one's competitors gaining access to confidential or proprietary information.
20. p.13, para.3	MasterCard disagrees to a substantial extent with Professor Katz's report. In this regard reference is made to the report in Part C of this Response by Professor C.C von Weizsäcker which addresses Professor Katz's report.

Chapter 2 – Collective Setting of Interchange Fees

MasterCard is extremely concerned with the proposal set out in this Chapter and Proposed Standard No. 1 for the Setting of Wholesale ("Interchange") Fees. For the reasons set out in Part A at Section 2.3 and in the paragraphs below, MasterCard believes that these proposals are not in the public interest and, indeed, are contrary to the public interest. In MasterCard's view, they will have significant adverse repercussions on Australia's payments systems and should not be adopted.

Further, for the reasons provided in the comments on Chapter 2 below, MasterCard believes that certain important information concerning the proposed interchange fee standard has not been provided by the Bank, with the result that the notification requirements prescribed by section 28(2) of the PSR Act have not been met and MasterCard is unable to make informed comments on those aspects of the proposed action. MasterCard maintains that the "reforms" proposed in the Consultation Document should not be considered until all relevant information has been provided and interested parties have been given an opportunity to comment on a further draft of the proposed interchange fee standard that incorporates the necessary further information.

1. p.15 para 1	The Bank states that merchants are not free to pass merchant service fees on to credit cardholders. This fails to acknowledge that merchants are allowed under MasterCard's rules to offer discounts for cash, a more equitable alternative to surcharging. As MasterCard explained in its June 8, 2001 submission to the Bank (at pp.17 and 37) discounts for cash ensure that consumers are not surprised at the cash register, and that the ticket price is the most they will be required to pay. Cash discounts provide merchants with price freedom while ensuring that the consumer can make the decision of whether to purchase or not while browsing at the shelf, rather than in the queue at the point of sale. The low prevalence of cash discounting in Australia is evidence of the value merchants derive from and equate to accepting credit cards. A more detailed discussion of this point can be found in Part A, section 2.7 of this submission. Specific comments on Restriction on Merchants Pricing are provided below in the comments on Chapter 3 of the Consultation Document.
2. p.15 para 2	MasterCard questions the accuracy of the information contained in Table 2.2.
3. p.16 para 1	The Bank alleges that interchange fees have not been reviewed by the schemes on the basis of a formal methodology. As the Bank is aware, this is incorrect with respect to MasterCard. MasterCard's Australian members engaged Edgar Dunn & Co. in 1996 to undertake an interchange cost study for credit cards. This study, which used the MasterCard interchange fee cost-based formula (which measures the cost of the payment guarantee, processing costs and the interest free

	period), indicated that the rates as they stood then in Australia were slightly below measured cost for electronic transactions, and slightly above measured cost for standard transactions. Members did not adjust interchange fees at that time. Although MasterCard is not aware of the reasons why no adjustment was made, it believes that the most likely explanation is the insignificant differential between the measured cost and actual rates. It should be noted however that, due to the subsequent rapid growth of electronic transactions as compared to standard transactions, the average effective interchange fee would actually have been higher had members adjusted the rates at that time according to the results of the Edgar Dunn study. Although the question of interchange fee reviews after 1996 was not (so far as MasterCard is aware) considered, MasterCard believes that the commencement in 1998 of an ACCC investigation into interchange fees most likely made its members wary of undertaking any further reviews pending the outcome of those investigations.
4. p.16 para 1	MasterCard does not agree that its membership access rules create any significant barriers to entry. This is demonstrated by the fact that the Proposed Access Regime proposed in Chapter 4 of the Consultation Document is broadly consistent with MasterCard's existing membership eligibility rules (subject to the comments in Chapter 4 of the Consultation Document below and MasterCard's comments concerning the inadequate provision of information in respect of the Proposed Access Regime). As the Bank itself states on p.109 of the Consultation Document, "Since all scheme members will continue to be authorised and prudentially supervised by APRA, there are no particular issues for the international card schemes." In fact, as has been witnessed by the proposed regulations, any barriers to entry exist in Australia's banking regulations due to the need (which is accepted in the Consultation Document) to prudentially regulate and supervise members. Moreover, under MasterCard's current membership rules, new members continue to join the MasterCard scheme in principal and affiliate form, and no Australian institution that has ever expressed a serious desire to join the MasterCard scheme has failed to qualify under those rules. It is also stated that "the ACCC reached the conclusion that the arrangements for the collective setting of interchange fees were in breach of the price-fixing provisions of the Trade Practices Act 1974." MasterCard disagrees with the ACCC's conclusion in this regard and notes that the ACCC discontinued its legal action against NAB, based upon such an alleged breach, prior to any substantive consideration of the issue by the Court . MasterCard regards the Proposed Standard No.1 as a fundamentally flawed response to the Bank's perceived concerns regarding barriers to entry into the credit card payments system. Rather than encouraging robust supply and demand in the payment system by

	ensuring competitive and efficient interchange fee levels, the Wholesale Fees Standard artificially replaces the dynamic of competition with a formula. In fact, the proposed Wholesale Fees Standard flies in the face of the Bank's assertion on page 11 that the payments system must give maximum rein to the workings of the price mechanism, and will substantially diminish competition within the payments market.
5. p.16 para 2	The Bank states that because schemes and member proposals on interchange fees are judged to "fall short" in important respects, it has been decided to determine a standard for the setting of credit card interchange fees. In fact, last year MasterCard proposed to the Bank to set its interchange fees in Australia using the same methodology as it employs in the setting of U.S. and global interchange fees (which methodology includes use of the MasterCard cost formula mentioned above). Rather than give MasterCard's proposal serious consideration, the Bank rejected it out of hand without any explanation as to any perceived deficiencies. When asked what the Bank would like to see in an interchange fee setting methodology, MasterCard was referred to the ACCC-RBA Joint Study. Based on this, it would appear that the Bank decided to determine a standard on interchange fees prior even to receiving MasterCard's proposal concerning the setting of interchange fees.
6. p.16 para 3	The Bank acknowledges that cardholders and merchants are joint consumers of credit card services. As such, for the reasons set forth in Part A, Section 2.3 above, a joint sharing of the costs is justified and, based on experience and the best economic thinking on the subject, necessary.
7. p.17 para 1	The Bank's attempt to objectify the merchant benefit over accepting credit cards is pointless and inconsistent with how markets work. If a merchant chooses to accept credit cards then, by definition, it receives a benefit. A merchant may make this decision because it believes it will thereby enjoy more sales or higher value sales, or because its customers will switch from more expensive payment methods, or even simply because its customers will be more satisfied with the merchant as a result of its accepting cards.
8. p.17 para 2	Professor Katz is cited as arguing that, as a payment network gets larger, it may need to do less to promote growth in membership. The MasterCard network in Australia is well short of maturity, as it continues to add members and is growing annually at greater than 20% in both total spend and new cards (the Bank's own data indicates that the Australian credit card business continues to grow at more than 20% annually). Such solid growth is evidence that the MasterCard network has not matured in Australia, and that there are measurable benefits to be gained from new network participants (members, merchants and cardholders) as they join the network. The evidence provided in Part A, Section 1 demonstrates the need for MasterCard in

	Australia to increase its financial expenditure on the brand and member support simply in order to meet the intense competition in the payments market. Not only is such a response to competition necessary, it is what competitors are expected to do under competitive conditions. Anyone who believes that a business can ever stop trying to grow and be comfortably satisfied with what it has achieved in the past does not understand how competitive markets work.
9. p.18 para 2	The Bank states that Baxter's analysis does not establish that interchange fees would be set at an economically efficient level if it were set collectively by a scheme. What the Bank fails to mention is that Baxter also says that, if it were not set collectively, it would "almost certainly produce chaotic results, such as higher fees and instability within the card systems" (as quoted in the Commissioned Report by Professor Katz at p.25). In fact the perverse results of one alternative to collective setting of interchange fees, namely, bilateral interchange fee agreements, are observed in the Australian EFTPOS debit card interchange model. Interchange fees in this system differ significantly from one arrangement to the other, with no apparent rational explanation (see for example the Consultation Document at p.127). In fact it would appear that the small issuers in the system are the ones most disadvantaged by such a system. It is worth noting that the "negative" interchange fee model of EFTPOS, where the issuer pays the acquirer a point of sale interchange fee, is the only such model in the world, and that many participants in EFTPOS as well as the Bank itself have suggested that it needs to be reformed. Bilaterally set interchange fees have a number of problems. For example, should an issuer and acquirer fail to agree terms the system would cease to function (unless there is a default system, in which the fees are not truly set bilaterally). Nevertheless, if it were possible to have bilateral interchange fee agreements (which MasterCard does not consider to be the case) it is clear that this would have negative effects on the level of interchange fees agreed. In a report commissioned by MasterCard and Europay for the purposes of the OFT proceedings in the United Kingdom, Professor von Weizsäcker in his accompanying paper (in Annexure A, paragraph 66) states firstly that *"merchants are likely to pay more under conditions in which interchange fees are set bilaterally"*. Second, *"a fallback interchange fee can produce benefits by reducing the costs incurred by bilaterals between all issuers and acquirers…"*. The significant transactional costs that would be incurred in each bilateral process, and the large number of bilateral agreements that would be needed, would make a structure of bilateral agreements extremely costly to implement. MasterCard estimates that bilateral arrangements are less efficient than multilateral arrangements as soon as the number of issuers and acquirers rises above five. In Australia, the MasterCard scheme has 10 issuers and 8 acquirers (each of which is also an issuer). If each issuer was to have individual agreements with each acquirer, the total number of bilateral agreements required would be more than 70.

	Third, in practice abandoning a collectively set interchange fee negatively impacts interchange fees. In Sweden, there are no domestic fall-back interchange rates; the fallback fee in the absence of an agreement is the Europay intra-regional fee. The results of this arrangement is that the bilaterals agreed in Sweden are generally higher than the intra-regional fall-back fee.
10. p.18 para 3	The Bank states that the credit card schemes have not provided any empirical evidence of the demand curves of merchants and cardholders or of the supply curves of issuers and acquirers. As noted in Part A of this submission, the Bank has itself not provided such data to support any of its arguments and, since it is the Bank that is proposing to change the *status quo* by intervening in the market, it is incumbent on the Bank (and required under the PSR Act) that it offer a basis for its intervention. [Confidential] Therefore merchants derive a higher benefit from participating in the payments system. Economic rationale dictates that, in allocating to participants the cost of producing a joint product such as credit cards, participants with lower price elasticity are assigned higher portions of the costs in order to optimise benefits overall. Notwithstanding the relative elasticities, merchants nevertheless have a high elasticity and an unduly high merchant service fee would result in them switching to other payment methods.
11. p.19 para 1	As pointed out in the previous paragraph, the demand curve of cardholders is highly elastic. Any reallocation of costs to them could be expected to result in them switching to other payment methods.
12. p.19 para 3	The Bank argues that no evidence has been provided that credit cards lead to lower transaction costs for merchants compared to cash and other payment instruments. We refer to Part A, Section 2.2 above where it was indicated that studies do not take into account all relevant costs associated with cash transactions. In addition, the absence of significant levels of discounting for cash (and of surcharging, in those countries where it is allowed) by merchants implies that merchants derive net benefits in accepting credit cards after taking into account the costs of handling cash and the incremental benefits conferred by accepting credit cards.
13. p.20 para. 1	It is asserted that the fact that discounts are offered for cash undermines the claims of substantial net benefits for merchants at current merchant service fees. The Bank provides no evidence of the extent of discounts being offered for cash in Australia. As set forth in Part A, Section 2.7 above, available evidence points overwhelmingly to the fact that merchants who accept credit cards generally do not offer cash discounts (or, where allowed, surcharge) to any great extent. Again, this supports the view that merchants derive significant net benefits accepting credit cards, after taking into account the costs of handling cash and the incremental benefits conferred by accepting credit cards.

14. p.20 para 2 and Figure 2.1	MasterCard disagrees with the findings of the ARA for the reasons set forth in Part A, Section 2.2.
15. p.21 Table 2.3	Table 2.3, which is based on a survey by the ARA, states that the average credit card transaction value is $55. However, numbers from the Bank's own statistics internet site (www.rba.gov.au/PaymentsSystem/AustralianPaymentsSystem/payment_statistics.html) show that the average bank-issued credit card transaction is over $100. The impact of corporate cards would be negligible due to the extremely small volume of transactions attributable to such cards. Such a large differential casts serious doubt over the accuracy of the data, and calls into question the many conclusions of Bank that are based on the ARA's data. Adjusting the rest of the ARA's analysis for this error, the cost of a credit card transaction as a percentage of the average transaction value falls to less than 1%, only marginally higher than the reported cost of cash. Factoring in the benefits a merchant accrues from accepting credit cards, this would suggest that the net cost of credit cards is significantly lower than that for cash. The benefits to the community are also significant, such as lower insurance costs due to reduced theft, and a smoother economic cycle due to the flattening out of income lumpiness. Clearly, the Bank should not draw any final conclusions unless and until a reliable analysis of the full cost of cash is undertaken.
16. p.22 para 2	Reference is made to [Confidential] and, in this regard, we refer to our comments at paragraph no. 17 below.
17. p.24 para 2	Evidence of a permanent economy-wide increase in sales from credit card usage is provided in Part A, Section 2.8 above. We also refer to our comments in Chapter 3, paragraph no.17 below.
18. p.24 para 2	The Bank states that Visa's claim that "people spend more on credit cards" is not supported by data provided to the Bank by the Australian Retailer's Association and some major retailers. However Visa's claim is supported by the Bank's own Transaction Cards Statistics Collection data, as outlined in footnote 23. If the Bank is preferring to rely on the ARA's data over its own, as appears to be the case, it is appropriate that the Bank explain its reasons for doing so, and whether these reasons affect the reliability of the Bank's other data more generally. Otherwise, MasterCard is concerned that this is an example of the Bank simply choosing to rely on whichever evidence is most favourable to its position. Clearly, any decision made on that basis would not be acceptable under the PSR Act and would violate the obligation of a regulator to act in accordance with the best information available.

19. p.25 para 1	The Bank argues that a reason for high average credit card transactions is the prevalence of credit card usage among higher income earning individuals. If this were entirely the case, one would expect that the average transaction would be falling as more lower income individuals take up credit cards. A review of average credit card transactions over recent years however suggests that the opposite has occurred, average credit card transactions have actually been gradually growing over the last five years[63]. In addition, as referred to in Part A, Section 2.1,[Confidential] the choice of the payments instrument is generally correlated with the value of the purchase. This survey is a random one, encompassing cardholders of varying incomes. The result, therefore, is further reason to doubt the Bank's income size hypothesis.
20. p.25 para 2	Evidence of a permanent economy-wide increase in sales from credit card usage is provided in Part A, Section 2.8 above. Based on the large amount of evidence that credit card usage is associated with increased spending, and paucity of the evidence cited by the Bank to the contrary, it would appear that the Bank's rejection of increased sales as a benefit of credit cards cannot stand and that the basis for imposing the draft Wholesale Fees Standard has not been established.
21. p.25 para 3	The Bank states, "Consumption is determined by expected income and wealth." MasterCard would point out that cash and debit cards, unlike credit cards, do not permit discretionary spending based on "expected income and wealth" and that, in the absence of credit cards, consumers discretionary spending would decline. Basic economic principles suggest that retailers derive greater benefit from selling their wares sooner rather than later, as a dollar today is worth more than one tomorrow. Other forms of consumer credit take significant time to source and do not give the consumer the opportunity to make impulse purchases. This is a demonstration of the great benefit of credit cards to merchants. It also supports the position that credit cards stimulate overall spending. The Bank also argues that use of revolving credit leads to reduced future consumption. Evidence of a permanent economy-wide increase in sales from credit card usage is provided in Part A, Section 2.8 above. The Bank's position on this is interesting, given its practice (and that of virtually every central bank) of lowering official interest rates in order to increase credit availability and spur economic growth. Whether it is through reduction in the price of money, or through an increase in its supply, the aim is the same – increase consumption by consumers and businesses. The Bank has not explained how that it could be that this works when the Bank does it but not when

[63] www.rba.gov.au/PaymentsSystem/AustralianPaymentsSystem/payment_statistics.html

	MasterCard's members are involved. Further, in its assessment that credit card usage will lead to a reduction in a consumers' future disposable income and consumption expenditure, the Bank completely disregards the effects of the interest free period available to credit cardholders. Consumers who use credit cards in place of alternative payment systems, for example cash, are able to earn a return over the interest free period on the funds that they would otherwise have used. This has the effect of increasing the consumer's expected income. According to the Bank's principle that consumption is determined by expected income and wealth, consumption should increase as a result. Secondly, as stated above, credit cards allow consumers who do not have available funds at the time of purchase to make payment at that time based upon expected future income. This creates a general shift of future consumption patterns to the present, and provided such purchases are repaid during the interest free period (based on the Bank's numbers, at p. 24, this occurs approximately 75% of the time), there is no reduction in a consumer's future disposable income and consumption expenditure.
22. p.25 para 3	It is illogical for the Bank to dismiss the benefits that credit cards provide in smoothing consumption expenditure over time, merely because this may be a characteristic of credit generally. The Bank ignores the large benefit of credit cards in this regard, namely, the ease with which credit is made available as required when compared to other forms of credit. Moreover, credit cards typically offer unsecured credit, which most other forms of consumer credit do not.
23. p.26 paras 1 and 3	It is fallacious to argue that the four-party system does not result in network externalities. The benefits have been shown in Part A, Sections 2.5 and 2.6 and elsewhere in Part B of this submission. By comparing four-party systems to closed three-party systems and retailer-based store card systems, some of the network externalities are clear. The disparity in the respective costs of the different systems is significant, resulting in a clear benefit to society resulting from the four-party systems. Bank issued credit cards are almost invariably cheaper to both the cardholder (typically annual fees for Amex and Diners are much higher than for MasterCard, while the annual interest rates on store cards are consistently above 20%) and merchants (closed system merchant service fees are generally double those of the MasterCard acquirers).
24. p.26, para. 2	The Board of Governors Study referred to is extremely dated. The size of the credit card networks in 1983 are a mere fraction of what they are today. In 1983, the total MasterCard issuing volume in the U.S. was [Confidential] . Last year, this figure was [Confidential] , an increase of over 1,611%. That alone may explain why the Fed study drew the conclusion that it did back then. The Bank's willingness to overlook the growth of credit card networks over the past nineteen year period is yet another example of its relying on any data, no matter

	how questionable, to justify its proposals.
25. p.27 para. 1	Evidence of a permanent economy-wide increase in sales from credit card usage is provided in Part A, Section 2.8 above. A discussion of the relative costs of cash and credit cards is provided in Part A, Section 2.2 above.
26. p.27, para 2	The Bank argues that differential pricing is another way of internalising externalities. Although MasterCard has provided arguments as to why surcharging is contrary to the public interest and unnecessary given merchants' freedom under MasterCard's rules to offer cash discounts, it would appear that, based on the Bank's own criteria, abolishing the "no surcharge" rule should satisfy the Bank that the objective of protecting merchants from allegedly high interchange fees can be met without the need to regulate the setting of interchange fees.
27. p.28 para 2	The Bank argues that network externalities decline to zero as the scheme matures. While it may be the case that <u>incremental</u> externalities decline as schemes mature, there is no evidence and no reason to believe that total externalities decline. It is this distinction that is being made in the two studies sponsored by Visa referred to by the Bank. There is also an implicit assumption in the Bank's discussion that the MasterCard scheme in Australia has matured. As discussed above, this is an incorrect assumption.
28. p.28 para 3	MasterCard disputes the Bank's assertion that the pricing behaviour of credit card schemes does not appear consistent with their stated objective of maximising benefits to cardholders and merchants by maximising network size. The Bank's comparison with the pricing structure of mobile phone companies is unhelpful and misleading because there is no 'transaction' between mobile phone users, and no equivalent of merchants in the mobile phone network. Unlike mobile phone systems, where each mobile user acts as both "issuer" and "acquirer", the size of credit card systems is constrained by the number of merchants participating in the system. Hence, it is not sufficient merely to lower the fixed cost of joining (that is, for cardholders) to expand the network size. Card issuers must also ensure that card acquirers encourage merchant participation by stimulating the demand for merchants who accept credit card payment. In the extract cited by the Bank, Professor Katz too, focuses on cardholding rather than both cardholding and merchant acceptance in his analysis of internalising the network effects of the credit card system. In addition, unlike mobile phone companies, credit card issuers face a considerable expense from cardholders who do not revolve – annual fees are a way to help compensate for this expense and to minimise the need to ask merchants to contribute even more to the cost of providing the service. It is interesting that, in this section, the Bank seems to endorse efforts by credit card schemes to keep cardholder fees down and to encourage usage, whereas in most other parts of the Consultation Document the Bank takes the schemes to

	task for attempting to do this.
29. p.29 para 2	The quote from Professor Katz demonstrates a basic misunderstanding of the objectives of card issuers. Card issuers primarily attempt to generate greater card usage, as opposed to cardholdership, which is a secondary objective. Obviously one is linked to the other, but an issuer would prefer one active cardholder to one hundred inactive ones. A card issuer's job is not done when a prospective customer takes up a new credit card. Significant effort is required and undertaken to encourage the new cardholder to actively use the card. The distinction between card usage and cardholdership is referred to by Prof. von Weizsäcker (in Annexure A, paragraphs 10 ff) as the distinction between Level I demand (credit card usage) and Level II demand (credit cardholdership). In focusing only on Level II demand, Professor Katz fails to appreciate the relevance of this distinction in analysing consumption within a credit card payment system. The Bank also contends that pricing to cardholders promotes excessive card use. Is not the object of any pricing by a producer of goods or services to increase sales or, in this case, usage? Who is to say it is excessive? Are rebates by car manufacturers to their customers leading to excessive car usage? As has been argued above, not only are fees to cardholders attractive as witnessed by the recent growth of credit card volumes, but also the price to merchants is one that compares favourably with cash, while providing significant additional benefits, as demonstrated by the steady growth in acceptance of MasterCard cards; from 1997 through 2001, the number of merchants accepting MasterCard cards has grown by approximately 30,000 merchants each year, from 391,000 to 483,000. This equates to a 6-7% annual growth rate.
30. p.30	The Bank continues to argue that economic welfare depends on a growth in total merchant sales, rather than total card accepting merchant sales. However, a growth in card accepting merchant sales will not contribute to economic welfare <u>if and only if</u> the incremental sales achieved through accepting credit cards is exactly compensated by losses of sales by non-card accepting merchants. The Bank has provided no evidence that this will be the case. The Bank does not attempt to link the Rochet and Tirole theory to the situation in Australia.
31. p.30 para 2	The Bank's criticism of the Schmalensee model is illogical – merchant willingness to accept credit cards is basically an indicator of the demand for card acceptance (and reflects the social benefits of credit cards). The Bank argues that the individual merchant demand for card acceptance, without taking into account the impact on rival merchants, somehow over estimates the benefits of card use to merchants as a group. What is the impact on rival merchants? If the impact is the

	competitive edge earned over rival merchants, this should be regarded as a benefit derived by card-accepting merchants, and hence a social benefit (see the discussion in the next point). MasterCard believes it is a fallacy to argue that the aggregate social benefit should be reduced to the extent that one merchant's acceptance of credit cards (and resulting competitive edge) has a negative impact on another merchant who does not accept credit cards.
32. pp.30 & 31	The Bank cites the statement by Rochet and Tirole that merchants may accept credit cards even though the merchant service fee exceeds the technological and payment guarantee benefits, because of their eagerness to obtain a competitive edge over other merchants. This proposition is misstated. Rather than being the reason for why merchants accept credit cards even though the costs outweigh the benefits, the fact that merchants derive a competitive edge over other merchants should be regarded a *benefit* of credit card acceptance, and weighed alongside other benefits, such as the technological and payment guarantee benefits. On the other hand, economic theory dictates that rational merchants will refuse to accept credit cards as soon as the costs (the merchant service fee) outweigh the benefits. Hence, accepting the contention by Rochet and Tirole is essentially accepting the notion that merchants do not behave rationally and according to the price elasticity of demand. The burden of proof here is clearly for the Bank to show that, as pointed out above, incremental sales are exactly compensated by loss of sales elsewhere. We have shown in Part A, Section 2.8 that credit availability creates new consumer demand, and that this new consumer demand, which generates new sales, would not be there without credit cards. Hence the incremental sales is not substituted by loss of sales elsewhere.
33. p.31, para 2	Reference is made (in footnote 45) to MasterCard's view that an undue lowering of the interchange fee could set in train a "death spiral". Given the seriousness of this potential consequence and its "public interest" ramifications, MasterCard does not believe that the Bank has responded to its concerns in this regard. We refer to the discussion in Part A, Section 2.3 in this regard.
34. p.32, para. 1	It is stated that there is a ready availability of cash discounts for items such as white goods. No evidence is provided in this respect. As indicated in Part A, Section 2.7, available evidence overwhelmingly indicates that cash discounts are not offered. Nevertheless, at the present time the offering of cash discounts is an option which is available to merchants.
35. p.31 para 3	In rebutting the neutrality argument, the Bank states that "though there can be a significant difference in costs to merchants between accepting cash and credit card transactions, that difference in most

	cases would not be enough to make it attractive for merchants to set up as cash-only merchants simply to avoid merchant service fees on credit cards". The Bank overstates the distinction between credit card acceptance and operating as cash-only. There is no process of "setting up" as a cash-only merchant, it merely involves ceasing to accept credit cards. There are no transition costs. Consequently, (assuming merchants are rational, which the Bank must) the Bank's statement amounts to a concession that, for most merchants, the benefits of card acceptance outweigh the costs. Further, in light of the fact that there is no obstacle to a merchant ceasing to accept credit cards, it is misleading for the Bank to state that there is a "significant" difference in costs between accepting cash and credit card transactions if merchants do not act upon that difference. It is also meaningless to discuss the costs of credit card acceptance without considering the benefits. Finally, the Bank's argument that merchants will not "set up" separate stores to compete on one aspect of their business – the payment method – demonstrates the Bank's failure to grasp this issue: Assuming that credit cards were more expensive for merchants than cash, merchants would drop credit card acceptance to compete on the basis of lower prices, not the payment method.
36. p.32 par 2	Professor Katz is cited to support the Bank's opinion that the collective setting of interchange fees may lead to excessive use of credit cards. Professor Katz argues that merchants' willingness to accept cards is a poor measure of the effect of card acceptance on merchant welfare. In other words the Bank and Professor Katz, without providing any supporting material, suggest that merchants do not act rationally. MasterCard contends otherwise, that in fact merchants are always seeking to maximise sales and minimise costs, and as such, would not be willing to accept credit cards were it not adding to their total welfare. As has been cited in Part A, Section 2.1 recent studies [confidential] show merchant sensitivity to increases in merchant service fees leads to a dramatic alteration of merchant behaviour. Indeed the fact that American Express and Diners Club have lower acceptance than MasterCard in Australia is a testament to the price sensitivity of merchants. In addition, the Bank cites Professor Katz' concern that the interchange fee set by a self-interested association and the socially optimal interchange fee can be expected to differ. One source of the divergence, as Professor Katz notes, is that private parties will respond to merchant willingness to accept cards, which may be a poor measure of the overall effects of card acceptance on merchant welfare. This amounts to no more than a statement that card issuers will consider the merchant demand for credit card acceptance when setting the interchange fee. As stated in the paragraph above, the Bank fails to demonstrate any theoretical or empirical evidence that

	merchants' willingness to accept cards is a poor measure of the overall effects of card acceptance on merchant welfare.
37. p.33 para 3	As referred to in paragraph 3 above, an interchange fee review was undertaken by the MasterCard members in Australia in 1996. The review, which the members engaged Edgar Dunn & Co. to undertake, confirmed that interchange fees rates at the time were close to costs measured under the MasterCard methodology. While, in view of the time which has elapsed, it has not possible to provide information on how the current level of interchange fees had been determined, the study by Edgar Dunn & Co nevertheless confirmed that, at the time the study was undertaken, the interchange fee rates in use were close to those which would be applied under the MasterCard methodology. MasterCard believes that the picture presented by the Bank, of MasterCard fees being "highly rigid", grossly misrepresents the situation. The Bank knows that MasterCard interchange fees were changed in 1993 by the introduction of a reduced rate for electronic transactions. Three years later a review of interchange fees was undertaken which did not find any great disparity between the interchange fees in use and those costs measured using MasterCard's methodology. It is noted in this regard that the draft standard on the setting of interchange fees (at clause 15) provides for a review of interchange fees every 3 years. In 1998 the ACCC commenced its investigation into the collective setting of interchange fees which, as explained above, no doubt created reluctance on the part of MasterCard's members to review interchange rates until the regulatory situation was resolved.
38. p.34, para. 1	As explained in the preceding paragraph, there was a review of MasterCard fees undertaken in 1996 using a "formal" methodology – namely, MasterCard's methodology for setting interchange fees in certain overseas jurisdictions.
39. p.34 para 2	The Bank suggests that the consequences of "the rigidity in interchange fee setting in Australia" have been a lack of downward adjustment with growth, downward adjustment with the introduction of annual fees and a range of different interchange fees for different types of merchants. The United States is used as a model system. What is not acknowledged by the Bank are the following points: • as pointed out in Part A, Section 2.2, interchange fees in Australia are amongst the lowest in the world, and significantly lower than other advanced economies, including the United States; • it is incorrect that interchange rates were not lowered when annual fees were introduced from 1993. As pointed out in Table 2.1 of the Consultation Document, the introduction of annual fees in Australia roughly coincided with the introduction of the lower electronic interchange rate in 1993; • the 1996 review referred to above validated the rates as they were;

	• there has not been a need to introduce sub-cost incentive interchange rates as is the case in the US in Australia because the current cost based rates have been low enough to encourage high acceptance without the need for an incentive rate; • indeed it should also be noted that the introduction of loyalty programs in the mid-1990s saw increased annual fees and interest rates, while the average interchange fee continued to decline as the proportion of electronic transactions increased.
40. p.34 para 3	As pointed out in Part A, Section 2.4, MasterCard confirms that its fees in Australia are low by international standards.
41. p.36 para 1	The Bank incorrectly claims there is overlapping governance of the four-party schemes in Australia. MasterCard in Australia does not have a governance board in Australia and it is a major misrepresentation so far as MasterCard is concerned to say that "the same banks control all three schemes in Australia". There is a MasterCard Executive committee in Australia upon which the major members are represented. However, as has previously been pointed out to the Bank on a number of occasions, this committee is solely a forum for information distribution by MasterCard management to its members, and no decisions are made with respect to the management of the MasterCard scheme in Australia. [Confidential] As has been stated in Part A, Section 2.7 and in MasterCard's June 8, 2001 Submission (at p.39 and p. 52) , there exists intense competition both between the schemes and within the four-party schemes, and MasterCard rejects any suggestion otherwise as baseless. The members are given the power to collectively establish interchange fees, because of the joint nature of interchange, however that is the extent of member control with respect to scheme management.
42. p.37 first bullet point	The Bank cites the fact that acquirers do not promote one brand over the other as a sign of a lack of competition between the four-party open schemes. This statement indicates a lack of understanding of the acquiring business not only in Australia but globally. Acquirers improve their chance of being successful if they offer all credit card brands as well as debit. Indeed some acquirers in an effort to secure a sale will offer to install American Express and Diners Club acceptance. Therefore one cannot suggest non-competition because acquirers offer all brands, doing otherwise is to the peril of the acquirer.
43. p.37 second bullet point	Another argument used by the Bank to demonstrate the lack of competition between the four-party schemes is the fact that on some occasions issuers offer the same loyalty programs across two or three schemes. In fact this is grossly overstated by the Bank, only the CBA and NAB offer the same benefits cross brand on some of their products, not all. All other members offer different cardholder benefits across the brands. For example CBA offer a Gold MasterCard only,

	an EZY MasterCard only and various affinity cards in one brand or the other, not both. ANZ offers its leading Qantas Telstra card in Visa only, Westpac its Altitude card in a Visa brand only, St.George offers its Starts Low Stays Low card in MasterCard only. BankWest and the Bank of Queensland offer both MasterCard and Visa products, but offer their generic loyalty programs with their Visa products only. The respective market shares and the huge variances in these market shares indicates the variance in offerings between the brands, and competition between the schemes in Australia. The statement following this bullet point suggesting competition is limited to brand advertising is demonstrably wrong as the information provided in this paragraph confirms, as well as the analysis in Part A, Section 1 which details investments made by MasterCard in Australia in the form of financial and consulting support to members.
44. pp.37-38	The Bank in its analysis of the market power of the international four-party open schemes implies that the relevant market is restricted to the market for credit and charge cards and, on this basis, the designated credit card schemes appear to have a dominant market position. As discussed in Part A, Section 2.1, [Confidential] the relevant market includes not only credit and charge cards, but all forms of consumer payment instruments, including debit cards, cheques and cash. Although MasterCard faces strong competition from Visa and American Express, it views cash as its greatest competitor. This is also acknowledged by the highly respected United States 11th Circuit Court of Appeal in *NaBanco*. It is also erroneous for the Bank to aggregate all bank issued credit cards. As demonstrated in Part A, Section 1 there is intense competition between MasterCard and Visa in Australia, and, as indicated in the Consultation Document, MasterCard's market share of bank issued cards is substantially less than 30% in Australia, and less than 23% when the three-party schemes are added. The important measure however is that of total volume, where MasterCard's market share slips to below 20%. When debit is added to the total, MasterCard's share is halved again to less than 10%, with cash and cheques added, MasterCard's share drops to insignificant levels. Any argument that the MasterCard scheme has market power ignores globally established principles on this subject. Furthermore, this analysis also demonstrates the negligible impact that interchange fees have on Australian consumers, casting serious doubts as to the merits of the Bank's intervention on interchange fees.
45. p.38 para 3	The Bank grossly understates the competitiveness of debit cards in Australia. The number of debit cards on issue still outnumber credit cards almost by a factor of 2, and total volume on debit cards is approximately equal to that of credit cards. However when comparing the pricing of debit versus credit cards, it is erroneous for the Bank to hold debit card pricing constant. Debit interchange in Australia sees a

	negative flow of the interchange fee from issuer to acquirer, the only such flow in the world, and widely recognised as illogical. In fact this pricing demonstrates the market power that large retail conglomerates have in the consumer payments market as a fee is typically charged by the large retailers, while smaller retailers pay a fee to the acquirer in effect subsidising the larger retailers. A correction of this situation would then allow the Bank to compare debit and credit on a more sound footing.
46. p.38 para 3	The Bank claims here that debit cards of international schemes are not actively promoted, but overlooks the fact that there are currently approximately 13 million Maestro/Cirrus cards, and to MasterCard's knowledge 4 million Visa Debit cards on issue in Australia, collectively almost double the number of credit cards on issue in Australia.
47. p.39 para 3	The Bank suggests here that merchants have a lack of choice whether or not to accept credit cards. MasterCard strongly objects to the contention by the Bank that the fact that most merchants that choose to take credit cards continue to do so means that they have no choice. An equally compelling explanation is that, considering the relative costs and benefits of card acceptance, and of other forms of payment, there is no reason for most merchants to stop accepting cards. The Bank has presented no evidence that contradicts this explanation. In addition, the Bank offers no evidence that once merchants accept credit cards, they are "locked in". Further, as discussed above, MasterCard's share of the payments market is so small that it is far fetched to argue that a merchant has no choice but to accept MasterCard credit cards. Concerning the comment on interchange fee rates in the U.S., the Bank fails to note that, historically, MasterCard's (and Visa's) U.S. interchange fees have fluctuated considerably, and that, at various times in the past they have been higher than they are at the present. Thus, the fact that they may have increased somewhat in the past several years does not indicate competition in the credit card business inexorably drives interchange fees up. In fact, as Weizsäcker has explained (in Annexure A), co-operatively set interchange fees actually keep interchange fees at competitively healthy levels.
48. p.40	The Bank's entire argument that there is insufficient competition relies on the assumption that merchants have no choice but to accept cards at the prevailing merchant service fees. The fact is that the major merchants have driven down the margins of acquirers on credit cards to extremely low levels (MasterCard understands that Coles Myer is paying merchant service fees that are only about 10 basis points higher than interchange rates and in some instances is paying merchant services fees that are equivalent to the interchange rates). With regard to debit cards, major merchants have been able to force major aquirers to share their interchange fee revenues (bearing in

	mind that the EFTPOS interchange fee is paid by the issuer to the acquirer). This is hardly indicative of merchants being at the mercy of the credit card schemes. As to the supposed "rigidity" of Australian interchange fees, the best evidence is that credit card interchange fees are at or near optimal levels as MasterCard determines them. Thus, the fact that interchange fees have not changed in the past few years should not be cited as evidence that they are too high. Indeed the research [confidential] shows merchants to be very price sensitive when it comes to merchant service fees, which suggests that if the interchange fee were too high the level of acceptance would drop off significantly. Research [confidential] indicates that, if the interchange fee were to drop to the level implied in the RBA's Wholesale Fees Standard, if in order to recoup lost revenue issuers were to increase fees to cardholders (for example, by introducing a transaction fee, raising interest rates or increasing annual fees), credit card usage would decline to levels that would threaten the survival of four-party schemes.
49. p.40 paras 3 & 4	The Bank makes the following points: • interchange fees have been rigid and not reviewed since 1993; • lack of competition between the four-party systems; • the competitive conditions necessary to ensure that the collective setting of an interchange fee is in the public interest are not present. As described in more detail in the preceding paragraphs: • MasterCard members engaged Edgar Dunn & Co. in 1996 to undertake an interchange fee cost study that showed existing rates were close to measured cost; • there is immense competition between and within the four-party schemes in Australia demonstrated by the large and increasing investments made by MasterCard in brand and member support over the last five years; • The Bank has not uncovered any evidence to support the view that collective setting of interchange fees is contrary to the public interest, or to rebut the view of Baxter and Weizsäcker (see Annexure A) that it is necessary to ensure the survival of four-party schemes and equal access for new entrants.
50. p.41 para 2	It is said that the "longstanding arrangements are characterised by secrecy, rigidity and lack of any objective and clearly articulated methodology". In response, MasterCard questions how many enterprises, including joint ventures, engage in pricing deliberations that are open to public scrutiny. That said, MasterCard is not opposed

	to a more open process, in fact, it proposed to set interchange fees in Australia in an open manner but the RBA refused even to seriously discuss the proposal. Further, the alleged rigidity is an unfair accusation in the case of the MasterCard scheme in view of the lower electronic interchange rate introduced in 1993 and the Edgar Dunn & Co. review of interchange rates in 1996. Further reviews after that date were no doubt hindered by the ACCC investigations which commenced in 1998. Finally, although due to lapse of time there is a lack of knowledge about how MasterCard's interchange rates were first set, the review undertaken by Edgar Dunn & Co. in 1996 did use MasterCard's clearly cost-based interchange formula. The Bank continually argues that four-party scheme interchange fees are too high. Conveniently, the Bank ignores that fact that the cost of accepting MasterCard cards is typically less than the cost of accepting American Express, Diners Club, Bartercard and other three-party payment cards such as store cards. Since the Bank acknowledges that four-party schemes compete head-to-head with these other payment systems, it is difficult to understand the Bank's position that only the <u>lower</u> prices of four-party systems need to be regulated. Nor is it understandable that the Bank's position on this can be said to be in the public interest.
51. p.42 para. 4	The Bank concludes that there is the "absence of a vigorous competitive environment" which justifies the introduction of a transparent and object methodology. For the reasons described in the preceding paragraphs, MasterCard believes that this conclusion is unfounded and, accordingly, a fundamental premise to the regulation of the setting interchange fees is lacking.
52. pp.41-46	The Bank concludes that none of the MasterCard, Visa and ABA approaches for setting interchange meets the "principles" for interchange fee setting put forward by the Bank. But the "principles" established are either already substantially incorporated in MasterCard's interchange fee methodology that it proposed to the Bank and the Bank rejected (cost-based and transparent, exclude non-relevant costs, provide for different interchange fee rates, independently verified, reviewed regularly), or, as explained by Professor von Weizsäcker, are inconsistent with basic economic principals of the pricing of joint supply products (based on services provided to merchants). Moreover, by imposing a formula that all four-party credit card systems are required (slavishly) to follow, the Bank actually eliminates all possibility of competition between four-party schemes in the setting of interchange fees. In effect, the Bank is insisting that the four-party schemes become part of a Bank-organised interchange fee cartel.
53. p.44 para 2	In relation to the Office of Fair Trading proceedings, MasterCard notes that, at the time of the issue of the Consultation Document, the Office of Fair Trading did not have the benefit of MasterCard's substantial

	analysis and empirical evidence in relation to the proceedings. These have recently been provided to the Office of Fair Trading. MasterCard is also providing these to the Bank in connection with its response.
54. p.45 para. 2	The Bank misrepresents the posture of the European Commission proceedings involving Visa interchange fees. Last July, the Commission published a notification of its intention to grant clearance on a Visa proposal which includes the adoption of a cost-based formula that, the Bank admits, is very similar to that used by MasterCard in the setting of interchange fees.
55. p.48	The Bank stipulates that efficient pricing principles require credit losses to be recovered through lending rates. As explained by Weizsäcker (in Annexure A), this violates the basic economic principle of joint supply, namely, that it is not possible to isolate the separate costs of two outputs which are of necessity produced in fixed proportions. The Bank's contention that by considering the credit losses in setting interchange fees the issuer collects these twice displays a fundamental misunderstanding of the nature of interchange fees and of the MasterCard methodology. MasterCard's methodology is based on the measurement of certain key costs with the understanding that these are costs that merchants would have in providing their own credit cards to customers and that, as long as interchange fees are at or below these measured costs, merchants will find MasterCard cards attractive to accept (especially since the MasterCard network is much larger than what a single merchant could duplicate). In fact, the MasterCard methodology is likely to underestimate by a significant extent the rate that most merchants would likely be willing to pay to accept MasterCard cards. The Bank's statement that recovering credit losses through interchange fees would lead to a "moral hazard" assumes merchants have no price sensitivity. However as cited earlier in this submission, [confidential] indeed an excessive interchange fee resulting in an overly high merchant service fee would lead to a marked reduction in credit card acceptance by merchants. Moreover, as explained by Professor von Weizsäcker, any excess interchange fees would be competed away and issuers would be left with fewer profits than if they were set at optimal levels, hence the schemes have no incentive to set interchange fees too high even apart from the impact it would have on acceptance (see Annexure A, page 21).
56. p.49	The Bank suggests that the provision of an interest free period is made without network considerations. How is this statement justified? Surely all issuer and acquirer decisions in a four-party scheme are made with the network in mind. As described above, MasterCard's reason for including the cost of the interest free period in its formula relates to the costs facing a retailer operating a store card. This is a cost that a store card operator must bear, but the magnitude of the cost is significantly reduced in the MasterCard system due to scale

	economies and network benefits. Furthermore, the Bank's analysis of the interest free period ignores a fundamental benefit of the interest free period, the ability of retailers to capitalise on a cardholder's improved short term spending power. Merchants are able to capture future spend in the current period, thereby maximising the value of their sales by receiving funds earlier than they necessarily might if a customer did not have access to an interest free period. The Bank counters the argument that the interest free period encourages cash-constrained customers to make "impulse" purchases by relying on its conclusions earlier in Chapter 2 that there is no evidence that merchants as a whole enjoy a permanent increase in sales from credit card usage. However, the Bank's discussion in Chapter 2 completely overlooked the effects of the interest free period on consumption levels. Therefore, it is ineffective for the Bank to rely on its earlier conclusions in rebutting the claimed benefits of the interest free period, particularly as it was demonstrated in Chapter 2, paragraph 21 above that the interest free period leads to a permanent increase in the level of consumption in the economy as a whole. If the Bank agrees that the provision of the interest free period produces benefits for merchants, by way of a sustained increase in purchases, and purchases being made sooner in time, it is inescapable that the Bank should also conclude that the costs associating with providing the interest free period fall within with the Bank's cost-based methodology for determining interchange fees. Specifically, such costs are based on the payment services which are provided to merchants, and it is appropriate that merchants contribute to the cost of these services. The Bank's approach of excluding from consideration the costs of those benefits that the Bank determines merchants are not or should not be interested in has the effect of defining the credit card product. This is outside of its mandate and exceeds its authority under the PSR Act.
57. p.50	Although the costs of loyalty points are not part of the MasterCard methodology, the ABA's justification for the inclusion of loyalty program costs rings true for all credit card costs. The fact is that loyalty programs, as has been demonstrated quite clearly in Australia, have contributed to the growth of credit card usage in Australia. The Bank acknowledges that credit cards do increase a card accepting merchant's sales, regardless of the whether total sales in an economy increase or not. Card accepting merchants (the only merchants required to pay a merchant fee) receive a substantial benefit from issuer decisions to provide cardholders with benefits additional to the "buy now, pay later" utility. Credit card networks in Australia were significantly smaller before the

	proliferation of loyalty programs, therefore casting doubt on the Bank's belief that credit card programs can be successful without loyalty programs. The decline of Bankcard, which essentially has no loyalty programs, is testament. Furthermore, loyalty programs were introduced in Australia by the closed schemes (American Express and Diners Club) and continue to be pursued aggressively by those schemes as well as being adopted by store card programs. Were open scheme members not to respond to its competition with similar programs, one can assume MasterCard and Visa might face the same decline as Bankcard. In the U.S., debit card issuers have begun introducing loyalty programs, which suggest that they are fundamental to the success of payment systems generally. The Bank's assertion that loyalty programs are not important ingredients to a payment system because the schemes themselves do not offer loyalty programs, nor are they "integral to them", is based on a misunderstanding of the nature of four-party schemes. No cardholder benefits are provided by the schemes per se, all benefits are provided by the issuers at the cost to the issuer, in return for revenue to the issuer. However MasterCard in 2001 (and will in 2002 again) undertook heavy marketing campaigns to highlight the benefits of loyalty programs. This demonstrates that loyalty programs, like interest free periods and fraud guarantees etc are so important to the scheme (network). Moreover, MasterCard assists its members in the development of their own loyalty programs. Indeed, co-branded cards which were the first to feature loyalty programs were pioneered by MasterCard in the U.S. in the 1990s. It should also be noted that the costs of loyalty programs have been borne entirely by cardholders in Australia. Interchange fees did not increase with the introduction of credit card based loyalty programs, but indeed annual fees and interest rates have risen for products offering loyalty programs. Any arguments alleging that interchange fees are subsidising loyalty points are false and can be easily proven to be ill founded. Whether the cost of loyalty programs should be included in interchange fees in the future should be left to the schemes and the market, not decided by regulatory fiat.
58. p.51	It is important for the Bank to acknowledge the need for credit card issuers to achieve a return on capital in any interchange cost formula. While one would usually assume that this is the case, the fact that the interchange fee reduction resulting from the Banks proposal is probably more than the industry's entire profits calls this into question. Moreover, there is nothing in the draft Wholesale Fees Standard that suggests that the Bank accepts that issuers are entitled to recover their costs and make a profit.
59. p.52 para 4	Gans and King are cited in support of the Bank's view that capital and sunk costs may be recovered by other revenue sources. This passage highlights MasterCard's concern that the Bank's treatment of

	the different costs involved in credit card issuing lacks cohesion. The fact that certain costs may be recovered through other revenue sources is irrelevant to the Bank's own cost-based methodology for determining interchange fees, as stated on p.42 of the Consultation Document. Indeed, one principle underlying this methodology is that the methodology be based on the credit card payment services which are provided to merchants. The Bank concedes on p.52 that there is a logic in individual issuers seeking from merchants a return on the capital committed to providing payment services to merchants. The fact that it is "not clear" how each of the card issuers' different rates of return could be averaged is an unacceptable reason for excluding these costs from the Bank's methodology for determining interchange fees. As mentioned above, we note that the Bank's Wholesale Fees Standard does not even permit card issuers to *recover* their capital costs, let alone to earn a rate of return.
60. p.53 para 2 ff	MasterCard is pleased that the Bank did not adopt the proposal suggested by the ARA. The proposal appears to be based on the negative interchange model which is currently adopted for debit transactions and has the same deficiencies described above.
61. p.54 fn 102	It is noted in footnote 102 that the ABA submitted that, if the Bank was to use its payments system powers, interchange fee setting should be regulated via an access regime rather than a standard. MasterCard agrees with the ABA in this regard and believes that setting interchange fees via a standard is incorrect.
62. p.55 para 5	As stated in Chapter 1, paragraph 7, MasterCard does not agree with the ACCC's view that the collective setting of interchange fees is a breach of the price-fixing provisions of the Trade Practice Act. MasterCard objects to untested conclusions of the ACCC being used by the Bank to justify its intervention into the setting of interchange fees and believes that this cannot serve as a basis for the Bank exercising whatever powers it may have under the PSR Act. Further, if this view is held by the ACCC it is not clear why the collective setting of interchange fees in accordance with the standard would not place MasterCard and its members at risk of contravening the Trade Practices Act. In fact, the Bank has raised this issue with MasterCard and used it as an excuse as to why any interchange fee standard has to be rigid. MasterCard does not understand how, by complying with a standard or access regime lawfully established by the Bank, it could be in violation of the Trade Practices Act. If, in fact, it is the Bank's or the ACCC's view that its powers under the PSR Act are incomplete to protect institutions seeking to comply with its access regimes and standards, then MasterCard believes that there needs to be legislation introduced to provide that actions taken by a person in complying with a standard or access regime under the PSR Act will not give rise to a contravention under the Trade Practices Act. No standard or access regime should take effect until this legislation is in

	effect. If this is not the view of the Bank or the ACCC, they should publicly say so.
63. p.57	MasterCard is concerned that the effect of the Wholesale Fees Standard will be contrary to the stated objectives of promoting efficiency and competition within the payments system. With respect to competition, by prohibiting card issuers from earning a profit on interchange fees, or even from recovering certain costs, the Wholesale Fees Standard eliminates the desirability of one of the two factors which would attract new entrants to the card issuing market. Nor does MasterCard believe that it can be said that a pricing decision is economically efficient if it does not take into account the need of privately owned companies in a market economy to make a profit.
64. pp.57-60 Draft Standard	As indicated in the introductory comments on this Chapter, MasterCard believes that in a number of very important respects, the draft Wholesale Fees Standard lacks the necessary information which is needed in order for MasterCard to be able to make informed comments on it. Some examples of the lack of information on some very important points is provided in the following comments. MasterCard believes that, having regard to the lack of information and consequent considerable uncertainty in respect of the drafting of the Interchange Fees Standard, as explained in the following paragraphs, and in respect of which considerable information and clarification needs to be provided, the Bank has not provided the necessary information upon which MasterCard can respond in an informed manner, and has not complied with its obligations under the PSR Act. The reforms proposed in the Consultation Document should not be implemented until such time as a more complete draft of the standard is published and time allowed for public comment.
65. Draft Standard para. 3	No definition is provided for a "credit card", yet the standard is supposed to apply to interchange fees in respect of credit card transactions. Communications with the Bank suggest that what is a "credit card" is what the schemes and its members currently recognise as a "credit card". This response belies the complex nature of this matter, the fact that there is no standard for defining a credit card. For example, issuers can offer cardholders a wide variety of features and services in connection with cards that offer a line of credit: may every one of these be added to (or removed from) the service without affecting whether the resulting product is a "credit card"? Are schemes free to change the nature of the payment guarantee, chargeback rights, or other basis features of their credit card offerings to members? With respect to new products that MasterCard may issue in the future, and that are different from MasterCard-branded cards currently issued, there is uncertainty as to how those cards will be treated under the standard. For example, if MasterCard proposes, at some time in the future, to issue a card that accesses a deposit account but that has a line of credit attached, will it be a credit card? A comprehensive definition of "credit card" is required to be included, and such definition

	must be flexible enough to accommodate new products and the normal competitive process.
66. Draft Standard para. 3	No definition is provided of what is a "payment transaction". While it is customary to call a purchase transaction a payment transaction, MasterCard recently created a new transaction type that enables any MasterCard cardholder to move funds to the account of any other, as long as the issuers of both participate in the program. It is envisioned that such transactions would be used in connection with so-called web auctions, which involve a purchase, but also that it could be used to "wire" funds. It is unclear whether such a transaction would be deemed a transaction for purposes of the draft Wholesale Fees Standard. More generally, it is not clear whether certain future transactions (such as transactions to fund stored value cards) would be deemed "purchase transactions." In addition, if they are, it is not clear whether they would be required to carry the same or a different interchange fee than other purchase transactions. This is another area in which lack of information makes it difficult for MasterCard to comment completely on the merits of the draft standard.
67. Draft Standard para. 3	There is a definition of "electronic transaction" which says "a credit card transaction for which authorisation is obtained by the merchant electronically." This definition is different to that which MasterCard currently treats as an electronic transaction. For a transaction to qualify as an electronic transaction under MasterCard's rules it must not only be swiped through an electronic terminal, as suggested in the draft standard, but must also meet certain other requirements such as clearing and settlement timeframes, the cardholder must be present at the merchant's premises and the transaction must be authorised by the issuer. Communications with the Bank on this point are not clear and it is requested that the definition be the schemes' definition of the term. In addition, such definition requires flexibility in order to accommodate new technologies, the need to deal with fraud, and the ability to develop new products (as discussed above). This is another example of the lack of information and imprecision in the proposed Wholesale Fee Standard.
68. Draft Standard para 3	From communications with the Bank it is understood that, in the context of the MasterCard scheme the "Scheme Administrator" is intended to mean MasterCard.
69. Draft Standard para. 7	This paragraph of the draft Standard sets forth the methodology for calculation of the interchange fees and specifies the only costs that may be taken into account in calculating those fees. These include issuer's costs incurred: in processing credit card transactions; in respect of fraud and fraud prevention; and in providing authorisation of credit card transactions. As we have previously communicated to the Bank, a major concern is that different schemes may adopt divergent understandings of what is to be included in the various cost items. If this were permitted then one scheme may be placed at a considerable

	advantage vis-à-vis another. In communications with the Bank it has been suggested that an accounting manual be prepared to ensure consistency. MasterCard believes that there is a considerable lack of information and, as a consequence, uncertainty with regard to what falls within the various cost categories and that substantial additional work is required, such as in the preparation of an accounting manual, before MasterCard is in a position to provide informed comments on this aspect of the proposal.
70. Draft Standard para 9	Paragraph 8 provides for four types of transactions in respect of which interchange fees must be calculated separately. These categories make little sense given that they distinguish between transactions with and without payment guarantees whereas all credit card transactions of every four-party scheme in the world of which MasterCard is aware offers a payment guarantee in connection with all of its transactions, although terms of the payment guarantees vary both within and among the schemes. Presumably, this relates to the Bank's view, expressed on p.55, that the payment guarantee could be unbundled from the other services rendered to merchants that accept a scheme's cards. MasterCard does not agree with this view since, in MasterCard's experience, the payment guarantee is an essential feature of a payment service. If a merchant were to receive no payment guarantee (ie., no assurance of being paid) it would not accept the card. The definition of payment guarantee included in the standard does not clarify the situation as it essentially is circular.
71. Draft Standard para 9	It is understood from communications with the Bank that each scheme may select its own independent expert, or that all the schemes may employ the same independent expert, to determine the eligible costs of each scheme. It is unclear whether the cost of undertaking the cost study (including the fees paid to the independent expert) are able to be included in the costs. MasterCard believes that they should be included.
72. Draft Standard para 14	This paragraph provides that "The interchange fees of a scheme must be calculated and published in accordance with the Standard within [3] months after this Standard comes into force." MasterCard makes two comments on this paragraph. First, the three month period proposed is far too short having regard to the system changes which would be needed in order to implement any new methodology for setting interchange fees, especially one requiring a detailed and accurate cost study. Second, having regard to the substantial reduction in interchange fees (and issuer revenue) that would ensue from the adoption of the draft Wholesale Fees Standard, MasterCard believes that any implementation of a new regime should be phased in over a number of years. It would be appropriate to implement the changes over 5 years with the proposed reduction being pro rated over that period. This would help issuers to adjust to the dramatic decrease in revenue. It is noted that the European Commission has proposed a phased-in reduction of the Visa interchange fees applying in Europe.

	While MasterCard believes that a phase-in period is called for, MasterCard does not believe that even a very long phase-in period would solve the problems cause by the drastic reductions in interchange fees that the Wholesale Fees Standard would bring about.
73. Draft Standard para 15.	Under paragraph 15 of Proposed Standard No. 1, it is proposed that there be a review of interchange fees every three years. From communications with the Bank it is understood that, if the Scheme Administrator wished to undertake a review prior to the expiration of the three year period, it would need to seek the approval of the Bank. MasterCard believes that schemes should have the discretion to perform interchange fee reviews as frequently as they wish.

Chapter 3 – Restrictions on Merchant Pricing

MasterCard believes that the proposal to permit merchant surcharging is unnecessary and that it is not in the best interests of its cardholders or, for that matter, consumers as a whole.

In particular, the Bank has failed to demonstrate that surcharging is in the public interest or promotes efficiency or competition.

Surcharging is unnecessary because MasterCard permits its merchants to pass on the cost of credit card acceptance, as long as they do so in a manner that does not force MasterCard cardholders to pay more than the posted or advertised price, result in cardholders being charged excessively for their decision to pay by credit card, or discriminates against particular MasterCard issuer's cards or types of MasterCard cards. The Bank's proposal does little or nothing to protect consumers from these practices.

The Bank's proposal regarding surcharging is also inadequate in that it does not deal with the "no surcharge" rules of three-party schemes other than to say, in effect, that the Bank is considering this issue. If, as the Bank asserts, "no surcharge" rules are bad for consumers, then there is no reason for the Bank not to prohibit them entirely, rather than allow some payment schemes to continue the practice.

MasterCard's specific comments on this Chapter of the Consultation Document are provided below:

1.	p.61, para.1	MasterCard's rules do <u>not</u> prohibit merchants from "charging customers who use [MasterCard] credit cards more than they charge customers that use" other forms of payment such as cash and cheques. In fact, as acknowledged in the Consultation Document on p. 63, MasterCard's rules expressly allow merchants to offer discounts for cash payment. MasterCard considers, for the purposes of this rule, cheques to be the equivalent of cash. In response to the Bank's comment about less costly payment instruments, MasterCard refers to the analysis in Part A, Section 2.2 disputing the assumption that cash is less costly than credit cards.
2.	p.61, para. 2	MasterCard does not agree that the term "surcharge" is misleading. By charging a customer who pays by credit card more than the posted or advertised price for goods or services, the merchant is indeed adding an additional charge for the goods or services purchased, ie., surcharging. The practice of charging more than the posted or advertised price is universally considered to be misleading and deceptive and, in many cases, is legally prohibited. Surcharging is often associated with price gouging, which can result when, for example, a consumer has no choice but to pay by credit card. Cash discounts, on the other hand, protect consumers of these practices while still allowing merchants the freedom to price differentiate based on the respective costs of various means of

	payment. As discussed in paragraph 5 below, surcharging is also inconsistent with the "honour all cards" rule. As discussed in Part A, Section 2.7 [Confidential] it is generally not true that the rule against surcharging results in "[p]rices paid for goods and services by users of [so-called] lower-cost payment instruments [being] higher ... than would otherwise be the case."
3. p.62 para. 3	For the reasons discussed in Part A, Section 2.7 and below in paragraph 7, the Bank's conclusion that surcharging promotes efficiency and competition is unsustainable.
4. p.63 para. 3	MasterCard's rules do not prohibit cash discounting in Europe, as the Consultation Document suggests.
5. p.63 para. 4	The Bank's statement that no other supplier of goods or services to merchants seeks – or is legally able – to restrain them from passing on the costs of these services to customers overlooks a distinguishing aspect of four-party payment systems, namely, that the merchants' customers are also the credit card issuers' customers. In order for such payment systems to be attractive to cardholders, issuers must ensure a basic level of acceptance of cards and a satisfactory (from the cardholder's perspective) acceptance experience. An analogy may be found in a buyers club. By participating in that club a merchant agrees to sell at a discount to members of the club in return for gaining access to those members. It is a condition, however, that it will sell at a discount to those members. This arrangement is not illegal. With the MasterCard scheme a merchant who agrees to accept MasterCard cards is given access to MasterCard cardholders. A condition of the merchant's participation in the scheme and having that access is that the merchant will accept all validly presented MasterCard cards (the "honour all cards" rule). Surcharging is inconsistent with this fundamental principle of four-party payment systems since, via surcharging, a merchant could elect which issuers' cards to accept and effectively refuse to accept all others. In addition, surcharging makes the cardholder's experience of using cards less acceptable and thereby undermines the value of the card to cardholders and tarnishes the card brand. MasterCard does not believe that the "no surcharge" arrangement is illegal under current law, and MasterCard is not aware that any court has ever determined that the "no surcharge" rule is anti competitive. The only case of which MasterCard is aware that considered the issue of surcharging for the acceptance of payment cards (in *Southtrust Corp v Plus System, Inc.*,[64]), rejected a claim that the Visa rule against surcharging of ATM transactions was illegal.

[64] 913 F.Supp 1517, 1995

	The Bank refers to the decisions of competition authorities to prohibit restrictions on merchant pricing in three European countries. The Consultation Document later points out (p.73), however, the European Commission recently upheld Visa's "no surcharge" rule. In the interests of a balanced analysis, this decision should have also been referenced in this context.
6. p.63 para. 5	The Bank asserts that one economic effect of so-called scheme restrictions on merchant pricing is that the general level of prices is higher than it would otherwise be. No evidence is presented in support of this contention. As discussed in Part A, Section 2.7 and in the following paragraph, in those countries where it is permitted, the great majority of merchants do not seek to impose a surcharge. If surcharging were to be allowed in Australia there is likely to be a similar experience. It is also likely, however, that some merchants will seek to increase prices for goods and services and this is more likely, in MasterCard's view, to increase the general level of prices. The European Commission, upholding the Visa "no surcharge" rule in October 2000 and referring to research undertaken in two European countries where surcharging is allowed, The Netherlands and Sweden, stated that "It is not established that the abolition of the ["no surcharge" rule] substantially improved the negotiating position of merchants, in particular not that it lead to decreased merchant fees."
7. p.64 para.1	The Bank also contends that the scheme restrictions, by allegedly distorting the relative prices of payment services to consumers, do not promote efficient resource allocation and maximum community welfare. This assumes that, if merchants were allowed to impose a surcharge, that they would do so. However, as just mentioned, in those countries where surcharging is allowed most merchants do not seek to impose a surcharge. For example, in the research undertaken in The Netherlands by ITM Research for the European Commission in March 2000, only 10% of merchants imposed a surcharge (at p.14). In the Final Report dated February 2000 concerning research undertaken in Sweden by IMA Market Development AB for the European Commission, only 5% of merchants imposed surcharges (at p.18). The U.K. Monopolies and Mergers Commission in its report on *Credit Card Services* referred to research it undertook in 1988 which indicated that if surcharging were allowed in the U.K. 72% of merchants would not change their pricing. In 1991 merchants in the U.K. were allowed to impose surcharges in respect of credit card transactions. [Confidential] MasterCard believes that even these studies overstate the level of surcharging because a surcharging merchant's share of total credit card transactions is lower than average. The most likely explanation for most merchants not imposing surcharges in those countries where they are allowed to do so is that merchants find it

	most efficient not to differentiate the price for a good or service depending on the means of payment.[65] If, however, the cost differential of different payment systems becomes too large (taking into account the relative value to the merchant of the various means of payment), merchants will be more inclined to impose a surcharge on the more expensive payment systems. The fact that there has not been a widespread imposition of surcharging by merchants of credit card transactions in those countries where it is allowed therefore demonstrates that merchants do not suffer from a large cost differential.
8. p.64 para. 2	As discussed in paragraph 1 above, merchants are free to offer discounts for cash and cheques. Therefore, there is no basis for the Bank to conclude that the "no surcharge" rule requires merchants to charge the same price for all purchases "irrespective of the payment instrument used." In response to the Bank's assertion that there is no evidence to suggest that credit cards contribute to higher sales for merchants as a whole, we refer the Bank to the discussion in Part A, Section 2.8 that credit cards do increase merchant sales. As stated above in paragraph 7, even if surcharging were allowed, experience in those countries where it is permitted suggests that most merchants will not impose a surcharge on credit card transactions. Such evidence of merchant behaviour, under conditions where they could surcharge and offer cash discounts should they want to, points to the inescapable conclusion that the merchants' net benefit of accepting credit cards is at least equal, and frequently exceeds, the net benefit of accepting cash. However, in view of the fact that some merchants will seek to impose a surcharge simply because they can thereby make higher profits, it is likely that allowing surcharging will result in a higher level of prices of goods and services. There is no basis for the Bank to conclude, therefore, that consumers using lower cost methods of payment pay a higher price for goods and services than they would otherwise.
9. p.64 para. 3	The statement is made that "the potential for consumers who do not use credit cards to be harmed by scheme restrictions on merchant pricing is recognised in the recent theoretical literature on credit cards networks." Rochet and Tirole in the article referred to, assume that if permitted, merchants would automatically seek to impose surcharges. However, the experience in the those countries where surcharging is allowed (referred to in paragraph 7 above) demonstrates this not to be the case. Hence, the Rochet and Tirole analysis is obviously flawed. See the Weizsäcker report included as Part C of this Response, especially sections A, D and E.
10. p.65	The description attributed to Schwartz and Vincent of the "no surcharge"

[65] see Professor C.C. von Weizsäcker, Annex A at p. 10

para. 1	rule being a means by which credit card schemes can indirectly "tax" purchases made by cash customers is facile and incorrect. Studies have shown that the cost of cash is only marginally lower than the cost of credit cards, yet as described above and by Weizsäcker (in Annexure A, paragraph 40), merchants do benefit from credit cards due to the increased sales which can be made. The assertion that the rule enables the card scheme to "raise the merchant service fee which in turn increases prices paid to all consumers" is unfounded. When the no-surcharge rule was abolished in the U.K. there was no significant reduction in the merchant service fee in that country.
11. p. 65 para. 2	The Bank states that, "as an empirical matter, the likely magnitude of the impact of the no-surcharge rule on the general level of prices in Australia is not easy to determine" but that "the effect is likely to be significant". Then based upon a 'back of the napkin' calculation, the Bank implies that $1.5 billion in merchant service fees is passed on in the form of higher prices to consumers who do not use credit cards. This suggestion is easily debunked since, as explained in the foregoing paragraphs, it is likely that the presence of the rule has had little impact on prices due to the general reluctance of merchants to impose a surcharge and the ability of merchants to offer discounts for cash. Moreover, many of the transactions made with other forms of payment are made by people who at other times use credit cards. Hence, the impact on consumers who don't use credit cards is likely to be minuscule. See also the discussion in the following paragraph.
12. p.65 para. 3	If, as the Bank asserts, 35% of retail transactions are made by credit and charge card and the average merchant service fee is 1.8%, and assuming that the level of surcharging in Australia would be similar to that in countries where surcharging is currently permitted (at most, 10-15%), the impact of the "no surcharge" rule on retail prices is at most in the order of only 0.1%. This is an order of magnitude less than the US Federal Reserve estimate cited by the Bank. In light of the fact that permitting surcharging enables unscrupulous merchants to impose any level of surcharge on cardholders, there is a very real possibility that it will result in consumers actually paying more, on average, for goods and services. Moreover, as discussed above, the Bank's analysis of surcharging does not take into account the benefits of credit cards to individual cardholders and to society as a whole. Hence, there is no basis for the Bank to conclude that abolishing the "no surcharge" rule is in the public interest.
13. p.66 para. 3	The Bank alleges that, irrespective of whether the technical definition of a cross-subsidy is satisfied, the public interest concern is that non-cardholders are harmed by restrictions on merchant pricing because they end up paying higher retail prices. For the reasons discussed above, MasterCard does not believe that this public interest concern is established because there is no evidence that consumers do end up paying higher prices. If anything, the elimination of the no-surcharge rule may result in an increase in prices. Regarding the Bank's reference to Professor Katz' conclusion that "what matters for consumer welfare and

	efficiency is what actually happens, not what labels are attached to the effects", the Bank cites no evidence that the "no surcharge" rule increases prices, and ignores the considerable evidence that it does not. The best evidence is the experience has been in countries – such as the UK - where the rule has been abolished. There, the price distortions suggested by Professor Katz have not been borne out.
14. p.67 para. 2	Scheme restrictions on merchant pricing can only be said to "suppress price signals" if, in the absence of such restrictions, most merchants could be expected to impose a surcharge. As discussed in paragraphs 5, 6 and 7 above, based on the experience in the those countries which allow them, the great majority of merchants do not seek to impose surcharges. As to the alleged further distortion of cardholders in loyalty programs who are said to be paid a rebate to use credit cards, this is no different than the time-tested, universal practice of merchants providing benefits selectively to certain customers. If Professor Katz' contentions are correct (and MasterCard disputes that they are) these should also have a distorting affect on price signals. For example: • Merchant offering benefits to holders of their store cards. For example, the Coles Myer store card offers up to 62 days interest free, no annual or joining fees and special interest free promotions (see http://www.card.colesmyer.com/benefits.asp#payment). The David Jones card, as well as interest free periods and no annual fees, offers an extra year's warranty on electrical appliances and a rewards program for cardholders (see http://www.davidjones.com.au/djcard_features.jsp#warranty). • Loyalty programs offered to certain customers, for example, airline frequent flyer programs and the Fly Buys card (which has 5 million cardholders and 2 million households in Australia collecting points. See: http://www.flybuys.com.au/information/whatisflybuys_h.html). • "Buy one, get one free" and other short-term special price offers, examples of which are too numerous to mention. Loyalty and other forms of promotional offers are an integral part of doing business. Is every business that uses them engaged in anti competitive conduct that distorts price signals and unfairly forces non-beneficiaries to pay higher prices? Of course not, and neither are credit card issuers.
15. p.67 Table 3.1	MasterCard has difficulty reconciling the numbers in Table 3.1. Firstly, the costs for a foreign ATM and own ATM are stated to be equivalent. Yet the costs to an issuer and acquirer are vastly different between own and foreign ATM transactions. The issuer's interchange fee cost is excluded, and as such the cost price by the cardholder appears to be inflated. Further costs such as interchange settlement costs, maintenance of interchange links, handling inter-bank customer disputes and switching costs (an omission acknowledged by the Bank) seem to be ignored. Secondly for the credit card category, the Bank has conveniently omitted

	the impact of annual fees on the cardholder's cost, whether it be for loyalty or interest free period cards or both. Credit cards which offer both typically have an annual fee around $50 per annum, and cards which just offer an interest free period commence from $20. There are also many MasterCard credit cards which do not offer a loyalty program or interest free period, that have escaped the Bank's analysis for the purposes of this table. The limited analysis undertaken by the Bank seems to be intended to derive a result to support the Bank's arguments, although when considered in the light of the preceding paragraphs of this submission is weakened.
16. p.68 para. 2	The Bank claims that "payment instruments themselves cannot generate a permanent increase in consumption". Based on the evidence presented in Part A, Section 2.8, there is ample reason to believe that credit cards do just that. In any event, in a free society with a market economy, consumers generally are afforded the opportunity to make their own economic choices irrespective of the inability of the government or anyone else to prove that those choices increase efficiency. The wisdom of this approach is demonstrated by the spectacular failures of market planners in the past. It is difficult to see what has changed such that the Bank believes it can substitute its views for those of consumers with a better result. Moreover, as discussed in Chapter 2, paragraph 21, the Bank's discussion of the effects that payment instruments have on the general level of consumption completely disregards the impact of the interest free period offered by card issuers, as well as the credit function. As a matter of basic economic theory, if a person who consumes a good or service is able to delay payment for the good or service, there are two consequences. Firstly, the person is able to invest the funds that would have otherwise been spent on the good or service over the interest free period, for example in a savings account, thereby increasing the person's income and wealth (in the Bank's own theory, the two determinants of future consumption). Secondly, consumers are able to consume goods and services before they have the means to do so. Provided that the consumer is reasonably confident of obtaining those means before payment is due, for example an employee who is paid each month on the same date, then there will be a sustained shift forward in the consumption of goods and services.
17. p.68 para. 3	The Bank suggests that there is no empirical evidence for the view that consumers prefer credit cards to debit cards when there is no material difference in the price of these services. However, the evidence [confidential] suggests three main things: • First, there is a considerable amount of overlap between different payment methods (including credit and debit cards) at a wide range of different transaction sizes.

	• Second, different methods of payment have different attributes. • Third, consumers make choices about what methods of payment to use for a given transaction depending on a range of different factors. These include demographics, the size of the particular transaction, the purchasing environment and (of course) whether a transaction charge is being levied. Depending on the consumer in question and the situation in which he finds himself consumers therefore rationally choose between credit cards and debit cards and frequently opt for the former.'
18. p.69 para.5	One reason cited by the Bank as to why it finds the "network externalities argument" unconvincing is that the benefits of credit card use have been overstated. For the reason referred to in Part A, Section 2.6, there is strong reason to believe that credit card usage does lead to a permanent increase in sales for merchants. Even if credit cards did entail a higher cost for merchants, this is more than offset by the benefits associated with an increase in sales. Moreover, the growth of credit card usage referred to by the Bank (see p. 2 of the Consultation Document) is strong evidence that consumers find them highly beneficial.
19. p.70 para.1	Two points may be made in relation to the Bank's statements in this paragraph. Firstly, under MasterCard's existing rules merchants are free to offer a discount for cash transactions. The effect of this is the same as a surcharge insofar as the market may "internalise effects that would otherwise be externalities." Secondly, to the Bank's claim that the removal of scheme restrictions on merchant pricing might encourage more merchants to accept credit cards, as discussed above, research shows that most merchants, if afforded the opportunity to impose a surcharge, will not. In light of this, it could reasonably be expected that the benefit to the scheme owing to the small number of merchants who may accept credit cards if allowed to surcharge would be more than offset by the harm resulting from cardholders who, as a result of a negative experience with the introduction of surcharging by some merchants, are likely to leave the scheme. MasterCard believes that the net effect for the designated schemes will be negative. In the research undertaken in The Netherlands by ITM Research for the European Commission in March 2000, it was stated (at p. 15): "Most cardholders (74%) think it is (very) bad that merchants are allowed to ask for a fee when they want to pay with their payment card." A smaller proportion (49%) thought that merchants offering a discount when paying with other means "is (very) bad".
20. p.70 para. 2	See the Weizsäcker report included as part C of this submission, which is a comprehensive rebuttal of some of the central foundations of Katz' position.
21. p.71	The Bank's conclusion that, in a country where personal automobiles are

para. 3	the normal means of transportation, free parking does not increase shopping as a whole is nothing short of amazing. It also explains why the Bank does not perceive the problems with surcharging – it is utterly out of touch with the wishes and motivations of consumers. MasterCard also believes that the car park analogy is useful in demonstrating that merchants do face choices in providing benefits to their customers. Some benefits directly assist some customers but not others and yet all customers of the merchant – including those not directly benefiting – pay for them. Accordingly, merchants decide to accept credit cards and/or provide free car parking depending on what they believe will best encourage consumers to shop with them. The illustration does not end there. There are a myriad of examples of merchant expenditure that benefit only some customers for which all customers pay. For example, expenditure on attractive stores and store fittings, from which customers who shop via telephone or the Internet receive no benefit; free delivery of goods, which are of no benefit to customers who carry their purchases home, sales help and customer support that more knowledgeable customers do not need; and benefits provided to holders of store cards issued by that merchant that are not given to customers who pay by cash or use bank-issued cards. The cost of many of these probably exceeds the cost of accepting credit cards by several times and, collectively, they certainly impose on consumers much more cost than credit card acceptance.
22. p. 71 para. 4	The Bank's assertion that the Australian payments market is characterised by overlapping governance arrangements and lack of competition is fallacious. There is no overlap between the relevant MasterCard governing bodies, the Asia/Pacific Region and Global Boards of Directors and the governing body of any other payment system operating in Australia. As to the alleged lack of effective competition, see the discussion in Part A, Section 1.
23. p.72 para. 3	The "more appropriate analogy" suggested by the Bank is inappropriate in a number of respects. In the analogy all trucking companies "collectively agreed" to a certain course of conduct to prevent the passing on of delivery costs. There has been no such collective agreement in Australia among providers of credit cards services. Rather, virtually every payment system in Australia and elsewhere, including three-party systems, independently prohibit surcharging and have for many decades. The most logical explanation of this is that those in the payments business have determined based on experience that surcharging is antithetical to the health of their businesses, not that there is a forty-year old global conspiracy to bilk non-cardholders.
24. p.73 para. 2	The Bank argues incorrectly that the two justifications presented in support of the "no surcharge" rule are contradictory. The fact that surcharging is not prevalent in those countries where it is allowed does not mean that it is not harmful to payment schemes and their cardholders. MasterCard, in its June 8, 2001 Submission to the Bank, pointed out that

	“in highly competitive retail sectors, surcharging is rare if not non-existent” (at p. 51). However, those few merchants who do impose a surcharge do harm the brand. Typically these merchants face reduced competition and are in a position to extract surcharges from cardholders and, in some cases, engage in “price gouging”. For example, in the research undertaken in The Netherlands by ITM Research for the European Commission in March 2000, despite the average merchant service fee being in the order of up to 4.5%, cardholders indicated that they were charged on average 19%. The authors stated that “This means that there are customers that are surcharged far more than the merchants say they do; at least in the opinion of the customers." (at p. 14) The fact that if surcharging were allowed, it may not be adopted by many merchants, does not lessen MasterCard’s concern about the potential harm of the practice as elaborated upon in its earlier Submission (at pp. 35-37), namely, that the practice allows the merchant to capture value in the transaction which the issuer has created, unfairly discriminates against cardholders as against other forms of payment and may be confusing for cardholders. In the research undertaken in The Netherlands by ITM Research, 74% of cardholders surveyed believed surcharging was bad, however, substantially less (49%) believed that merchants offering discounts for payment by cash was bad (at pp.11-12). Further, in this report it was stated that “most customers do not change to another means of payment once they find out they are surcharged for paying with their Visa or Eurocard/MasterCard. On the other hand 38% say they do refrain from paying when they are surcharged and they are also very negative when you ask them what they think of the fact that merchants have the right to surcharge” (at p. 16). In the Final Report dated February 2000 concerning research undertaken in Sweden by IMA Market Development AB for the European Commission, it was found that “cardholders having been surcharged in the past mainly believe the most probable reason for abolition of the surcharge was negative cardholder reactions and loss of customers.” In addition “although certainly not pleased with the surcharge, approximately 75% paid with their card anyway, whilst the remaining one forth used other means of payment – mainly cash” (at p. 22).
25. p.73 para. 4	In attempting to de-emphasise the upholding of the Visa “no surcharge” rule by the European Commission, the Bank fails to cite the Commission’s conclusion that “Cardholder’s reaction to surcharging is in general negative.” (see ttp://europa.eu.int/comm/competition/antitrust/cases/29373/studies/).
26. p.74 para. 2	MasterCard agrees with the Bank that surcharging could have beneficial results if used to avoid excessively high merchant service fees. But the Bank overlooks the fact that the same result can be accomplished through cash discounts and without the negative effects of surcharging (eg., cardholders being forced to pay more than the posted or advertised price; unscrupulous merchants taking advantage of customers who have insufficient cash to make the purchase).

27. p.74 para. 3 and Table 3.2	In Table 3.2, the figure of 19.0% given for The Netherlands in relation to "merchants who price discriminate" is incorrect. The correct figure for merchants which impose a surcharge is 10% (see p. 14 of ITM Research Survey). The figure of 6.5% given for Sweden is also incorrect. The correct proportion of merchants imposing a surcharge is 5% (see p.18 of IMA Market Development AB Survey).
28. p. 75 para. 2	For the reasons expressed in Chapter 2, paragraph 1, and paragraph 20 above, MasterCard disagrees with the statement that "the argument that removal of scheme restrictions on merchant pricing will have little impact on merchants is an argument, in principle, against retaining these restrictions."
29. p.75 para. 3	In arguing that the difference between surcharging and cash discounts is simply a matter of "framing" or perception, the Bank overlooks the fact that consumers, rightly, object to being asked to pay more than the posted or advertised price for goods and services. The evidence supports this view. In the research undertaken in The Netherlands by ITM Research, 74% of cardholders surveyed believed surcharging was bad, however, substantially less (49%) believed that merchants offering discounts for payment by cash was bad (at pp. 11-12). These are factors to which the Bank should have regard in determining whether allowing merchants to impose a surcharge on credit card transactions is in the public interest .
30. p. 76 para. 2	The Bank states that arguments about consumer confusion are "easy to overstate". However, it is instructive to compare the situation when the goods and services tax ("GST") was introduced in July 2000. There was, in the period prior to its introduction, considerable concern about possible confusion of consumers and exploitation of them by unscrupulous merchants. The level of the concern was such that a new Part VB prohibiting price exploitation was inserted into the *Trade Practices Act* 1974 and the ACCC released guidelines as to what was expected of merchants in complying with these changes. MasterCard does not understand why there is not a similar level of concern shown towards consumers if surcharging is allowed by merchants in Australia. MasterCard believes that the Bank's policy stance in this regard is inconsistent with the government's historical and proper concern that merchants not engage in practices that take advantage of consumers. Regarding the Bank's reference to minimum purchase obligations, MasterCard does not allow merchants to impose minimum purchase obligations on cardholders (Rule 9.04(b)(15) of the MasterCard Rules provides: "The merchant shall not require, or post signs indicating that they require, a transaction amount below or above which the merchant shall refuse to honour otherwise valid MasterCard cards.")
31. p. 76 para. 3	The Bank refers to the Report of the U.K. Monopolies and Mergers Commission. Three comments may be made in response. First, even if domestic consumers may be able to look after their own

	interest (which, the existence of the numerous consumer protection laws demonstrates is not always the case) this is not likely to be the case for overseas visitors. Visitors to Australia from countries where surcharging does not occur are apt to be confused if they are confronted by surcharging in Australia. Apart from having an adverse effect upon the MasterCard brand, this is also likely to be detrimental to Australia's efforts to encourage tourism. Second, the Monopolies and Mergers Commission stated in its report that it had consulted the U.K. Department of Trade and Industry which had indicated that, if surcharging were allowed in the U.K., that Department would provide guidance to traders on differential pricing. The Consultation Document is silent on this point and it is not clear whether education of cardholders and merchants as to the right to surcharge a credit card transaction would be undertaken by the Bank or would be left to the respective credit card schemes (with the ensuing costs). Third, while the Bank suggests on p. 79 of the Consultation Document that merchants can be prohibited contractually from imposing excessive surcharges, it is not clear how this is to be accomplished or enforced.
32. p.76 paras. 4 et seq	The concern about potential price "gouging" of credit card users by merchants is dismissed by the Bank without regard to the evidence and with a shocking lack of concern for consumer well-being. While in a competitive retail sector surcharging is not likely to be common (as evidenced in those countries where surcharging is allowed), it is likely to be utilised by some merchants who are subject to reduced levels of competition or who otherwise can take advantage of their customers. For example, as referred to above, in the research undertaken in The Netherlands by ITM Research for the European Commission in March 2000 (referred to in paragraph 28 above), despite the average merchant service fee being in the order of up to 4.5%, cardholders indicated that they were charged on average 19%. The example cited by the Bank, Australian taxis, is also illustrative. The Bank states, incredibly, that taxis in Australia are not exploiting their customers when they impose a 10% surcharge for use of credit card because the taxi industry is simply "protecting its own" payment system, Cabcharge. Cabcharge imposes a 10% surcharge on its own proprietary charge card as well as on all other cards, including debit. Effectively Cabcharge is penalising card using consumers because of the inefficiencies involved in its own product which somehow requires a 10% surcharge to make profitable. Given that the cost to taxis of accepting credit cards is well below 10%, the Bank's conclusion is inexplicable. This further demonstrates MasterCard's rationale for the "No Surcharge Rule." Cabcharge which operates in a monopoly, whose taxi driver constituents are better served, for reasons of personal security, accepting non-cash payments, takes advantage of its position and charges a surcharge well above its true cost of accepting credit cards.

	Also troubling is the Bank's apparent belief that it is permissible for an industry to overcharge the customers of a competing payment system in order to protect their own. Taken together, these conclusions are further evidence that the Bank's proposal with regard to surcharging is not in the public interest.
33. p.77 paras. 2 and 3	MasterCard does not believe that discrimination against wealthier customers is necessarily the main issue if surcharging is allowed. As described in the paragraphs above, the main concern relates to merchants who have market power or who otherwise may be in a position to exploit consumers. The behaviour of such merchants may not necessarily have a one-off effect, as some consumers may not have any choice but to acquire goods or services from that merchant. An example may be a merchant offering goods or services in a rural area with the nearest competitor being some distance away. MasterCard is also concerned that overseas tourists to Australia may be subject to exploitation by merchants that cater to those tourists. By their very nature there is a large customer turnover at merchants catering to tourists. Accordingly, the fact that tourists may not return to shop at one particular merchant may be of little concern to the merchant, and tourists will therefore have little ability to deter anti consumer behaviour. The Bank acknowledges the need for consumers to be made aware of the existence of surcharging and the amount of any fees prior to the sale. As indicated in paragraph 34 above, however, it is unclear who will be responsible for educating merchants and cardholders as to acceptable practices for surcharging so that consumers will not be misled or confused. Will this be the responsibility of the Bank or will the schemes need to ensure that such education takes place (with the attendant costs in doings so)? It is noted that the draft standard (clause 10) requires the scheme Administrator to advise merchants in Australia of the standard. However, compliance with this requirement is not the same as an education campaign for cardholders and merchants and does not deal with the question of placement of appropriate signage by merchants who choose to impose surcharges. MasterCard would like assurances from the Bank, if its "no surcharge" rule is struck down, that it may take steps to protect its cardholders, including prohibiting merchants from surcharging more than the level of merchant service fees, and requiring merchants to post conspicuous signage stating that the merchant imposes surcharges and explaining how the surcharge is calculated.
34. p.78 para. 1	For the reasons set forth in this Response and in its June 8, 2001 Submission to the Bank, MasterCard disagrees with the Bank that its "no-surcharge" rule is not in the public interest, or that it will promote efficiency and competition.
35. p.78	For the reasons discussed above, MasterCard is concerned that the Bank's proposal will not effectively prevent some merchants from

	para. 2	surcharging their customers more than the cost of accepting credit cards.
36.	p.79 para. 3	The Bank's proposal to "consult the three-party schemes, American Express and Diners Club, on why the standard on merchant pricing should not apply to them" is patently inadequate. If all of the alleged problems with the "no surcharge" rule are true, the Bank would be derelict in its duty not to protect cardholders from the rule where imposed by three-party payment schemes. Moreover, in the 12 April 2001 Media Release by the Bank (No:2001-09) it was stated that "Any decisions taken by the Bank in this area [ie, in respect of 'no-surcharge' rules] would, of course, apply to both credit card systems and "three-party" systems." MasterCard also notes that a number of submissions have been made to the Bank by American Express and a confidential submission has been made by Diners Club. It appears that substantial consultation has already taken place with the three-party systems. Given the statement made by the Bank in its Media Release some 11 months ago and the fact that extensive consultation has already taken place, MasterCard believes that adequate time has now elapsed for the Bank to decide whether the three-party systems should be subject to the same restrictions on merchant pricing practices as are proposed to be applied to the designated four-party card schemes. MasterCard believes that, if the Bank determines that such restrictions are to apply to the designated schemes, those restrictions should also apply to the three-party systems from the same time, in order that the three-party schemes not be given even a temporary competitive advantage. Not only would this be unfair to the four-party schemes and their members, it would not be in the public interest or promote efficiency and competition, which the Bank admits it is required to do.
37.	p. 81 Draft standard	The following comments are offered by MasterCard concerning Standard No. 2 – Draft Standard for Designated Credit Card Schemes. MasterCard understands, based upon p.79, paragraph 3 of the Consultation Document, that the standard will not preclude scheme rules and/or contractual arrangements between a credit card acquirer and a merchant that would limit the size of the "fee for service" for accepting credit cards to the level of the merchant service fee. The standard should specifically provide for this. It is not clear from the draft standard whether it would be permissible for the MasterCard Scheme to create, and enforce, rules concerning the appropriate disclosure by merchants to cardholders of surcharges imposed by them on transactions paid for by MasterCard cards. It is understood from communications with the Bank that there is nothing in the standard that would prevent MasterCard from doing this. MasterCard believes that this needs to be clarified. While there may be other government agencies that have an interest in ensuring that appropriate disclosure be made to customers, MasterCard believes that this issue is so important (as evidenced by the Government's approach to adequate

	disclosure of GST referred to in paragraph 33 above) that it behoves the Bank to take a more active interest in this important issue. The standard should specifically permit four-party schemes to prohibit any surcharging practice that undermines the “honour all cards” rule, for example, the practice of discriminating between cards issued by different members of the scheme or between different types of scheme cards. The standard should apply to three-party credit card schemes as well and that, until this is the case, it ought not to be made effective against four-party schemes.

Chapter 4 – Restrictions on Entry

MasterCard recognises that many of the significant concerns raised by MasterCard in its Submission to the Bank of June 8, 2001 have been addressed by the Bank in the Proposed Access Regime. Subject to the comments below, MasterCard is generally less concerned about the Proposed Access Regime than with the Standards on the Collective Setting of Wholesale Fees and on Merchant Pricing for Credit Card Schemes. However, one exception in this regard, relates to the proposed abolition of the “net issuer” rules. MasterCard believes, for the reasons below, that the proposed abolition of those rules is not in the best interests of the MasterCard scheme and could have significant adverse ramifications for competition within the payments market.

The Consultation Document (at p. 108) indicates that the proposed expansion of access to include specialist credit card issuers and acquirers is being progressed with the Treasury as it is proposed that regulations will be enacted under the *Banking Act* 1959 to extend the definition of “banking business”. APRA is also to supervise and regulate this new class of specialists. This aspect of the Proposed Access Regime appears to be an attempt to address many of MasterCard’s concerns as to its members being regulated and supervised. However, as MasterCard has communicated to the Bank, it is not possible for MasterCard to comment on the Proposed Access Regime in an informed manner, unless the Bank provide more detail on the form of regulation to be enacted and also on the proposed form of regulation and supervision of specialist institutions by APRA. MasterCard has met with APRA, which has advised that it is only at an early stage in its consideration of the appropriate form of regulation for specialists. MasterCard understands that any further information on this matter will not be available before the date fixed by the Bank for the submission of responses to the Bank on its proposals.

In the circumstances MasterCard maintains that there has been inadequate notice of the proposed imposition of an access regime, and that the reforms outlined in the Consultation Document should not be introduced until the draft regulations under the Banking Act have been prepared, and APRA has finalised the proposed form of prudential supervision. It is not possible for MasterCard to comment on the proposed action in an informed manner unless this further important additional information is available.

MasterCard also feels it necessary to indicate instances in which the Bank has mis-characterised MasterCard’s membership eligibility rules and policies. MasterCard is surprised by this, as it engaged in detailed discussions with the Bank on this portion of the proposed regulations. In particular, MasterCard repeatedly emphasised to the Bank that it does not require that members be deposit-taking institutions and even cited examples of non-deposit-taking institutions that are long-standing MasterCard members. Hence, MasterCard feels the Bank has incorrectly and unnecessarily portrayed MasterCard as opposing the expansion of membership opportunities in Australia. In fact, when one considers what the Bank has proposed, it would appear (subject to the Bank providing the necessary further information concerning, for example, the APRA supervisory standards that will apply to SCCSPs) that it is essentially the same as MasterCard’s current eligibility requirements.

MasterCard offers the following specific comments on this Chapter of the Consultation Document and on the Proposed Access Regime:

1.	p.83, paras 2 and 3	MasterCard's membership eligibility rules and policies are designed to protect the scheme from undue risk, to ensure that the value of the MasterCard brand is maintained and enhanced, and to maintain operational capabilities. MasterCard does not and never has used its eligibility rules and policies to restrict competition. The Bank's assertion that MasterCard's membership eligibility rules are anti competitive is neither supported by evidence nor consistent with the Bank's ultimate decision to adopt MasterCard's position that any institution eligible for membership in MasterCard must be supervised by APRA.
2.	p. 84 para. 1	The Bank puts forward evidence of profitability in Table 4.1, claiming that issuers' profit margins are $0.30 per transaction. Based on MasterCard's estimate of total MasterCard, Visa and Bankcard transaction volume in 2001 of $96.4 billion, and an average transaction size of $108.54, there were 888 million transactions in 2001. At $0.30 per transaction, that equates to an industry profit of $266 million. However, the loss in interchange fee revenue if the Bank's interchange fee standard is adopted, will be $622 million (based on total interchange fee revenue of ($916 million x 0.65%/0.95%), which is nearly two and a half times the total profits of all issuers. This suggests that the Bank may be taking its concern over issuer profitability just a little too far.
3.	p. 85	Barriers to entry may lead to incumbents enjoying extra profits that are not due to efficiency advantages over potential entrants (Weizsäcker, 1980, Gilbert, 1989). The Bank believes that the four large banks that together make up 87% of credit card issuing and 91% of credit card acquiring business in Australia (Table 4.2) enjoy such extra profits due to the dominance of the networks that they jointly operate through the three designated credit card schemes. The Bank puts forward evidence of profitability in Table 4.1 claiming profit margins of just under 10% of revenues for issuing and around 30% for acquiring. The first fundamental point to make is that barriers to entry have to be related to the relevant market. Barriers to entry can only be relevant for considerations of anti-competitive practices if they relate to the inability of an efficient entrant to start competing with incumbent suppliers. It is not appropriate for the Bank to claim that restrictions on membership of a particular credit card scheme are anti-competitive and constitute a barrier to entry if there are other means by which an entrant can start competing for customers. As Weizsäcker points out in his report (in Annexure A, para 74): "entry can be obtained if the entrant is prepared to invest in initial losses: the entrant will have to induce merchants to accept the card and at the same time offering card holders first year incentives based on the volume of purchases paid for by the new card. But initial losses are the normal

	case with entry into any market. They cannot be considered a barrier to entry. Any kind of business relies on established customer relations. An entrant will always have to invest into acquiring established customer relations. There is no fundamental difference in the case of payment systems. The only difference is that customer relations to one group of customers depends on customer relations with the other group of customers. But there is a characteristic of any kind of market for intermediation services. For example, a real estate agent can only hope to obtain custom among people who want to buy a house if he or she has custom among people who want to sell a house: and vice versa. I am not aware of a theory in economics which would say that any kind of market for intermediation services is by this very fact of intermediation characterised by barriers to entry." If the market for payment systems is open and includes competing payment systems other than designated credit cards, then there can be no barrier to entry that supports and enhances profitability of members of credit card schemes. This is arguably the case in Australia as elsewhere with four-party credit card schemes competing with three-party credit/charge card schemes, four- party or three-party debit card schemes, cash and cheques. With an aggregate share of the relevant market of less than 25%, the large members of the designated credit card schemes cannot enjoy extra profits due to barriers to entry that do not relate to the relevant market as whole. If the large banks do manage to operate a profitable business (which is disputed as described in Part A, Section 1) then this may be due to a number of factors. Managing a superior business is one source of profits that any policy to promote an efficient and competitive market would encourage. Enjoying superior profits in a period of economic expansion and low interest rates is a temporary phenomenon and a sign of prudence. As is well known in any downturn of the economic cycle it is creditors who suffer from higher default rates triggered by a drop in investment spending by businesses, lower sales by consumers and often higher interest rates. This pattern is well recognised and has been explored by economists with respect to credit card business[66] A major constraint on any position of long term profitability being maintained by a group of incumbent payment service providers (whether credit or debit cards) is the ability of retailers to set up and operate their own payment systems. As is spelled out with great clarity by Prof von Weizsäcker (in Annexure A, paragraph 84,85): "It is important to understand that one source of entry can be customers.

[66] see LM Ausubel *'Failure of Competition in Credit Card Market'*, American Economic Review, and Evans/Schmalensee, 1999 Chapter XXX

	Obviously this is an unlikely source of entry if there are millions and millions of small customers. But it is a very likely source of entry, if customers are large and well organised organisations. This is the case with the merchant customers of payment systems. Large retail chains do already issue pay cards to their customers. These store cards are well established. Their management can be delegated to financial services companies like GE-Capital and thereby can be run very efficiently even on behalf of firms with a different specialisation, like retailing or the hotel business. Without too many problems large retail chains, large hotel chains, large travel businesses can get together to create their own credit card. They can hire GE-Capital or other financial service businesses to run the organisation on their behalf. For this group of large merchants it is even easier to enter the business: their costs of acquiring customers is lower than for other entrants. They themselves are the merchant customers of the new credit card. And their customers as purchasers are a natural base to obtain card holders. The credit component of the card can be run by the financial services firm: not by accident is a firm like GE-Capital in the business of consumer loans."
4. p.86 para. 1	The Bank provides no basis for disregarding the acknowledged sunk costs incurred in establishing the credit card scheme, other than that 'credit card activities for banks moved into profit in 1991/92'. The Bank takes no account of the estimated difference in magnitude between the sunk costs and profits, surely the more appropriate consideration rather than the Bank's belief that the 'credit card is now a well-established product and familiar to customers'.
5. p.86 para. 2	MasterCard agrees with the ABA that the cost of loyalty programs should be taken into account in evaluating issuer's profits. Irrespective of whether the Bank regards loyalty programs as a cost integral to the provision of credit card services, they are nevertheless a real cost for the issuer and should be taken into account just as any other marketing and promotions costs would be so counted. In MasterCard's experience in Australia regulators have generally accepted costs borne by businesses in carrying out their business and not questioned whether those costs were integral – either for the purposes of the preparation of the statutory accounts of the business or the preparation of tax returns for the business. MasterCard does not believe that the Bank is entitled to hold the Banks to a different standard so far as the cost of loyalty programs is concerned. Nor does it make commercial sense to do so.
6. p.86 para. 4	MasterCard is aware that the Australian Banker's Association has previously submitted data to the Bank, which indicated that merchant service fees charged by its acquirers have fallen on average, in recent years.
7. p.87 para. 2	In response to the Bank's criticism of *ad valorem* merchant service fees, whilst acquiring may be essentially volume based, a large part of the costs of acquiring is the interchange fee, which is itself set on an ad valorem

		basis. The interchange fee is ad valorem because the costs of issuing increases with the size of the transaction, for example as the size of a transaction increases, so does the cost to an issuer in writing off that transaction.
8.	p.88 para. 3	The ARA draws the conclusion that the fact that a few retailers with high turnover still pay high merchant service fees, results from a lack of knowledge on the part of the retailer, or a belief that the merchant service fee is non-negotiable. The Bank presents no evidence to support its contention that the ARA's interpretation is consistent with less than vigorous competition in the acquiring market. It is hardly the fault of acquirers that a few retailers fail to properly inform themselves of the conditions of the acquiring market. The ARA is effectively suggesting that merchant ignorance betrays a lack of competition amongst merchant acquirers.
9.	p.88 para. 4	Evidence of declining merchant service fees is indeed evidence of vigorous competition.
10.	p.89 para. 1	The Bank's comparison between the credit card business and specialist mortgage originators is too simplistic. The fact that one business may or may not be competitive has nothing to do with the competitiveness of another. As discussed in Part A, Section 1, there is no reason to believe that the Australian credit card business is not highly competitive.
11.	p.89 para 4	The various tasks that issuers must undertake to lower credit risk are necessary for four-party schemes to provide merchants with a guaranteed payment. If a merchant were to offer its own credit card to its customers, it would have similar (probably higher) costs. It is for this reason that MasterCard includes the costs associated with credit risk in its interchange fee formula in assessing the level of interchange fee.
12.	p.89 para 5	While the Bank acknowledges that issuers do have significant responsibilities to other participants in the scheme, this is not reflected in the draft interchange standard which provides very little financial recognition of these responsibilities.
13.	p.90 para 2	While the Bank may be correct that risks are generally fairly predictable, it should not overlook the fact that issuers must be vigilant in monitoring the performance of their portfolio and matching risk management carefully with marketing and portfolio expansion efforts so that they do not find themselves assuming more risk than they previously anticipated. In addition, issuers must monitor prevailing economic conditions and other factors that could result in otherwise unanticipated increases in default levels. The history of the credit card business is replete with examples of issuers that found themselves in financial difficulty because they did not properly manage credit risk. In early 2002 in the U.S., both NextBank N.A. and Net First National Bank were closed by the Office of the Comptroller of the Currency and put into

	receivership, due in large part to unsound underwriting practices in their credit card issuing businesses. Providian National Bank, a monoline (credit-card only) US bank, is currently subject to regulator-imposed business restrictions and restructuring requirements resulting from its aggressive risk model and lending practices in connection with card issuing, which brought about higher-than-expected credit losses when the economy went into a down cycle in 2001.
14. p.91 para 1	In relation to transactions completed on a "delivery vs payment" basis and the comment concerning the scope for a customer to initiate a refund being virtually nil, it is noted that it is not always possible to identify merchants which exclusively operate on this basis. For example, a supermarket which operates on this basis may also have, or commence to operate, Internet shopping and may then be in the situation where goods are delivered after payment.
15. p.92 para 2	As indicated in the comments on Chapter 2, paragraph 41 above, the [Confidential]
16. p.93 para. 2	It is stated here by the Bank that an application for membership of MasterCard is decided by a vote of the international or regional directors. We note that membership of MasterCard in Australia is a matter for MasterCard's regional board.
17. p.95 para. 2	The Bank's suggestion that MasterCard requires applicants to be deposit-taking institutions is incorrect. (This error is repeated at p. 96 paragraph 3 and elsewhere in the Consultation Document.) As the Bank observed on pp. 92-93, MasterCard requires that applicants be *financial* institutions, not that they be *deposit-taking* institutions. Moreover, it is not correct that any flexibility in MasterCard's membership rules would not apply to Australia. The simple fact of the matter is that, with one exception (discussed in the following point) no non-deposit-taking institution has ever applied for membership in Australia.
18. p.95,para 2	The Bank's suggestion that MasterCard requires that all members be supervised by APRA is also not correct. As observed by the Bank (p. 95), MasterCard's rules require that members be regulated and supervised by "a governmental agency". While MasterCard would generally expect that Australian members would be supervised by APRA, it permitted GE Capital, which is not a deposit taking institution and is not supervised by APRA to issue MasterCard cards in Australia on the basis that it is supervised in the US and is a longstanding MasterCard member with an excellent track record and substantial experience in the credit card business.
19. p.95 para 3	It is not strictly true that all issuers "ensure the creditworthiness of all other issuers." It is MasterCard, not members individually or collectively, that guarantees the settlement obligations of members to each other. This

	means that, if settlement guarantee risk were to increase in Australia, MasterCard, not the Australian members, would have to assume the burden of that additional risk. This is one reason that MasterCard has insisted that any regulatory change in membership eligibility rules provide for a level of government supervision adequate to protect MasterCard from having to assume additional risk.
20. p. 96 para 3	As noted above, MasterCard does not require that members be deposit-taking institutions.
21. p.97 para 1	MasterCard's discussions with the Bank about "non-ADI's" being able to participate in its scheme through co-branding and outsourcing took place while the Bank was proposing that *merchants* that wished to become members should not be required to be regulated and supervised. It is misleading for the Bank to suggest that MasterCard took the position that co-branding and outsourcing are the only manners in which non-deposit-taking institutions can participate in MasterCard. As explained above, MasterCard's rules allow for regulated and supervised non-deposit-taking institutions to become members.
22. p.97 para 3	Over the past several years, MasterCard has experienced a variety of member failures around the world. As globalisation and use of the Internet continue to grow, it is likely that this trend will grow with them. Thus, MasterCard believes it will be more important than ever to maintain and perhaps even strengthen membership eligibility standards, as well as internal risk management processes. Some recent examples of bank failures include: • In late 2001, Credit-Yerevan in Armenia, failed without paying US$385,000 in settlement obligations. • In late 2000, National State Bank of Metropolis was unexpectedly driven into FDIC receivership by massive merchant fraud, resulting in an almost US$1,200,000 chargeback loss to MasterCard. • Also in 2000, Joint Stock Agroindustrial Bank in Ukrainia failed due to a fraudulent ATM-cash-withdrawal scheme, resulting in settlement failure of US$465,000. • In early 2000, Life Co. Ltd., one of MasterCard's largest Japanese members, went under. Although MasterCard's exposure was US$10,000,000, the member's credit-card business was one of its strengths which allowed it to reorganise successfully. • In 1997, Bepsa, a Paraguayan acquirer, failed along with its parent company, subject to unpaid settlement obligations of US$260,000, US$1,300,000 in unpaid merchant obligations, and a multi-million dollar fraud claim from another member. • In 1991, BCCI failed, resulting in a loss to MasterCard of

	approximately US$2 million in settlement obligations. • Acquirer liability for merchant chargebacks is an increasing risk due to Internet commerce. In 1999, MasterCard terminated Bank of Nevis due to excessive Internet gambling chargebacks, thus avoiding potential member failure. In 2001, a merchant acquired by MasterCard's member First U.S.A Bank went bankrupt with assets of US$27,000,000 and owing 200,000 customers over US$83,000,000. The merchant, CyberRebate, sold merchandise from its Internet website, promising to rebate significant discounts later. It was unable to meet this promise, and a significant part of the loss had to be borne by First USA. While in all of these cases, the acquirer was able to cover the loss, the trend is worrying and leads MasterCard to conclude that risk management will be even more important to the success of credit card schemes in the future.
23. p.99 para. 3	MasterCard believes that under the PSR Act the access regime only should relate to access as that term is defined in section 7 of that Act. This relates to the "entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable." As a "user" of the system in MasterCard's views it would be possible for such a participant to have less rights than a member, for example, to ownership interests in the administrator of the scheme.
24. p.102 para 5	The "competitive impact" cited by the Bank in connection with self-acquiring would stem from the fact that the self-acquiring merchant was not setting aside adequate reserves or taking such other precautions to protect the scheme from the risk of the merchant *qua* merchant being unable to settle its obligations to the scheme. This is not the type of "impact" that competition laws encourage, but rather one based on a circumvention of the risk-mitigating business practices, of which the Bank seems to approve elsewhere in the Consultation Document.
25. p.104 para 4	Contrary to the Bank's assertion, MasterCard does claim that incentives are needed to encourage acquiring. These incentives are achieved through merchant service fees. As stated in Chapter 2, paragraph 27 and at other paragraphs above, the development of credit card schemes is constrained by the expansion of card accepting merchants. However, the Bank is correct to suggest that the argument is not symmetrical. Typically, there are efficiencies for merchants to accept many different payment systems, and so acquirers do not generally promote any one particular payment system. On the other hand, card issuing is particular to, and expands, one credit card scheme, even though the card issuer may be capable of issuing several different brands of credit card. It is in this sense that card issuing and card acquiring are not symmetrical, and creates the potential for specialist acquirers to 'free ride' on the efforts of issuers.
26. p.105	As stated in its Submission dated June 8, 2001 (at p. 49) the MasterCard Acceptance Development Fee ("ADF") imposed on members which have

para 1	a disparity between acquiring and issuing volume is not a "penalty"– as is referred to by the Bank in this paragraph. The Bank also states that there is no evidence backing the assertion that card issuers have not been appropriately rewarded for their efforts. However this comment misses the point. The ADF is not a fee which is paid to the issuers. It is a fee that is paid to MasterCard and used by it to fill the gap in promoting and developing the MasterCard brand created by a net acquiring members' failure to do so.
27. p.105 para. 2	MasterCard disagrees that arguments in favour of "net issuer" rules may only have merit when schemes are in their infancy. It believes that the rule is vital for the continuing growth and development of the MasterCard scheme. MasterCard is particularly concerned that, if the rule is not allowed, it will be harmed as the smaller of the global four-party systems, as there may be a migration of significant issuance by members to the larger scheme while, with respect to the MasterCard scheme, members limit for the most part their efforts to acquiring, leading to the erosion of the MasterCard scheme in Australia.
28. p.105 para 3	The Bank's assertion that acquirers have a clear interest in promoting any scheme for which they acquire flies in the face of experience. Acquirers typically spend very little money promoting any scheme. In the US, where specialty acquiring of a sort is commonplace, it is MasterCard's experience that these acquirers spend nothing on promoting the use of MasterCard cards or on building recognition of the MasterCard brand, apart from places decals and signage at merchant locations which they are required to do by MasterCard's rules, and then, often only after receiving warnings or inducements from MasterCard. The Bank states that it regards it as highly unlikely that an issuer/acquirer in one scheme would deliberately set out to undermine another of which it was also an acquirer. Following on from the comment in the previous paragraph, the potential difficulty which MasterCard fears, as the smaller of the international schemes, that there may be issuance migration by large issuer/acquirer members to the larger scheme - the allegiance of such issuers to the larger scheme would be an expected consequence of this and would not require that they "deliberately set out to undermine" MasterCard.
29. p.106 para 4	The argument that the "net issuer" rule harms small issuers is absurd. Small issuers have very little opportunity to participate in acquiring, which is very much a scale economy business. The "net issuer" rule actually benefits small issuers, which typically have small advertising budgets, by enabling MasterCard to promote its brand, products and services to consumers on their behalf.
30. p.107 para 1	For the reason specified in the preceding paragraphs of this Part B, MasterCard disagrees with the Bank's conclusion that the Australian credit card business is characterised by high barriers to entry, or that MasterCard's membership eligibility or other rules create such barriers.

31. p.108 para 5	It is proposed that there be a new category of organisation which will be supervised by APRA referred to as "specialist credit card service providers" ("SCCSP"). It is stated that this matter is being progressed with the Treasury and it is proposed that regulations will be enacted under the *Banking Act* 1959 to extend the definition of 'banking business". It is stated that APRA will need to determine prudential standards to apply to SCCSPs. However, as MasterCard has communicated to the Bank, in order to be able to comment on the Proposed Access Regime in an informed manner, it is necessary that MasterCard have more detail on the form of regulation to be enacted and also on the proposed form of regulation and supervision of specialists by APRA.
32. p.109 para 2	The Bank claims that "The proposed access regime is therefore consistent with the objectives of the credit card schemes that their members have sufficient financial substance to undertake credit card activities. It specifically targets the risks generated by credit card issuing and acquiring and so does not compromise safety and stability. Since all scheme members will continue to be authorised and prudentially supervised by APRA, there are no particular implications for the international card schemes." The statement made in the Consultation Document that "there are no particular implications for the international card schemes" is incorrect so far as MasterCard is concerned. An ADI is typically engaged in a number of different businesses and its credit card acquiring and issuing business would comprise only a part of those businesses. A SCCSP, however, by its very nature would only be engaged in the business of issuing credit cards or acquiring credit card transactions. SCCSPs could, therefore, be expected to be subject to different risks than an ADI. These different risks are of material concern to MasterCard. Although the Bank states that the Proposed Access Regime "specifically targets the risks generated by credit card issuing and acquiring and so does not compromise safety and stability", there is no information provided in the Consultation Document or elsewhere as to how these risks are targeted. Indeed this statement is contradictory to the statement made on p. 109 of the Consultation Document and elsewhere that SCCSPs will be required to "meet prudential standards, as determined by APRA, in relation to credit quality and liquidity management that are no less strict than would apply to an ADI's credit card business." (However, even this statement does not address the important question that it may be necessary, in light of the limited business activities of SCCSPs, that the prudential standards to which they are subject be more strict than would apply to ADIs.) The question of how the different risks to which SCCSPs are subject will be dealt with by APRA is important for MasterCard because, as explained above, it has a financial interest in who is eligible to be a member. Until MasterCard is provided with further information concerning the prudential standards to be developed by APRA with regard to the risks faced by SCCSPs in credit card issuing and acquiring, it is not possible for MasterCard to comment in an informed manner on the Proposed Access

	Regime in the Consultation Document. As MasterCard is required to guarantee settlement of MasterCard transactions in which its members are involved, it has a very real financial interest in knowing the details of these proposed prudential standards. These could have ramifications for MasterCard in terms of the degree of risk to which it is exposed and how MasterCard deals with that risk. The Bank is well aware of the different nature of the risks inherent in credit card issuing and acquiring. An example of the risks relating to acquiring is provided in the financial collapse of Ansett. NAB, a member of MasterCard, was the acquirer of credit card transactions for Ansett. When Ansett collapsed, NAB was exposed, as acquirer, to liabilities which MasterCard understands to be in the order of [Confidential] in respect of unused tickets sold by Ansett that were paid for credit card. The liability of NAB as acquirer of these transactions related to refunds to be made to persons paying for the Ansett tickets by credit card. In this situation MasterCard understands that NAB has sufficient capital across its various businesses so as to be able to meet its exposure to this liability that it faced as acquirer. Had the acquirer of credit card transactions for Ansett been a SCCSP that had as its only business the acquiring of credit card transactions, rather than a major ADI like NAB, it is not clear to MasterCard that the SCCSP would have had sufficient capital to meet its liabilities as acquirer. The answer to this question, however, very much depends on the prudential standards and requirements imposed by APRA on a SCCSP that is a specialist acquirer, which proposed standards and requirements are not currently available for MasterCard's review. Further, it is possible that an SCCSP that is a specialist acquirer may propose to engage in some amount of self-acquiring. Self-acquiring refers to credit card transactions in which the SCCSP itself is the merchant or a related body corporate of the SCCSP is the merchant. Self-acquiring of credit card transactions entails potentially more risks than pure acquiring and for which APRA would need to determine prudential standards. These risks were referred to in MasterCard's Submission of June 8, 2001 to the Bank and relate, for example, to the possible compromising of an acquirer's use of independent judgement in respect of transactions proposed to be acquired. SCCSPs that are specialist credit card issuers have more obvious risks than acquirers as they pay the acquiring members for goods and services purchased using credit cards in advance of that issuer receiving payment by the cardholder. The issuing member may also be required to make refunds to cardholders, for example, in respect of goods or services paid for by credit card, and paid by the cardholder to the issuing member, but which have not been received by the cardholder. APRA would need to develop standards to deal with the special risks to which specialist credit card issuers, or SCCSPs that are predominantly issuers, will be subject. In light of the different degree of risks to which acquirers, self-acquirers, issuers and SCCSPs (that may have a mix of those activities), are exposed, and which may be very different to the degree of risk to which

	ADIs are exposed, MasterCard requires more information to be provided by the Bank as to changes to the Banking Act regulations and the proposed prudential standards that will apply to SCCSPs, in order to be able to comment in an informed manner in respect of proposed the Access Regime, in which MasterCard has a real financial interest. Since publication of the Consultation Document on 14 December 2001, MasterCard has tried to obtain further information. It has communicated its concern about the absence of information to the Bank and also met with APRA. MasterCard understands that APRA has not made very much progress on developing prudential standards for SCCSPs and that any draft of those standards will not be available for some time. MasterCard does not believe it is appropriate for the reforms envisaged in the Consultation Document to be implemented until this further information has been made available for public comment. In the absence of any substantive consideration of this issue by APRA, MasterCard does not believe it is possible for the Bank to determine whether credit card systems will be “financially safe for use by participants”, or will not “materially cause or contribute to increased risk to the financial system” for the purposes of being able to make any determination of whether the public interest test under section 8 of the PSR Act is satisfied, or whether, for the purposes of section 12(2) of the PSR Act, the Proposed Access Regime will be appropriate having regard to the interests of current participants in the system and the interests of people who, in the future, may want access to the system.
33. p.110 Draft Access Regime	We understand from our communications with the Bank that MasterCard may continue to specify its own rules, standards and practices as to eligibility to be a member in the MasterCard scheme – as long as those rules do not discriminate between organisations which are ADIs and those which are SCCSPs. This should be made clear in the Access Regime, and it should be clarified that such rules, standards and practices would not cause the scheme to contravene paragraphs 6, 7 or 8 of the Proposed Access Regime.
34. p.111 Draft Access	Paragraph 4 provides that the Access Regime is to be interpreted by its objective and by looking beyond form to substance. While this sounds nice in theory, MasterCard believes it is impractical and unworkable due to likely differences between what the Bank may regard as the substance and what the scheme and participants may regard as the substance. Indeed, it is often difficult to determine the “substance” in respect of many of the provisions in the Access regime. There is no excuse for sloppy drafting. There needs to be greater clarity in the drafting of provisions in the Access Regime so that MasterCard and participants in the system have more certainty in complying with the access regime and there is less likelihood of disputes.
35. p.111 Draft Access	Paragraph 7 of the Proposed Access Regime states that the rules of a Scheme must not discriminate between an ADI and a SCCSP in relation to the rights, obligations and entitlements of such participants in the

Regime	Scheme. We understand from our communications with the Bank that this paragraph may require MasterCard to issue shares in MasterCard to an SCCSP which is entitled to become a member. MasterCard believes that this approach goes beyond the Bank's power under section 12 of the PSR Act. Section 7 of that Act defines "access" as meaning the "entitlement or eligibility of a person to become a participant in the system, as a user of the system, on a commercial basis on terms that are fair and reasonable." To have to confer ownership privileges on an SCCSP, let alone entitlements to use MasterCard's intellectual property, goes beyond the meaning of the term "access".
36. p.111 Draft Access Regime	As previously communicated to the Bank, while paragraph 9 of the Proposed Access Regime removes fees etc that are calculated on the differential between issuing and acquiring, we believe that it should be made clear that it would be permissible for a scheme to charge fees to participants that are based solely on acquiring volume as long as those fees are not linked to issuing volume. Further, MasterCard at the present time has [Confidential]. We understand from our communications with the Bank that the Proposed Access Regime will not affect these agreements or prevent the MasterCard entering into such agreements in the future. We understand from our communications with the Bank that, if it transpired that there was evidence that the effect of paragraph 9 was harming MasterCard [confidential], that the Payments Systems Board would examine this as part of its mandate to promote efficiency and competition and, if this were an impediment to competition, would examine this closely and consider solutions.
37. p.112 Draft Access Regime	Paragraph 10 of the Proposed Access Regime indicates that self-acquiring is permitted as long as the self-acquirer can establish to the reasonable satisfaction of the Scheme Administrator (or a majority of participants) that it has the capacity to meet the obligations of an acquirer as a self-acquirer. In this regard we understand from our communications with the Bank that a Scheme may regulate self-acquiring and seek appropriate protection against potential losses arising from self-acquiring, which may require seeking guarantees or other security from a participant that proposes to self-acquire. We also understand that any additional costs borne by the Scheme in this regard may be recovered directly from the participant that proposes to self-acquire. We believe that these points should be made clear in the Access Regime.
38. p.112 Draft Access Regime	Paragraph 13 requires the Bank to be notified of changes to scheme rules relating to participation. If a change does not contravene any other paragraph, but the Bank for some reason does not like the change, it is presumed that there would be no consequences for the scheme.

Chapter 5 – Promoting Efficiency and Competition

Many of the assumptions, contentions and conclusions of the Bank in this Chapter of the Consultation Document are dealt with in other parts of this submission and for the most part will not be repeated here.

MasterCard's specific comments on this Chapter of the Consultation Document are provided below:

1. p.113	This Chapter, indeed the entire Consultation Document, is replete with comments to the effect that the rules and practices of four-party payment systems "represent significant departures from the normal workings of the market" and that four-party payment systems "would be expected to be responsive to competitive pressures," and that "there is likely to be a role for private-sector regulations to ensure the safety, technical consistency and orderly operation of" four-party payment systems. The implication, if not the intent, seems to be to suggest that the rules and practices of four-party payment systems are unusual and pernicious. If this is, in fact, the Bank's position, it demonstrates a remarkable lack of understanding of the nature of business enterprises and normal competitive activity. With the possible exception of single employee sole proprietorships, every business venture involves cooperation, and many involve cooperation among competitors. For example, the joint setting of standards, cooperative marketing arrangements, research, manufacturing and/or distribution joint ventures are all common and well accepted examples of cooperation among competitors. Four-party payment schemes are an example of joint ventures involving many competitors (issuers and acquirers) who have pooled certain resources under a common brand to create payment services that none of the participants could likely create of its own and, certainly, could not create as cost-effectively. As such, there is nothing anti competitive or otherwise suspect about them, and innuendo to the contrary by the Bank in the Consultation Document are unfair and impede a thoughtful analysis of the issues at hand. Likewise, the need for four-party payment schemes to establish rules and policies regarding the manner in which participants shall conduct their respective operations and be entitled to the benefits of participation in the scheme is uncontestable. This includes the need to set the terms, including the price terms, under which issuers and acquirers will interchange transactions, rules for eligibility to participate in the scheme, and limitations on the practices of merchants who accept the schemes cards. Clearly, these rules and policies need to be "binding" and "widespread", otherwise they cannot be effective. The proper question for the Bank in the instant case is whether the rules and policies under consideration have been demonstrated to be against the public interest because they impede efficiency or competition.

	MasterCard respectfully submits that no such demonstration has been made. Rather, the Bank has come to such a conclusion largely on the basis of questionable economic theory and minimal facts, after ignoring a great deal of evidence that the practices in question are not only necessary to the health of four-party schemes but beneficial to cardholders, merchants and society in general, especially when one considers the alternatives. In this respect, MasterCard refers the Bank to Section 2.3 of Part A and Part B, which deal with the public interest test and the inappropriate benchmarks adopted by the Bank.
2. p.114	The statement that "cardholders face no transaction fees" is misleading. There are costs to cardholders for using credit cards which may include annual fees, interest charges, late payment charges, and others. The Bank exaggerates how expensive the credit card system is compared to other payment systems for the reasons indicated in Part A, Section 2.2. As has also been explained, the Bank ignores the benefits inherent in credit card systems, which offer more benefits to both parties, namely the ability to buy when liquidity constrained, on impulse and when requiring extended credit. These facilities do not come for free and cardholders and merchants pay jointly for these benefits. Cardholders pay a number of fees related to a transaction and in fact pay for most of the cost of the credit card system [Confidential] A consumer paying for a transaction with a credit card does not know for sure whether she will repay the outstanding balance at the end of the month. She has the option to repay and avoid any interest charges or late payment penalties but it depends on a number of things that cannot be known for certain in advance when making the payment. It is this optionality that makes credit cards so useful. In effect, in Australia it appears that 75% of outstanding balances are revolved. Regarding the statement that merchants "are prevented from recovering their credit card costs from cardholders", see MasterCard's comments above regarding Chapter 4 of the Consultation Document. Regarding the Bank's contention that "merchants are at a disadvantage in negotiating with acquirers because merchant service fees are not posted", several points need be made. First, it is generally the case in service industries, such as acquiring, that prices are not "posted", but that does not mean they are not known to customers or potential customers. Nor is it common in any industry, indeed it is almost unheard of, for negotiated fees to be posted or otherwise made public. Second, with respect to merchants being at a disadvantage to acquirers, merchants have much more opportunity to influence the price of payment services in four-party systems given that they can choose between any acquirer to receive services whereas, with three-party systems, they have no such choice. Third, regarding transparency, MasterCard offered to set interchange fees in Australia (currently, its members set the fees) in a manner that would be transparent but the Bank rejected the offer out of hand, presumably because it takes into account costs and other factors that the Bank had already concluded should not be considered.

	There is nothing “broad brushed” about MasterCard’s membership eligibility requirements as demonstrated by the fact that the Bank, at least conceptually, has adopted them in the Consultation Document. Throughout its discussions with the Bank, MasterCard has emphasised that it has no objection to non-deposit-taking institutions participating in its scheme (indeed, in many countries, including the US, this is already the case) as long as prudential supervision by the regulators is adequate to protect MasterCard and its members from increased risk due to the new member’s participation. It is difficult to fathom what “barriers to entry that are higher than needed to preserve safety” MasterCard’s desire that new members be supervised by APRA creates when the Bank has specified this in its proposal. While it is true that some of MasterCard’s Australian members operate or participate in competing payment schemes and offer competing payment products to their customers, MasterCard ultimately determines the manner in which they operate their MasterCard programs, and can be relied upon to make judgments and enforce its rules and policies in a manner that it deems best for the MasterCard brand. The fact that its members do not offer MasterCard-branded services exclusively is no different from the practice in other competitive distribution arrangements, and should be looked on by the Bank as an indication of the robustness of competition in the payments market, not as evidence that there is a desire or design not to compete. The Bank’s observation that “there are ready substitutes” for credit cards is utterly inconsistent with its assumption elsewhere in the Consultation Document (eg, see pp. 55 and 71 of the Consultation Document) that the credit card business does not face effective competition.
3. p114 para.6	The Bank postulates that the relative negotiating strengths of merchants are adversely affected merely because acquirers do not advertise merchant service fees. No evidence is offered to support this claim. The Bank also fails to present any evidence that merchants would incur ‘significant search costs’ in comparing merchant service fees. As the Bank is aware, merchant service fees will vary between merchants according to the costs of establishing processing equipment, on-going costs, estimated revenues etc. This fact is not unique to credit card schemes – many of a merchant’s input costs are determined according to the bargain struck by that merchant. It is does not follow that because merchant service fees are “negotiated bilaterally between a merchant and its acquirer” the merchant is somehow at a disadvantage.
4. p.115	As demonstrated in paragraph 3 above, the issue of transactors not making a contribution to costs is not a major or relevant issue for the Bank to use when judging the efficiency of four-party schemes. Only 25% of cardholders settle their outstanding balances without incurring interest, according to the Bank’s statistics. Moreover, a cardholder has the option of paying off their balance or to revolve, but only has to decide this after the purchase of a good or service with a credit card. A rational cardholder

		will have to expect to pay some fees and take into account the likelihood of not paying off their balance in full. Further, the fact that the cost of credit cards is principally borne by credit card users who revolve and by merchants, ought not to be surprising in light of the fact that these are the constituencies who derive the most benefit from credit cards. Any other outcome would be remarkable and, as demonstrated in Part A, Section 2.3 of this submission, unsustainable. The Bank's conclusion that network externalities in four-party payment systems are small runs counter to historical experience, the great weight of the economic literature and, as demonstrated in Part A, Section 2.3, the available evidence. The view that cardholders derive great benefit from credit card use is not inconsistent with the fact that cardholders are unwilling to pay a lot for those benefits, when one takes into account the availability of other inexpensive forms of payment. The Bank has not demonstrated that there is a lack of competition within the payments market. In fact, the evidence is decidedly to the contrary. See Part A, Section 1 of this submission. As to the current entry rules of MasterCard "entrench[ing] market power of incumbents", MasterCard notes that, in the past 5 years, 30 new members have joined its scheme in Australia including 1 member that entered the Australian market from the US and that, during that time, MasterCard has received no serious inquiry about membership from an entity that did not. Nor is there any evidence that MasterCard's eligibility rules have kept merchant service fees high. In fact, and as stated in Chapter 4, paragraph 6, MasterCard is aware that the Australian Banker's Association has previously submitted data to the Bank, which indicated that merchant service fees charged by its acquirers have fallen on average, in recent years.
5.	pp.115 – 116	The Bank offers no evidence to support its claim that current restrictions on entry serve mainly to entrench the market power of incumbents. On the basis that the primary restrictions to entry are those determined by APRA according to its prudential standards, and the Bank now acknowledges in the Proposed Access Regime that prudential supervision is necessary, MasterCard believes it is inappropriate that the Bank accuse the credit card scheme incumbents with employing these restrictions to entrench their market power.
6.	p.116 para. 5	As indicated in this response, MasterCard has a question as to why the Bank believes that its proposals will be more effective at arriving at an appropriate interchange fee than the application of MasterCard's established methodology. Indeed, as discussed in Part A, Section 2.6, the interchange fee proposals of the Bank will most likely result in a drastic decline in, if not outright elimination of four-party credit card schemes in Australia, with the concomitant loss in the efficiency and competitive benefits they bring to the payments market. Hence, the Bank's interchange fee proposal, if implemented as envisioned by the Bank, will

	have the opposite effect from what is intended. If by "re-pricing" of credit card payment services the Bank means that they will become more expensive for cardholders and, ultimately merchants, MasterCard agrees with this assessment. MasterCard fails to see, however, how the Bank could consider such a result to be in the public interest. If by "user pays" and "consumers should face prices that take into account the relative costs of producing goods and services" the Bank means that cardholders should pay issuers' costs and merchant acquirers' costs, then MasterCard respectfully suggests that the Bank does not understand the joint supply nature of and the cardholder and merchant demand constraints faced by four-party payment systems, and refers the Bank to the discussion of this in Part A, Section 2.3**.** It may be appropriate after a period of a few years to undertake a review of the effect of the changes implemented to see whether they have achieved the public interest objectives under the PSR Act. This review may include surveys of cardholders and merchants to determine their satisfaction with the changes as well as a review of the state of competition in the market.
7. p.117 para. 3	The Bank lists three "unintended consequences" of credit card "reform" which have been raised in arguments against such supposed reform. MasterCard believes that while the points listed are important, there are other more important consequences which would likely flow from the Bank's proposal. These consequences were identified in detail by MasterCard in Part A, Section 1 of its Submission to the Bank of June 8, 2001. These consequences include moves by large issuer/acquirers to increase the proportion of "on-us" transactions and eventually the elimination of the four-party schemes. MasterCard notes that the Bank has chosen not to address these concerns and asserts that, consistent with its statutory obligations, the Bank cannot make a decision relating to its proposals until it has done so.
8. pp.117 - 119	In respect of competition between four-party and three-party schemes, MasterCard refers the Bank to the points made in Part A, Section 2.5 above. The Bank's analysis of the likely consequences of its proposed reforms on four and three-party credit card schemes suffers from three significant faults. Firstly, the Bank's analysis is based on a snap-shot of the market share of both four and three-party schemes, and does not grasp the underlying dynamic of competition between the two schemes. Secondly, the Bank selectively focuses on the effects that its proposed reforms will have on merchants, whilst disregarding completely the effects on cardholders. With no immediate reduction in merchant service fees, the three-party schemes will gain an advantage in card issuing for the reason that they will continue to be able to offer attractive loyalty programs and other benefits to cardholders. (The Bank attempts to dismiss this argument on page 120 by arguing that the merchant service fees charged by the three-party schemes will be forced down along with those of the four-party schemes, even though currently the three-party schemes enjoy

	merchant service fees that are higher than those of the four-party schemes. This point is taken up further in paragraph 4 below.) [Confidential] the four-party schemes could very quickly suffer a massive decline in market share if, because of regulatory intervention, three-party schemes were allowed to continue to charge merchants whatever amount merchants were willing to pay, and use these revenues to provide higher levels of services to cardholders at lower prices than those of four-party scheme issuers. The third fault in the Bank's analysis is that the network size of the three-party schemes is assumed to be constant. This assumption becomes a fallacy once the three-party schemes retain an unfair competitive advantage in card issuing. Consequently, the Bank fails to have regard to the effects that cardholder demand will have on merchant acceptance of different payment systems. The effect of an increase in the issuance of three-party scheme cards will be a corresponding demand for merchant acceptance for such cards. Hence, more merchants will discover a competitive advantage in being able to accommodate the increased demand for three-party scheme cards. Comparison with the US market, or indeed any other market is unhelpful unless the interchange fees in those markets reflect the Bank's proposed reforms – that is, that the interchange fees have been set at a level lower than the level necessary for card issuers to earn a competitive return on the service provided to other network participants. As noted previously, the "view" of the ACCC that the setting of interchange fees allegedly is a breach of the Trade Practices Act is irrelevant, given that the ACCC discontinued its legal action on this question before the issue could be determined by the court.
9. p.118 para. 2	The Bank's position that it need not worry about placing four-party systems at a competitive disadvantage to three-party systems because the latter do not need to set interchange fees is manifestly unreasonable and plainly inconsistent with its obligations under the PSR Act to protect the public interest and enhance competition. The Bank cannot fulfil its statutory obligation of protecting competition by hiding behind the fact that three and four-party payment systems operate differently. If regulating one type and not the other would distort and undermine competition, then the Bank cannot regulate. The Bank argues that regulation of the 'implicit' interchange fees of the three-party systems is not justified because such systems do not have a process under which "competitors collectively agree to set prices". The Bank appears to misunderstand the economics of the four-party schemes. Without cooperation between issuers and acquirers (and which is a necessary incident of a four-party scheme in being in the nature of a joint venture) four-party schemes would become three-party schemes. Four-party schemes, being a joint venture, depend upon cooperation among its participants to achieve efficient pricing. And again, the Bank is being selective in its justifications for regulating only the MasterCard, Visa and

	Bankcard schemes. The Bank maintains on page 116 of the Consultation Document and elsewhere that ineffective competition and other factors result in the merchant service fees of the four-party systems being higher than they should be. In fact, the merchant service fees charged by the three-party schemes are higher than the four-party schemes, lack transparency, and yet the Bank can find no reason to designate the three-party schemes.
10. p.118 paras. 3-4	The current success of four-party credit card schemes is no guarantee against the threat of misguided regulation, given that the market is "dynamic" and not "static". Moreover, the Bank's focus on American Express and Diners as the only three-party schemes that would threaten the viability of four-party schemes overlooks the fact that it is the four-party schemes own, large members, and dominant retailers, that would have the motivation and the means to render four-party schemes non-viable. Again, MasterCard refers the Bank to its discussion of how this could be achieved in Part A, Section 2.5 of this submission. The fact that, under conditions in which both three and four-party credit card systems are free to set their own pricing, competition between them leads to lower prices, does not mean that, under conditions in which the Bank effectively sets the interchange fee of four-party systems, three-party systems will not benefit and seek to exploit their greater freedom to set their own prices. Given the nature of payment systems, one would expect three-party systems to take every opportunity to set higher merchant service fees than their four-party system competitors and to use their higher merchant revenue to offer consumers better and less expensive card products (eg, better rewards programs, lower annual fees). In the long run, if not sooner, one can only assume that this advantage would lead to three-party systems taking share away from four-party systems and, depending upon the extent of the advantage, eventually compete them out of business.
11. p.119 para 2 – p. 121, para 1	The Bank's theory that merchants would be able to prevent three-party payment systems from setting merchant service fees at higher levels than those four-party system acquirers overlooks the simple fact that, for the past several decades, merchants throughout the world have willingly paid higher merchant service fees to American Express, despite the fact that there are fewer American cardholders. Similarly, the Bank's reliance on the ability of merchants to pass onto consumers the higher cost of accepting three-party cards flies in the face of the experience with surcharging in those countries that permit it. Given most merchants' preference not to surcharge, it is unlikely that higher merchant service fees charged by three-party schemes would be felt by cardholders, who would therefore have no reason not to switch to three-party schemes in order to obtain better rewards than the constrained four-party issuers could afford to offer. Due to this factor, it is certainly not clear that the "Boston Fee Party" scenario referred to by the Bank could occur in Australia (not to mention that collective action of the type undertaken by the US restaurants would probably violate the Trade Practices Act). In

	this regard reference is made to Part A, Section 2.5 and Chapter 3, paragraph 7.
12. p.120 para. 2	As demonstrated in Part A, Section 2.5, the ABA's view that the Bank's interchange fee proposals are likely to lead to a credit card business dominated by three-party schemes is similar to that which was pointed out by MasterCard in its Submission dated June 8, 2001 (at p.10). As was pointed out there: "A self-reinforcing cycle could be set in motion that could eventually lead to the whole open system unravelling: interchange fees set too low, leading to issuers charging higher fees to cardholders, leading to a diminishing cardholder network, leading to fewer merchants acquired, leading to the need to further lower the interchange fee, and so on. This could be characterised as a "*death spiral*" process. In this process, large issuers and acquirers would seek to maximise self-interest by focusing on "on us" transactions, and would effectively be motivated to evolve towards the more socially costly and less efficient three-party system. Smaller issuers and acquirers will not have such an option, and would thereby be squeezed out.". [Confidential] MasterCard is aware that in countries in which regulators are considering forcing interchange fees down to very low levels, several of MasterCard's larger members are already considering how they could operate their own three-party programs. Moreover, as explained in Part A, Section 2.6, the replacement of four-party schemes by three-party systems would not benefit either cardholders or merchants. Both would lose the benefits of higher efficiency and intra-system competition that four-party systems make possible. In the short term the merchants may not be worse off because presumably they would pay lower fees to the designated schemes. In the longer term, however, merchants would be worse off because, as more and more cardholders migrate to the three-party schemes, they will end up paying higher fees than currently. The Bank's suggestion that credit cardholders currently pay nothing for the use of credit cards is erroneous. Annual fees in Australia can range from zero (for non-interest free days cards), to approximately $300 for a Platinum MasterCard. The typical fee is approx $40, late payment fees in the range of $30 are typical, and 80% of cardholders who at one time or another use the credit facility pay interest charges ranging from introductory rates as low as 3.5% to standard rates of approximately 17% per annum. In fact the low interchange rates in Australia are reflected by the fact that credit card holders are typically asked to pay more. In the United States and UK for example Annual Fees are uncommon. The Bank's suggestion that the fact that cardholders would switch to cheaper three-party cards to avoid paying higher charges for four-party cards "confirms the inefficiency in current credit card pricing", is absurd. [Confidential] It also explains why MasterCard's issuers have limited ability to recover lost interchange fees through higher charges to cardholders which, consistent with Weizsäcker's explanation of credit card economics, justifies the current level of interchange fees.

13.	pp.123-124	The Bank's comments on the impact of the proposals on small credit card issuers are puzzling. In an economy where there has been increasing public disenchantment with the big banks and an increasing move to smaller banks and financial institutions, including the so-called community banks, MasterCard would have thought that the Bank would be endeavouring to encourage those smaller banks to stay in the credit card business. This is particularly the case because the ability of a financial institution to issue a credit card could be an important factor in a person's decision as to which institution will be their bank. The Bank's attitude to this issue very clearly is that it does not care whether these smaller banks and financial institutions cease to issue credit cards, if to do so would be unprofitable for them under the proposed new interchange fee regime. Apart from the Bank's lack of concern over the fate of smaller financial institutions and the long-term effect that this might have on competition in the Australian banking industry, the Bank's analysis is flawed because it is inconsistent with the Bank's obligation under the PSR Act to act in a manner that promotes competition. It would be one thing for the Bank not to be concerned about the inability of smaller banks to be competitive in the credit card business in general; it is quite another for the Bank to be unconcerned when the reason for the smaller banks exiting the credit card business is the Bank's very own regulations. Given that the Bank's interchange fee proposals are likely to result in the exit of the smaller banks and financial institutions from credit card issuing, and that this may result in a decrease in their attractiveness to customers and contribute to a general decline in their business, MasterCard does not believe that the Bank's proposals with respect to interchange fees are in the public interest. Finally, on this point, the Bank's suggestion that persons who favour interchange fees being set at unnecessarily high levels do so in order to protect smaller banks is unfounded and a red herring. What is at issue is a proposal by the Bank to set interchange fees at a level at which no issuer will find the credit card business profitable. At that point, the Bank's hopes that non-traditional institutions will step forward to save four-party credit card schemes will be proven very forlorn. In the credit card business, it is not possible to lose money on every transaction but make it up in volume.
14.	p.124 paras. 3 and 4	MasterCard agrees that, over the medium to long run, there is likely to be a pass-through of lower interchange fees to consumers. In the short term this may even result in some merchants lowering their prices. However, for the reasons referred to in Part A, Section 2.6, the standard on interchange fees is likely to contribute to a contraction in the designated schemes and an expansion in the three-party systems, which have higher costs and, historically, have been more expensive to accept. The Bank has not uncovered any evidence that the three-party schemes' business economics or desire to maximise revenues have changed, such that they can be expected to reduce their merchant service fees after they supplant

	four-party schemes. Accordingly, if the three-party schemes become predominant, then this will result in merchants paying higher merchant service fees and it will lead to higher prices to consumers.
15. p.125, para 5	For the reasons given in Part A, Section 1, MasterCard submits that there is no basis for the Bank to conclude that competition in the Australian credit card business is ineffective. Given the ability of merchants to move freely from one acquirer to another, it is implausible that merchants cannot learn of the various merchant service fees being charged. The fact that they must seek quotes is no different than in most other service businesses. If in fact the ARA can learn and publish the merchant service fees of various acquirers, there is not even the need for merchants to seek quotes. The Bank's concern with the alleged inability of small merchants to achieve favourable merchant service fees rings hollow in light of the Bank's lack of concern that its interchange fee proposals are likely to result in more expensive three-party schemes replacing four-party schemes. At least in four-party schemes a small merchant can seek a quote. When dealing with a three-party scheme they are given a "take it or leave it" price.