

A Variation to the Surcharging Standards: A Consultation Document

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Reserve Bank

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1. Introduction

The Bank initiated a public consultation on potential changes to the Standards relating to merchant surcharging of MasterCard and Visa credit and Visa Debit transactions in June. The Standards, which came into force in 2003 and 2007 respectively, ensure that card schemes cannot prevent merchants from applying a fee or surcharge for the acceptance of the cards of those schemes. While the Standards currently prohibit any scheme or participant restrictions on merchant surcharging, the proposals outlined in June would give card schemes the capacity to limit the level of surcharges, so that merchants could not recover an amount significantly in excess of the cost of acceptance. This would represent a relaxation of the Standards, but would continue to emphasise the right of merchants to recover fully their card acceptance costs, something the Bank believes is critical to the efficiency of the Australian payments system.

In light of the views expressed in consultation and developments in surcharging practices in recent years, the Payments System Board considers that there is a case for varying the Standards, by allowing the schemes to limit surcharges to a reasonable cost of acceptance, while at the same time ensuring the schemes' rules cannot prevent full cost recovery by merchants. The Board believes that the proposed variation is in the public interest and would improve the efficiency of the payments system by providing better price signals to cardholders and increasing the level of comfort with surcharging among both consumers and merchants.

This document outlines the views presented during the consultation process, presents some additional relevant information obtained by the Bank, and sets out the conclusions reached by the Payments System Board as a result. In light of the Board's conclusions, it seeks views from interested parties on the specific form of the variation to the Standards proposed by the Board.

Section 2 of the document provides background on surcharging practices in Australia and the current Standards. Section 3 discusses the various views from consultation and the Board's consideration of those views, while Section 4 sets out the various options for imposing some limit on surcharges, including the Board's preferred approach. Section 5 discusses the elements of the proposed variation to the Standards and Section 6 provides details of the next steps in the process.

2. Background

In 2003, the Reserve Bank began implementing reforms to the credit and debit card systems in Australia. These reforms are intended to improve the efficiency of the payments system and to promote competition. As part of these reforms, the Payments System Board imposed standards that required the removal of the schemes' no-surcharge rules that had previously prevented merchants from surcharging for credit card and scheme debit card transactions: *Standard No. 2, Merchant Pricing for Credit Card Purchases*; and *The 'Honour All Cards' Rule in the Visa Debit and the Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System*. These Standards became effective from 1 January 2003 for the MasterCard and Visa credit card systems and from 1 January 2007 for the Visa Debit system. American Express, Diners Club and MasterCard (for the Debit MasterCard system) provided voluntary undertakings to remove their equivalent rules.

The removal of the no-surcharge rules was expected to have a number of benefits for the efficiency of the payments system. First, it was expected to improve price signals to cardholders about the relative costs of different payment methods. This was clearly stated in the Gazette notice that accompanied the first of the Standards:

... the price signals facing consumers choosing between different payment instruments would lead to a more efficient allocation of resources in the payments system, in the public interest.¹

Second, the ability to surcharge provides a negotiating tool for merchants who might use the threat of surcharging to negotiate lower fees. Third, with the ability to surcharge, merchants no longer need to build the costs of accepting card payments into the overall prices of their goods and services; hence, customers who choose alternative payment methods are no longer subsidising credit card users. The Payments System Board is satisfied that surcharging has been successful in achieving these benefits and by reviewing the Standards it is seeking to ensure that this continues to be the case.

The Standards

The prohibition on no-surcharge rules is stated in the Standards as:

Neither the rules of the Scheme nor any participant in the Scheme shall prohibit a merchant from charging a credit cardholder any fee or surcharge for a credit card transaction.²

¹ Gazette notice to *Standard No. 2, Merchant Pricing for Credit Card Purchases*.

² Paragraph 8 of *Standard No. 2, Merchant Pricing for Credit Card Purchases*. Paragraph 8 of the Standard titled *The 'Honour All Cards' Rule in the Visa Debit and the Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System* is worded similarly.

This wording is quite open-ended; it provides merchants the freedom to set surcharges without constraint. That is, there is little that the card schemes can do to directly restrain surcharges, even where they are clearly well above acceptance costs.

The Board was of the view that this level of discretion for merchants was appropriate at the time the Standards were first put in place. The environment then was one where surcharging was thought likely to emerge slowly and was, therefore, unlikely to be used to recover more than the cost of card acceptance. In part, this was because there had been a strong expectation by cardholders, built up over many years, that surcharges would not apply.

Nonetheless, paragraph 9 of each of the Standards expressly provides that agreements between merchants and acquirers to limit the size of any surcharge to the fees incurred by the merchant would not be inconsistent with the Standards:

Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a credit cardholder will be limited to the fees incurred by the merchant in respect of a credit card transaction.³

The intention was that this provision would provide merchants with a tool to bargain down merchant service fees.

Together, these elements of the Standards imply an expectation that surcharges would generally be in line with acceptance costs, but that it would be open to merchants to apply higher surcharges and equally open to acquirers to attempt to bargain surcharges down to the fees incurred. It has become apparent over time, however, that paragraph 9 – the provision allowing agreement to limit surcharges to the fees incurred – has had limited use, and has therefore been ineffective. This is because acquirers for the four-party card schemes (as opposed to the schemes themselves) do not have an incentive to limit merchant surcharges in exchange for reducing merchant service fees.

The Current Review of the No-surcharge Standards

Despite the Board's view that the surcharging reforms have been successful and have provided significant public benefit, the efficient allocation of resources relies on the effectiveness of the price mechanism – in this case, the extent to which surcharging practices reflect the cost of acceptance of alternative payment methods. Over the past few years the Board has become concerned that in some instances surcharging has developed in a way that potentially compromises price signals and reduces the effectiveness of the reforms. In particular, the Board has been concerned about cases where surcharges appear to be well in excess of acceptance costs (sometimes referred to as 'excessive' surcharging) and an apparent increased tendency for surcharges to be 'blended' across card schemes (often at a rate above the cost of acceptance of the lower-cost card). These practices are inefficient because they can cause consumers to underutilise a particular payment method. For instance, when the costs of card acceptance differ across card schemes and the merchant applies a blended surcharge, the consumer may have an incentive to use the higher-cost card more intensively than would be the case if the surcharges reflected the cost of acceptance for each card product. This is particularly the case if higher merchant fees are being used to fund more generous reward schemes. If the blended surcharge is at a level above the cost of acceptance of the lower-cost card, the lower-cost card is also likely to be underutilised

³ Standard No. 2, *Merchant Pricing for Credit Card Purchases*. Paragraph 9 of the Standard titled *The 'Honour All Cards' Rule in the Visa Debit and the Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System* is similarly worded.

relative to other payment methods, not just the higher-cost card. A potential flow-on effect from this is that such practices dull the incentive for the card schemes to compete down their effective costs to merchants.

The Board considered some of these issues as part of the 2007/08 review of the card payment reforms. It concluded that the Standards had provided substantial benefits through the improvement of price signals to cardholders, but nonetheless considered whether there was a case to modify the Standards to allow scheme rules to limit the size of any surcharge imposed by merchants. At that time, the Board assessed that cases of merchants imposing high surcharges appeared to be isolated, and the merchants doing so tended to be those with market power. It was considered that the isolated cases provided insufficient grounds to allow the schemes to impose restrictions on all merchants.

As noted in the June 2011 Consultation Document, the Board now believes that these cases are more widespread and has therefore sought views on modification of the Standards.

3. Consultation

The Consultation Process

At its May 2011 meeting, the Payments System Board decided to conduct a public consultation on potential modifications to the Standards. The Bank released the document, *Review of Card Surcharging: A Consultation Document*, in June 2011, seeking the views of interested parties on seven interrelated questions:

- i. Is there a case for modifying the Standards to allow schemes to limit surcharges?
- ii. Is a surcharge cap best implemented by the Board setting a transparent and specific permissible cap that is specified in the Standards, and may then be imposed in scheme rules? Or, should the Standards allow scheme rules to limit surcharges to an amount that is either reasonably related, or equal, to each particular merchant's cost of card acceptance?
- iii. Should there be some level of tolerance allowed around any surcharge cap?
- iv. Is the merchant service fee an appropriate measure of the cost of card acceptance (that can be applied consistently across all merchants)?
- v. Should the no-surcharge Standards clarify that, notwithstanding any surcharging cap, scheme rules cannot prohibit merchants from applying a surcharge that is either a blended rate for each card scheme or the cost of accepting each card *within* a card scheme? Are there alternative ways to allow for differential surcharging?
- vi. Should the no-surcharge Standards require acquirers to pass on information about the merchant's cost of acceptance for each different card type if it is requested by the merchant? And, for those on 'interchange-plus' pricing, should the no-surcharge Standards require acquirers to pass on information about the weighted-average merchant service fee if it is requested by the merchant?
- vii. Is there a case for disclosure of the cost of card acceptance by merchants? Or, would it be sufficient for the Bank to collect and publish more detailed data on merchant service fees, such as the range and average of merchant service fees across merchant categories for each card scheme?

In total, 51 submissions were received, including from financial institutions, merchants, card schemes, a consumer group and private citizens, most of which are published on the Reserve Bank's website. Around 25 parties took up the invitation to discuss their submissions with the Bank. The main points made in response to the questions in the Consultation Document are discussed below.

Issues Raised During Consultation

Is there a case to modify the Standards to limit surcharges?

A number of submissions from merchants and financial institutions suggested that the Bank had not demonstrated that there is sufficient market failure to justify further modification to the Standards. These submissions suggested that excessive surcharging remains limited to a few merchants with market power. Some of these submissions questioned the veracity of the survey data presented by the Bank in its Consultation Document, arguing that both the gap between average surcharges and merchant service fees, and the rising trend in surcharge levels shown by the data might not be representative. Given that many of these submissions suggested that the cases of excessive surcharging that exist are a reflection of anti-competitive behaviour, they proposed that the issues are best investigated by the Australian Competition and Consumer Commission (ACCC) or the Australian Securities and Investment Commission (ASIC). Other suggestions put forward in place of regulatory intervention were self-regulatory or market-based solutions, such as industry codes. Some submissions also expressed a view that modifying the Standards to allow for limits on surcharges may have limited effect in certain industries or for certain transaction types.

By contrast, submissions from the four-party card schemes, a consumer group, an acquirer and some private citizens expressed support for a limit to be placed on surcharges, agreeing that excessive surcharging is becoming more commonplace, potentially undermining the Bank's previous reforms. Many submissions also raised concerns about surcharging for card transactions where there are few genuine payment alternatives, such as for online purchases. Several parties suggested that merchants that only accept card payments (or do not offer genuine alternatives) should not be allowed to surcharge.

Implementation of a cap on surcharges

The Consultation Document proposed two potential modifications to allow for some limit to be imposed on surcharges. These were:

- the Board setting a transparent and specific permissible cap in the Standards that could be adopted in scheme rules
- the Standards allowing scheme rules to limit surcharges to an amount that is either reasonably related, or equal, to each particular merchant's cost of card acceptance.

Nearly all submissions were opposed to the Bank setting a specific fixed cap, arguing that such a cap would inevitably be too high in many circumstances and too low in others. Many also saw potential for a cap of this type to become the norm for surcharging, even for merchants that have lower acceptance costs and might otherwise have adopted a lower or even no surcharge. Instead, most submissions preferred surcharges to be limited to an amount that is 'reasonably related' to the cost of acceptance. There were divergent views, however, about what constitutes the cost of acceptance. A number of submissions suggested that the merchant service fee is the most appropriate indicator of costs, although the majority of submissions indicated that the merchant service fee does not adequately reflect all the costs of accepting card payments. For example, other related costs of accepting card payments that were noted included: charge backs; terminal rental fees; fraud compliance; gateway fees; and terminal modifications. Accordingly, many submissions indicated that, depending on how a cap is implemented, there should be some level of tolerance to capture other related costs of card acceptance.

Most submissions were broadly in support of merchants choosing how to apply surcharges and the majority of submissions were supportive of merchants being able to differentially surcharge *across* card schemes. In particular, the four-party schemes were opposed to merchants applying blended surcharges across schemes where a price differential exists, citing the significant differences in the cost of card acceptance between different card schemes. However, one merchant argued that blended surcharging is a legitimate strategy employed by merchants, with the current arrangements reflecting competition between the card schemes. During consultation, some parties also suggested that the Bank should not promote or restrict any specific model of surcharging.

By contrast, many submissions questioned the benefit of clarifying the ability of merchants to surcharge differentially *within* a card scheme. In particular, some submissions pointed out that differentiating between card types within a scheme in real time would be a difficult technical challenge, both at the point of sale and for card-not-present transactions. Other submissions, including merchants, also cited the confusion for consumers that surcharging beyond a few different rates would cause.

Views on the most appropriate body to implement, monitor and enforce a cap on surcharges were mixed. While a number of submissions agreed that the card schemes are best placed to implement and monitor such rules, others recommended that another body, such as the Bank, should take on the role. Other parties interpreted the issues raised in the Consultation Document as relating to consumer protection and therefore suggested that the ACCC and ASIC should be involved in developing a solution.

Disclosure of merchant service fees by acquirers and merchants

A number of submissions supported measures to require acquirers to provide better information to merchants about their costs of card acceptance, though several submissions indicated that merchants are already able to obtain this information if they request it. By contrast, nearly all submissions were strongly opposed to any requirements for disclosure of merchant service fees at the point of sale, citing the fact that merchant-acquirer agreements are subject to commercial confidentiality. A related argument was that the merchant service fee might form part of a wider set of prices offered by a financial institution to merchants, so disclosing only one price might not provide an accurate picture of the competitive landscape. Some also argued that disclosure of individual merchant service fees would make acquirers reluctant to negotiate fees with merchants.

Finally, the parties that commented were generally supportive of the Bank collecting and publishing more detailed data on merchant service fees. Suggestions on the additional data that could be published included: scheme debit and eftpos merchant service fees; merchant service fees across different industries; and data on surcharge amounts.

Discussion

The Board has carefully considered the views put to it during consultation. It acknowledges in particular that the views were mixed as to whether excessive surcharging has become sufficiently widespread to warrant modification of the Standards. While the Bank believes that the costs of modifying the Standards would be relatively low and therefore that a modification could provide a net public benefit even if the incidence of excessive surcharging were relatively low, it has nonetheless sought additional data to those presented in the June 2011 Consultation Document in order to aid this discussion. Specifically, it has obtained confidential data from several acquirers on the distribution of merchant service fees for credit cards across their entire merchant books. This distributional information provides an indication of the different merchant service fees paid by

a range of merchants and is therefore a richer dataset than the average merchant service fee data that the Bank regularly obtains and publishes. The Bank has also identified a cross-section of advertised surcharges in a range of industries. Based on this information, observed surcharging practices do not appear to reflect the distribution of merchant service fees. For instance, it is not uncommon to find merchants of many different types applying *ad valorem* surcharges at levels that are significantly greater than would be implied by the distribution of merchant service fees.⁴

The Board also carefully considered the views expressed about whether the Reserve Bank is the appropriate body to respond to concerns about the surcharging practices discussed above. It is important to note that the Board's concerns relate to the efficiency of the payments system, for which the Board has a clear mandate, not to consumer protection. The Board's concerns therefore, reflect a judgement that these surcharging practices are potentially distorting price signals and payment patterns and that addressing them will help to ensure that the Standards continue to achieve their original aims. In light of this, the Board recognises that a modification to the Standards to allow scheme rules to impose some limit on surcharges may not address the public's concerns about all surcharging practices. A modification will, however, address inefficiencies that have arisen, in line with the Board's legislative mandate.

The Board also notes the views expressed by some that it should not be the card schemes that impose limits on surcharges. The Board, however, believes that this is the most practical approach to addressing the issue, given that the proposed amendment relaxes the Standards to simply restore some element of the powers that the schemes previously held through scheme rules. The Reserve Bank does not itself have powers over merchant pricing.

It is clear that there is some concern among consumers that surcharges are being imposed in circumstances where they feel they have few alternatives to using a scheme card. This is often the case for online payments, particularly where there is a desire for the payment to be confirmed in real time. Certain industries where some form of bond or deposit is required, such as the car rental and hotel industries, also rely disproportionately on scheme card payments. This issue is related to the *Australian Consumer Law*, which requires that any fee or charge (including a card surcharge) that is unavoidable be incorporated into the advertised price. However, in the cases that have been brought to the Bank's attention, at least one alternative payment method is available without a surcharge. The Bank has observed that in some cases the alternative (non-surcharged) payment methods offered are relatively uncommon or not available to customers of many financial institutions. Nonetheless, the Bank does not believe that preventing surcharging for online payments, as some have suggested, would lead to efficient outcomes. For instance, this would inhibit the ability of any emerging payment system with lower acceptance costs to compete, given that those lower costs could not be signalled to consumers if surcharging were prevented. The Bank would nonetheless like to see merchants that surcharge scheme products offer genuine payment alternatives.

The consultation also touched on the potential for greater differential surcharging within schemes, for instance applying a higher surcharge for premium cards than standard cards. While such a practice could potentially serve to constrain the high interchange fees that are evident in some card categories, the Bank acknowledges

⁴ For example, *ad valorem* surcharges above the level of merchant service fees that are paid by the vast majority of merchants are common among merchants in the following industries: accommodation and travel; entertainment, leisure and recreation; hospitality; professional services; rental, hiring and transport; restaurants, dining and takeaway; retail; taxis; and telecommunications and internet. Apart from the airline industry, flat-fee surcharging is not common. The distribution of the Bank's cross-section of surcharges is consistent with distributional data on surcharges provided to the Bank confidentially by East & Partners. The average surcharge for MasterCard and Visa credit card transactions from the cross-section of advertised surcharges collected by the Bank is also in line with the average from East & Partners' sample of 1.9 per cent.

that merchants generally would like to avoid the complexity of such an approach. Indeed, the merchant service fees charged to many merchants do not differentiate between card types, even though the mix of cards may influence the level of fees charged over time. The Bank has contemplated the possibility that acquirers could be compelled to provide more information on the mix of transactions to merchants in order to help them understand their costs, but is satisfied this information is available on request. It nonetheless believes there is a case to make it clear in any modified Standards that schemes and acquirers cannot prevent differential surcharging within a scheme.

Finally, the Board sees some benefits in greater transparency of merchant service fees to give consumers greater comfort that the levels of surcharges they face are reasonable. However, given the widespread opposition to the proposal that merchants disclose their merchant service fees, the Board does not anticipate pursuing this particular option further. The Board believes that the modifications to the Standards proposed in this paper have the potential to give consumers greater comfort with the level of surcharges without this change. There was nonetheless widespread support for the Bank publishing more detailed information on merchant service fees at an aggregate level. The Bank will engage with acquirers to determine the most appropriate approach to doing so.

The Board has considered the views expressed in consultation on specific approaches to modifying the Standards. Its consideration of these views is incorporated in the discussion of the policy options in Section 4.

4. Policy Options

The Board has weighed the options regarding modification of the Standards at two levels. First, it has considered whether modification of the Standards to allow schemes to place a limit on surcharges is in the public interest, and second, it has considered the form that any modification should take. These questions are dealt with separately below.

Is there a Case to Modify the Standards?

The Board remains of the view that the benefits of the removal of no-surcharge rules have been substantial, reflecting the improved price signals that have been provided to cardholders and the resulting improvements to the overall efficiency in the payments system. This transmission of more accurate price signals to consumers is also an effective discipline on acceptance costs, which should, over the long term, reduce upward pressure on interchange fees. The Board, however, remains concerned that surcharges in excess of the cost of card acceptance, and the blending of surcharges for cards with differing acceptance costs (particularly at rates above the acceptance cost of the lower-cost card), are reducing the effectiveness of the earlier surcharging reforms. The Board is aware that, under the current wording of the Standards, the industry is prevented from addressing even the more extreme cases on its own. While the original intent was for the Standards to provide a mechanism for surcharges to be limited to the fees incurred by the merchant for a card transaction, should both parties agree, over time it has become evident that this provision has not been as effective as originally intended.

Following the consultation and further work by the Bank, the Board considers that surcharging is now sufficiently common, and surcharging above the cost of acceptance sufficiently widespread, that an unconstrained capacity for surcharging may no longer be appropriate. The Board is of the view that relaxing the Standards to allow schemes to limit surcharges would provide a number of public benefits. It is likely to generate more efficient price signals than if the Standards were left unchanged and the inefficient surcharging practices that have developed over recent years continued. In addition, whereas consumers currently have little capacity to assess whether a surcharge is reasonable, the ability for schemes to enforce surcharge limits if needed is likely to provide consumers with greater confidence that surcharges are in line with merchants' cost of accepting cards. This is likely to result in increased acceptance of surcharging by consumers and merchants and, therefore, has the potential to further increase the incidence of surcharging and improve price signals to consumers.

The Board has weighed the expected benefits from modifying the Standards against a number of potential drawbacks that have been noted during consultation. First, it has been suggested that a modification to the Standards may constrain merchant bargaining power. When the surcharging reforms were first put in place, the Board sought to place as many bargaining tools in the hands of merchants as possible, given

the public's presumption that merchants would not surcharge. The Board's assessment is that surcharging is now sufficiently common, and surcharging above the cost of acceptance sufficiently widespread, that an unconstrained capacity for surcharging is no longer appropriate. In any case, it is not clear that giving the schemes the ability to limit surcharges will have a significant effect on merchants' negotiating power; while merchants have indicated that the threat of surcharging has enabled them to negotiate lower merchant service fees, it is unlikely that the threat of surcharging well above the cost of acceptance is significantly more effective than the threat of surcharging alone.

A second potential drawback of modifying the Standards is that the schemes may either seek to apply the revised Standards in a way that makes it more difficult for merchants to surcharge, or apply restrictions aggressively across the whole merchant base, resulting in high compliance costs. The Board is of the view that an appropriately worded Standard would reinforce the rights of merchants to recover their card acceptance costs. This is discussed further below and in Section 5. The Board also believes that the schemes and acquirers will jointly have an incentive to find an appropriate balance between managing excessive surcharging and ensuring that compliance costs are not unnecessarily high.

The Board has also considered the possibility that excessive surcharging could be addressed and price signals improved without varying the Standards. Under this approach, the Reserve Bank would make a public statement clarifying that the intent of the Standards is for merchants to pass through an amount to consumers that reflects the cost of card acceptance. The Reserve Bank may also provide some specific guidance that it is expected that card surcharges would be no more than a certain percentage of the transaction value, potentially differentiated between the three-party and four-party schemes reflecting differences in acceptance costs.

The effect of such a statement may be to set expectations about acceptable surcharge levels, both for merchants and consumers. In this way it may cause consumers to question higher surcharges and place pressure both on merchants that already impose surcharges that are excessive and on those that may consider doing so in the future.

This approach has the advantage over the status quo that it potentially provides at least some constraint on the surcharging practices that have concerned the Board, and does so at low cost. On the other hand, moral suasion alone might not be sufficient to change the behaviour of some merchants – particularly those with some market power. Some merchants may, therefore, require an element of compulsion to bring surcharges into line with card acceptance costs.

A statement that identified a specific surcharge level that might be considered reasonable could also potentially suffer from concerns about those levels becoming the norm for surcharges and would not account for the large differences in acceptance costs among merchants (see discussion under Option 1 below).

On balance, the Board is of the view that relaxing the Standards to allow scheme rules to impose some limit on surcharges will result in the most efficient outcomes and is in the public interest. The options for varying the Standards are considered below.

Options for Varying the Standards

In weighing the options to modify the Standards, the Board considered the advantages and disadvantages of being more prescriptive in its approach relative to providing a little more flexibility to schemes in setting surcharge limits. It considered three options: setting a specific permissible cap itself; allowing surcharge limits

to be set in line with merchant service fees or some function of the interchange fee; and allowing surcharges to be limited to a reasonable cost of card acceptance.

Option 1: Specific permissible surcharge limit

Under this option, the Board would determine a specific permissible surcharge limit, possibly expressed as a percentage of the transaction value, for the designated MasterCard and Visa credit card systems, and the Visa Debit system.⁵ This would be the *lowest* limit that scheme rules could choose to impose; that is, scheme rules could limit the surcharge that a merchant could apply, but could not prevent the merchant from applying a surcharge up to the limit determined by the Board.

As set out in the June 2011 Consultation Document, this option has the appeal of being transparent and makes monitoring of compliance relatively straightforward. The practical difficulty with this approach, however, is that the Board would be required to determine an appropriate level for the surcharge limit across all merchant types and sizes. Inevitably, for some merchants the limit would be higher than the cost of acceptance and may encourage merchants to simply set surcharges at the limit determined. For other merchants the limit may be too low and may therefore prevent them from recovering their costs and providing appropriate price signals to cardholders. A fixed permissible limit for surcharges would also be unresponsive to competitive pressures that might influence average merchant service fees over time.

As discussed in Section 3, nearly all submissions to the initial consultation were opposed to this option for these reasons.

Option 2: Surcharge limit equal to the cost of card acceptance

A second option is to modify the Standards to allow scheme rules to limit surcharges to the merchant's cost of card acceptance, and for this cost to be defined clearly as part of the Standards. As discussed in the June 2011 Consultation Document, this option raises the difficulty of determining the appropriate cost of acceptance, particularly if a wide range of other costs, such as annual fees, terminal rental or other transaction fees are to be included along with the merchant service fee. While one approach might be to only include 'other' costs that are charged by the acquirer, there are also a range of legitimate costs for card transactions that, for some merchants, may not be charged by their acquirer. For example, while some merchants rent their terminals from their acquirer and incur terminal rental fees, others invest directly in terminals themselves; if only costs charged by the acquirer are included, merchants that rent their terminals from their acquirer would be able to impose higher surcharges than those that own them. Similarly, in the case of online transactions, some merchants use a payment gateway, which may differ from the merchant acquirer, to process their card transactions. In addition, 'other' costs may not always be entirely attributable to acceptance of a particular card; terminals, for example, may process many types of payment methods and the costs would therefore need to be apportioned accordingly.

Given these difficulties, a simple and consistent approach across all merchants under this option would be to define the cost of acceptance as the merchant service fee. The main benefit of this approach over Option 1 is that surcharge limits would vary with the cost of card acceptance for each individual merchant and so would send more appropriate price signals to cardholders. Therefore, concerns about setting a limit too high or too low would be reduced. The June 2011 Consultation Document also suggested that under this option some

⁵ For this, and the other options considered below, the American Express, Diners Club and Debit MasterCard systems would be expected to modify their relevant voluntary undertakings accordingly.

sort of tolerance around the cost of card acceptance could be expressly allowed for in any revised Standards, such as for rounding purposes.

The Board recognises, however, that a number of arguments have been made against this approach. One is that acquirers have the ability to alter the mix of fees included in the merchant service fee, which would have a direct effect on the amount any given merchant would be able to surcharge. For example, acquirers may have an incentive to include a wider range of costs in the merchant service fee in order to attract the business of merchants that wish to impose higher surcharges. Second, the merchant service fee may not adequately reflect all the costs of accepting card payments, with some variation in these other costs across industries. And third, merchant service fees are commercial-in-confidence between the merchant and its acquirer, which means it would be difficult for the four-party schemes (and the public) to monitor merchant compliance with the surcharge limit.

A variant of this option, suggested during consultation, is to allow scheme rules to set a surcharge limit as a specified function of the interchange fee – for instance a multiple of the interchange fee or the interchange fee plus a set margin. The key benefit of this approach over using the merchant service fee is that interchange fees are more transparent, with fees for individual card and transaction types published and the weighted average of fees for each four-party scheme capped at 0.5 per cent of the transaction value by the Reserve Bank. This means that it would be relatively easy for the schemes and consumers to monitor merchant compliance with the surcharge limit. It would also eliminate the possibility, discussed above, that acquirers might seek to incorporate a wider range of costs in the merchant service fee to attract merchants that wish to impose higher surcharges. Another benefit of this approach is that it may be more effective in placing downward pressure on interchange fees by creating a direct link between these fees and surcharges; schemes would need to balance the desire to set higher interchange fees with the likelihood of facing higher surcharges.

The principal drawback of this approach is that it would not reflect genuine differences in card acceptance costs where they are not related to interchange fees and so would suffer some of the same drawbacks as Option 1.

Option 3: Limit surcharges to a reasonable cost of acceptance of cards

A third option is to allow the schemes to set limits that are a little more flexible. The proposal considered here is to allow a scheme's rules to limit surcharges to a reasonable cost of acceptance of cards of that scheme. A reasonable cost of acceptance would not be defined, but would include, at a minimum, the merchant service fee. As noted in some submissions to the consultation, an approach that provides some degree of tolerance in the setting of surcharges has been adopted in New Zealand and parts of Europe.

The key advantage of this option is that it provides the flexibility to consider the different costs that may be faced by different merchants and industries. In this way, it is likely to generate more efficient outcomes to the extent that it enables surcharges to reflect better the cost of acceptance across a wide range of different types of merchants.

A potential drawback of this approach, though, is that it may take longer to establish new surcharging behaviours as schemes and merchants determine what is 'reasonable' on a case-by-case basis.

The Board's Preferred Option

After considering the various options in light of the developments in surcharging practices over recent years, the Board is of the view that the benefits of varying the Standards to allow schemes to limit the level of surcharges outweigh the costs. In particular, such a variation would be in the public interest because it would allow the card schemes to address cases where merchants are clearly charging more than is justified for card acceptance, a practice that may distort price signals and result in inefficiencies in the relative use of payment methods. Nonetheless, an appropriate variation of the Standards would continue to allow merchants to pass on the legitimate costs of accepting cards.

On balance, the Board is of the view that Option 3 – allowing a limit based on the reasonable cost of card acceptance – would be the most effective way to relax the Standards. The Board believes that this is the approach that is likely to result in the most efficient outcomes; by not being too prescriptive, it will enable surcharges to best reflect the actual costs of card acceptance faced by each individual merchant.

The Board wishes to stress that this approach is aimed at improving the efficiency of the payments system and may not necessarily address all surcharging practices that are viewed by the public as being of concern. This approach does not, for instance, prevent surcharging in circumstances where there are only limited payment alternatives available. It does, however, provide the capacity for the schemes to ensure that the surcharges collected in these circumstances reflect card acceptance costs.

5. Draft Variation to the Standards

The Board proposes to vary the Standards titled *Standard No. 2, Merchant Pricing for Credit Card Purchases* and *The 'Honour All Cards' Rule in the Visa Debit and Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System*. The proposed variations are marked in the Draft Standards, as set out in Attachments 1 and 2.

The variations relax the current Standards to allow scheme rules to impose a limit on surcharge levels. Specifically, the variations provide that neither the rules of a designated card scheme nor any participant in the scheme may prohibit a merchant from recovering part or all of the reasonable cost of acceptance by the merchant charging fees or surcharges to credit cardholders. The effect of the variation is that scheme rules may limit surcharges to a reasonable cost of acceptance, but are not able to prevent merchants from fully recovering their costs. The varied Standards also provide that the merchant cannot be prohibited from applying different surcharges for different card types, either across card schemes or within a card scheme. That is, as is the case under the current Standards, the merchant can choose to differentially surcharge, including within a card scheme, if desired. While the Board recognises that there are practical constraints to applying differential surcharging within a scheme, the Board wishes to make it clear that merchants should not be prevented by schemes or acquirers from doing so.

The Board also recognises that this variation does not explicitly prohibit the practice of blended surcharging across card schemes. However, given that the variation allows scheme rules to limit surcharges to the cost of acceptance, under such rules any blended surcharge would be limited to the lowest cost of card acceptance, ensuring that blended surcharging is not also associated with excessive surcharging for lower-cost card schemes. Further, to the extent that blended surcharges are set at the cost of acceptance of the lower-cost scheme, the variation is likely to discourage the practice of blended surcharging because the merchant will not be recovering its acceptance costs overall.

Given that under the Draft Standards schemes will have the ability to impose a limit on surcharges through their rules, the provisions that currently allow a merchant to voluntarily agree with its acquirer to limit the size of any surcharge to the fees incurred by the merchant will be redundant. The variation to the Standards will therefore remove this provision.

Paragraph 10 of each of the Draft Standards defines the merchant's cost of acceptance to include, but not necessarily be limited to, the applicable merchant service fee. The cost can be determined by reference to:

- i. the cost to the merchant of the particular card transaction;
- ii. the average cost to the merchant of acceptance of all credit cards (Visa Debit cards, for the Visa Debit Standard) of all types issued under the scheme; or
- iii. the average cost to the merchant of acceptance of a subset of credit cards (Visa Debit cards, for the Visa Debit Standard).

The effect of this clarification is that the merchant will still be able to recover its costs of card acceptance from a cardholder in any way it chooses. That is, merchants may choose to recover their costs of card acceptance by applying: a different surcharge for each different card type; a single surcharge rate for all credit cards (or Visa Debit cards, for the Visa Debit Standard) for a particular scheme; or some combination, such as one rate for 'standard' card transactions and another rate for 'premium' card transactions. Merchants may also apply a surcharge on either an *ad valorem* or a flat-fee basis.

6. Next Steps

The Board invites comments on the specific form of the proposed variations to the Standards for the designated MasterCard and Visa credit card systems and the Visa Debit system. Given that the current paper reflects the output of a public consultation on the case for a variation of the Standards, this issue will not be considered as part of the current consultation.

Formal written submissions should be provided by no later than 10 February 2012 and should be sent to:

Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001

or

pysubmissions@rba.gov.au.

Submissions provided by email should be contained in a separate document, in PDF, Word or equivalent format.

In the normal course of events, submissions will be posted on the Reserve Bank's website and those making submissions will be provided with an opportunity to discuss their submission with the Bank.

Attachment 1

Draft Standard No. 2

Merchant Pricing for Credit Card Purchases

Objective

The objective of this Standard is to promote:

- (i) efficiency; and
- (ii) competition

in the Australian payments system by providing merchants the freedom to make a reasonable charge according to the means of payment.

Amended and restated Standard

1. This Standard was gazetted on 27 August 2002 and amended on [] to read as set out above and below.

Application

- ~~1.~~ 2. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.

- ~~2.~~ 3. This Standard applies to the credit card system operated within Australia known as [] designated on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, and referred to as follows in this Standard as the Scheme.

- ~~3.~~ 4. In this Standard:

an 'acquirer' is a participant in the Scheme in Australia that provides services to a merchant to allow the merchant to accept a credit card;

'credit card' means a card issued under the rules of the Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

'credit card transaction' or 'transaction' means a transaction in Australia between a credit card holder and a merchant involving the purchase of goods or services using a credit card;

'merchant' means a merchant in Australia that accepts a credit card for payment for goods or services;

'merchant service fee' means a transaction-based fee charged to a merchant for acquiring credit card transactions from that merchant whether collected on an *ad valorem* or flat-fee basis, or

charged as a blended rate across all credit card types or on an interchange plus acquirer margin basis or any other basis;

'rules of the Scheme' mean the constitution, rules, by-laws, procedures and instruments of the Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in the Scheme in Australia consider themselves bound;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

~~4. 5.~~ Each participant in the Scheme must do all things necessary on its part to ensure compliance with this Standard.

~~5. 6.~~ If any part of this Standard is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.

~~6. 7.~~ This Standard is to be interpreted:

- in accordance with its objective; and
- by looking beyond form to substance.

~~7. 8.~~ This Standard ~~comes originally came~~ into force on 1 January 2003. This Standard as amended and restated comes into force on [_____].

Merchant pricing

~~8. 9.~~ Neither the rules of the Scheme nor any participant in the Scheme shall prohibit ~~a merchant from charging a credit cardholder any fee or surcharge for a credit card transaction;~~

~~(i) a merchant from recovering part or all of the reasonable cost of acceptance of credit cards issued under the Scheme by the merchant charging fees or surcharges to credit card holders; or~~

~~(ii) a merchant, in recovering part or all of the reasonable cost of acceptance of credit cards issued under the Scheme, from applying different fees or surcharges to credit card holders for different card types either within the Scheme or across card schemes.~~

~~9. Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a credit cardholder will be limited to the fees incurred by the merchant in respect of a credit card transaction.~~

~~10. For the purposes of paragraph 9, the merchant's cost of acceptance of credit cards issued under the Scheme may, for the purpose of determination of a fee or surcharge, be determined by reference to:~~

~~(i) the cost to the merchant of the credit card transaction in relation to which the fee or surcharge is to be levied;~~

~~(ii) the average cost to the merchant of acceptance of all credit cards of all types issued under the Scheme; or~~

~~(iii) the average cost to the merchant of acceptance of a subset of credit cards issued under the Scheme, which includes the type of credit card in relation to which the fee or surcharge is to be levied,~~

and includes, but is not necessarily limited to, in the case of (i), the applicable merchant service fee and, in the case of (ii) and (iii), all applicable merchant service fees.

Transparency

~~10.~~ 11. Each acquirer must notify, in writing, each merchant to whom the acquirer provides services of the provisions of this Standard (as amended) as soon as practicable after this Standard (as amended) comes into force.

Attachment 2

Draft Standard

The 'Honour All Cards' Rule in the Visa Debit and Visa Credit Card Systems and the 'No Surcharge' Rule in the Visa Debit System

Objective

The objective of this Standard is to ensure that the rules of the Visa Debit system and the Visa credit card system promote:

- (i) efficiency; and
- (ii) competition

in the Australian payments system.

Amended and restated Standard

1. This Standard was gazetted on 7 July 2006 and amended on [] to read as set out above and below.

Application

~~1. 2.~~ This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.

~~2. 3.~~ This Standard applies to the payment system operated within Australia known as Visa Debit, which was designated as a payment system on 23 February 2004, and to the Visa credit card system operated within Australia which was designated as a payment system on 12 April 2001 (together referred to as the 'Scheme').

~~3. 4.~~ In this Standard:

an 'acquirer' is a participant in the Visa Debit system in Australia that provides services to a merchant to allow that merchant to accept a Visa Debit card;

'merchant' means a merchant in Australia that accepts a Visa Debit card or Visa credit card for payment for goods or services;

'merchant service fee' means a transaction-based fee charged to a merchant for acquiring Visa Debit card transactions from that merchant whether collected on an *ad valorem* or flat-fee basis, or charged as a blended rate with Visa credit cards or on an interchange plus acquirer margin basis or any other basis;

'rules of the Scheme' means the constitution, rules, by-laws, procedures and instruments of the Visa Debit system and of the Visa credit card system as applied in Australia respectively, and any other arrangement relating to the Scheme by which participants consider themselves bound;

'Visa credit card' means a card issued by a participant in Australia in the Visa credit card system, under the rules of the Scheme, that allows the cardholder to make payments to merchants for goods or services on credit, or any other article issued under the rules of the Scheme and commonly known as a credit card;

'Visa credit card transaction' means a transaction in Australia between a Visa credit card holder and a merchant involving the purchase of goods or services using a Visa credit card;

'Visa Debit card' means a card issued by a participant in Australia in the Visa Debit system, under the rules of the Scheme, that allows the cardholder to make payments to merchants for goods or services by accessing a deposit account held at an authorised deposit-taking institution;

'Visa Debit card transaction' means a transaction in Australia between a Visa Debit card holder and a merchant involving the purchase of goods or services using a Visa Debit card;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

4.5. Each participant in the Visa Debit system and the Visa credit card system must do all things necessary on its part to ensure compliance with this Standard.

5.6. If any part of this Standard is invalid, the Standard is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.

6.7. This Standard is to be interpreted:

- in accordance with its objective; and
- by looking beyond form to substance.

7.8. This Standard ~~comes originally came~~ into force on 1 January 2007. This Standard as amended and restated comes into force on [_____].

Merchant pricing

8.9. Neither the rules of the Scheme, nor any participant in the Visa Debit system, shall prohibit ~~a merchant from charging a Visa Debit cardholder any fee or surcharge for a Visa Debit card transaction;~~

(i) a merchant from recovering part or all of the reasonable cost of acceptance of Visa Debit cards issued under the Scheme by the merchant charging fees or surcharges to Visa Debit card holders; or

(ii) a merchant, in recovering part or all of the reasonable cost of acceptance of Visa Debit cards issued under the Scheme, from applying different fees or surcharges to Visa Debit card holders for different card types either within the Scheme or across card schemes.

9. Notwithstanding paragraph 8, an acquirer and a merchant may agree that the amount of any such fee or surcharge charged to a Visa Debit cardholder will be limited to the fees incurred by the merchant in respect of a Visa Debit card transaction.

10. For the purposes of paragraph 9, the merchant's cost of acceptance of Visa Debit cards issued under the Scheme may, for the purpose of determination of a fee or surcharge, be determined by reference to:

(i) the cost to the merchant of the Visa Debit card transaction in relation to which the fee or surcharge is to be levied;

(ii) the average cost to the merchant of acceptance of all Visa Debit cards of all types issued under the Scheme; or

(iii) the average cost to the merchant of acceptance of a subset of Visa Debit cards issued under the Scheme which includes the type of credit card in relation to which the fee or surcharge is to be levied,

and includes, but is not necessarily limited to, in the case of (i), the applicable merchant service fee and, in the case of (ii) and (iii), all applicable merchant service fees.

Honouring cards

~~10.~~ 11. Neither the rules of the Scheme, nor any participant in the Visa Debit system, or the Visa credit card system, may require a merchant to accept Visa Debit cards as a condition of the merchant accepting Visa credit cards. Likewise, neither the rules of the Scheme, nor any participant in the Visa Debit system or the Visa credit card system, may require a merchant to accept Visa credit cards as a condition of the merchant accepting Visa Debit cards.

Transparency

~~11.~~ 12. (i) All Visa Debit cards issued after 1 January 2007 must be visually identified as debit cards. By 31 December 2009, all Visa Debit cards on issue must be visually identified as Visa Debit cards.

(ii) From 1 January 2007, all Visa Debit cards issued in Australia must be issued with a Bank Identification Number (BIN) that allows them to be electronically identified as Visa Debit cards.

(iii) On request, acquirers must provide to merchants for which they acquire Visa Debit and credit card transactions, BINs that would permit the merchant to identify separately Visa Debit and Visa credit card transactions electronically.

(iv) Each acquirer must notify merchants to which it provides acquiring services of the provisions of this Standard (as amended) as soon as practicable after this Standard (as amended) comes into force. This requirement must be met by 31 December 2007.