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australian taxpayers' alliance
fighting tax, regulation & waste

3 February 2016

Glenn Stevens
Chairman, Payment Systems Board
Reserve Bank of Australia
GPO Box 3947
Sydney NSW 2001
Sent via email: <pysubmissions@rba.gov.au>

Dear Mr Stevens

Review of Card Payments Regulation – Consultation Paper

Please find enclosed a submission on behalf of the Australian Taxpayers' Alliance in relation to the above review. The submission is primarily concerned with the issue of interchange fee regulation.

The Australian Taxpayers' Alliance would appreciate the opportunity to speak to this submission to the Payment Systems Board as this review progresses.

If you have any questions, please do not hesitate to contact me.

Yours faithfully

TIM ANDREWS
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Submission to the Reserve Bank of Australia's consultation on Draft Standards for Credit Card Payments

Tim Andrews and Aaron Lane, Australian Taxpayers' Alliance

February 2016

Introduction and outline of position

The Reserve Bank of Australia (**RBA**) has powers under the *Payments Systems (Regulation) Act* 1998 (**Act**) to determine standards, and vary those standards, to be complied with by participants in a designated payment system. Interchange fee standards fit within these powers. It should be noted that while the RBA has the power to make determinations, nothing in the Act *requires* the RBA to intervene in financial markets.

The Act sets out the decision framework. Section 18 of the Act provides that the RBA must consider that determining the standards is in the public interest. In determining the 'public interest', section 8 of the Act provides that the RBA must have to regard to the desirability of payments systems:

(a) being (in its opinion):

  (i) financially safe for use by participants; and
  (ii) efficient; and
  (iii) competitive; and

(b) not (in its opinion) materially causing or contributing to increased risk to the financial system.

The RBA may have regard to other matters that it considers are relevant. The Australian Taxpayers' Alliance submits that proper attention should be given to the likely effects of interchange fee regulation on consumers.

On 3 December 2015 the RBA released '*Review of Card Payments Regulation – Consultation Paper'* (**Consultation Paper**). The Consultation Paper discussed reform options for a number of issues, including interchange fees, companion cards, scheme payments to issuers, and surcharging. The preference of the Board has been expressed in a number of draft standards (**Draft Standards**).

In relation to interchange fees, the Draft Standards provide that:

- The weighted-average benchmark for credit cards will remain at 0.50 per cent (Draft Standard No. 1, clause 4);
- No credit interchange fee will be able to exceed 0.8 per cent at any time (Draft Standard No. 1, clause 4);
- The weighted-average benchmark for debit cards will be reduced from 12 cents to 8 cents (Draft Standard No. 2, clause 4); and
- No debit interchange fee will be able to exceed 15 cents if levied as a fixed amount or 0.20 per cent if levied as a percentage amount (Draft Standard No. 2, clause 4).

The release of the Consultation Paper and Draft Standards should be seen in a wider public policy context. The Final Report of the Financial System Inquiry was released in December 2014. The government's response to the FSI, released in December 2015, indicated that it did not endorse a proposal to lower interchange fees. Further, a Senate inquiry into matters relating to credit card interest rates was referred to the Senate Economics References Committee in June 2015. Amongst other issues, the committee specifically considered interchange fees.

The Senate committee report noted the competing perspectives in relation to interchange fee regulation and ultimately recommended that "the government consider a Productivity Commission inquiry into the value and competitive neutrality of payment regulations, with a particular focus on interchange fees". Importantly, the Senate committee did not endorse the position of lowering interchange fees.

The Australian Taxpayers' Alliance was involved in the Federal government's FSI consultations and made a joint submission to the Senate inquiry in conjunction with the International Alliance for Electronic Payments.

For the purposes of the current review, the Australian Taxpayers' Alliance submits that the RBA should not implement the Draft Standards, or any other standards that have the effect of increasing regulation of interchange fees. The Australian Taxpayers' Alliance submits that determining the Draft Standards would not be in the public interest on the grounds of efficiency and competition – and that the adverse effects on consumer welfare should be also taken into account.

In summary, this submission is based on three propositions:

- there is no economic evidence justifying proposals to increase regulation of interchange fees – indeed, the economic evidence supports the case for deregulation; and
- There is an underlying assumption in the Consultation Paper that the higher the interchange fee, the higher the efficiency costs. In this regard, there is an overemphasis on interchange fee costs to merchants, without proper recognition of the corresponding benefits – and a lack of emphasis on the benefits to consumers that are taken away through interchange fee regulation;
- Draft Standards explicitly target – and have the effect of banning – premium credit cards tied to reward and frequent flyer programs, severely limiting competition.

In the alternative, the Australian Taxpayers' Alliance submits that the RBA should not make a decision about whether or not to implement the Draft Standards until the foreshadowed Productivity Commission inquiry has completed its review and made recommendations.

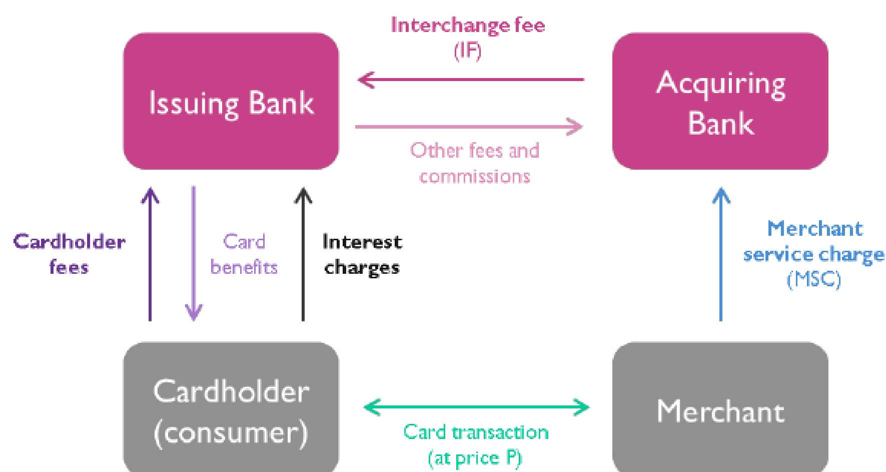
Section One: Issues with interchange fee regulation

Interchange fees generally

An interchange fee is, to put it at its simplest, a fee paid by a merchant when the customer uses a credit or debit card to purchase goods or services.

In more detail, a merchant does not pay the interchange fee directly to the customer's bank. The payments system is an interdependent, interconnected cost sharing mechanism, with four main parties: the cardholder/consumer, the merchant, the cardholder's bank (the "issuing bank"), and the merchant's bank (The "acquiring bank"). The network (such as Visa and MasterCard) only plays a role between the issuing and acquiring bank.

Three main income streams support the system: interchange/merchant discount, interest and fees (annual fees, etc.) The networks set the interchange fees, but interchange fees are collected by the acquiring banks/processors that add a small fee—together with interchange, this is known as the merchant discount or merchant service charge. The interchange collected is then transmitted to the issuing bank. Interest and fees come primarily from consumers (including businesses who use cards for purchasing) and again are paid to the issuing bank. The issuing bank then pays the networks for the operation of the system, recovers its own costs and then hopefully has enough left over to make a profit.



Source: Europe Economics, 2014.

The features of a two-sided market are important for economic analysis. We attach to this submission, as an appendix, *Amici Curiae* brief in *United States of America v American Express Company* – where the *amici* are scholars and experts on the economic analysis of antitrust law. The Board may find this brief of interest in considering competition aspects of the public interest test.

Transparency

The Consultation Paper noted, at page 4, that "the [RBA] has…held concerns about the lack of transparency available to merchants at the time of a card transaction", and cited two examples which it argued justify the RBA's concern:

> The first is the inability of many merchants to distinguish between debit and credit cards in card-not-present (e.g. online) environments. The second is the uncertainty over the cost of individual cards for merchants that do not benefit from merchant-specific interchange rates, such as 'strategic merchant' rates.

There is no doubt that these are two examples of knowledge problems that exist within the financial marketplace. The question then becomes who is in the best place to deal with this knowledge problem? Is it the merchants and the acquiring bank through their own contractual relationship, or is it the RBA through imposing further regulation? The Draft Standards do not deal with this issue in a meaningful way. For instance, it does not follow that proposing hard caps on interchange fees solves these knowledge problems.

The Australian Taxpayers' Alliance submits that the best way to deal with knowledge problems is through robust competition. This is important, because – as we seek to explain below – it is the intention of the Draft Standards to restrict competition.

It is important to state at the outset a few facts about interchange fees that are often ignored or obscured. Merchants around the world can — and do — directly negotiate with the networks to lower their interchange costs through a variety of incentive arrangements with networks, including deals in which the savings are rebated to the merchant. Merchants also understand the exact breakdown of the fees they will pay based on the agreement they each negotiated with their acquiring bank, including the interchange fee. Finally, it is important to note that even in countries that do not have the same sort of interchange fee caps that Australia has, interchange fees have not been going up. The weighted average of interchange fees in the USA actually decreased between 2005 and 2010 (when caps on debit card fees were enacted), even with the significant advancements in technology, convenience, and new security and fraud protection measures — all advances that add significant value for merchants and consumers.

The real transparency issue with interchange fees is the decision making process when regulators decide to implement price caps, as the RBA is proposing to do here. Price caps are by their nature arbitrary. Because of this, they are intensely difficult to set at an appropriate level as there will be disagreements about what the appropriate cap is (including whether a cap should exist at all) – and there are enormous consequences for getting it wrong. A few percentage points could result in distortions of billions of dollars. If a price cap is to be implemented, then the RBA should be seeking the best possible information to put itself in the best position to making a good decision that satisfies the public interest test. This requires an open and transparent process, and requires decisions to be made on robust evidence.

The Australian Taxpayers' Alliance is concerned about the way in which the Payment Systems Board has approached interchange fee regulation decisions in the past. We are not alone. For example, during the recent Senate inquiry, Chairman Senator Dastyari expressed concern over "the lack of transparency around how the decisions have been made about [interchange fee] regulation."[i]

We consider that transparency cuts both ways. One way of ensuring an open and transparent decision making process is for the Productivity Commission to hold an inquiry into interchange fee regulation, as recommended by the Senate committee. In this regard, the Australian Taxpayers' Alliance submit that the RBA should not make a decision about whether or not to implement the Draft Standards until the foreshadowed Productivity Commission inquiry has completed its review and made recommendations.

Efficiency

There is an underlying assumption in the Consultation Paper that the higher the interchange fee, the higher the efficiency costs. In this regard, there is an overemphasis on interchange fee costs to merchants, without proper recognition of the corresponding benefits that interchange fees provide to the payment system. For instance, it must be recognised that interchange fees deliver significant benefits to merchants represented by an increase in sales, a guarantee of payment, and a shifting of the problem of credit risk to financial institutions. There is also a lack of recognition of the costs of interchange fee regulation on consumers. Finally, there is an apparent assumption that the efficiency of the payment system should be measured by reference to cash. Historically, the RBA has had a nostalgic preference for cash transactions over EFTPOS and credit and debit cards. It appears there is a lack of recognition that cash has its own transaction costs – e.g. handling time, physical storage, risk of theft, etc. – and benefits of interchange fees become increasingly apparent when these are taken into account.

The Australian Taxpayers' Alliance submits that the above factors must be taken into account when assessing efficiency. More detail about these is provided in the discussion that follows.

Benefits to merchants from interchange fees

- **Larger purchases**

Credit and debit cards were adopted in order to reduce the need for consumers to carry large amounts of cash around to make purchases, minimising the chances for loss or theft, and providing greater convenience for the merchant than checks.[ii] The consequence is that consumers are able to offer larger sums for purchases than they would otherwise be willing and merchants are more willing to accept them. This is borne out by research for the RBA, which suggests that credit card sales at large merchants are on average three times as big as cash-only transactions.[iii] The average cash payment in the sample was $27, compared with the average debit card payment of $66 and the average credit card payment of $83.[iv] This suggests that merchants' sales would suffer if consumers were discouraged from using credit and debit cards because of higher interchange fees.

- **Guaranteed payment**

A significant benefit to merchants is that, if the charge is approved, they are paid for their goods or services by the card holder's bank regardless of whether or not the card holder had sufficient cash on-hand to pay for the goods or services in question. This guaranteed payment results itself results in higher sales. As Professor Todd Zywicki of George Mason University points out:

> For merchants that would not otherwise have operated their own credit systems, the bank guarantee facilitates transactions that would not otherwise have occurred because of the

> unavailability of credit. For small merchants (and consumers, of course) this benefit could be enormous, creating more product market competition and opening up entire new lines of business to entrepreneurs otherwise foreclosed from them. For these merchants, too, however, there is also a benefit from sales made (and profits earned) that would not otherwise have been made. Credit losses represent sales that, by definition, the consumer was unable to pay for, but for which credit was extended anyway.[v]

This guarantee is a major reason why stores have shifted away from their own credit schemes to those offered by financial institutions. The interchange fee helps to pay for this guarantee.

- **The credit risk borne by the financial institutions is significant**

The average transaction of $139 studied by the RBA included 78c in write offs and credit collections, meaning that for every $100 in transactions, 56c are written off as bad debts.[vi] For MasterCard and Visa transactions, the costs are higher, at 63c per $100.[vii] The RBA's current cap on interchange fees remains at 0.5c per transaction, which represents 50c per $100.[viii] The RBA does not allow these costs to be taken into account when calculating the costs of interchange fee regulations[ix], but the cost is evidently higher than the revenue gained from the interchange fee for every transaction. In other words, despite all the other benefits provided by interchange fees, the interchange fee itself fails to cover the cost of one single element of the transaction – the credit risk. That risk is born by the financial institutions.

Indeed, according to RBA research, banks have written off around 3% of all credit card balances as losses in recent years (a figure that neared 4% after the financial crisis).[x] The approximate amount of debt outstanding and collecting interest rates on Australian credit cards has been around $33 billion for the past two years.[xi] Without the interchange fee, banks would almost certainly look to shift this risk back to the merchant. Either merchants would accept the risk and pay the cost, denting their bottom lines by more than the total they pay in interchange fees, or they would look to mitigate the risk by making less risky sales, again denting their bottom lines in lost sales while increasing policing costs.

Costs of interchange fee regulation for consumers

In the assessment of the likely implications of the Draft Standards on consumers, the Consultation Paper claims that "lower merchant service fees [through hard caps on interchange fees] would be expected to lead over time to a slightly lower overall level of prices of final goods and services to consumers" (p. 38). The RBA does not present any evidence to support this claim. Indeed, all of the available evidence from previous interchange fee regulation points to the contrary.

Cardholders are paying more for their cards. Between 2002 and 2008, the RBA estimates that the average payment card fee rose by $40 per account, indicating that (with 12 million accounts held in 2008) cardholders are paying $480 million more to hold their cards than they did before the regulations took effect in 2003.[xii]

In 2012, the RBA itself admitted that costs to consumers have gone up while costs to merchants have gone down:

> Overall, reward points and other benefits earned from spending on credit cards have become less generous while annual fees to cardholders have increased. At the same time, merchant

> service fees – the fees charged to a merchant by its acquirer – have declined, with the benefit likely to have been passed on to all consumers, not just those who pay by credit card.[xiii]

The last point is only half true. Merchants have indeed benefited from a significant windfall in reduced service fees. According to CRA International's review of the effect of the regulations in 2008, merchants were saving approximately $676 million annually as a result of reduced fees, meaning that over the 12 years of fee regulation they have saved over $8 billion (in 2008 prices) in costs.

However, there is little evidence that these cost savings have been passed on to consumers as price cuts or better products, as the RBA claims. Reviewing the evidence, Europe Economics notes, "As in the Spanish case, no evidence was found neither [sic] of a reduction in retail prices nor of an improvement in the quality of products."[xiv]

This is consistent with evidence not just from Spain but from the USA following the imposition of debit card interchange fee caps after 2010. Analysing the effect of the regulations through an event study analysis, Evans et al. concluded:

> There is no reason to believe that merchants would give this windfall back to consumers or the banks could absorb the full loss in their profits. A wealth of economic studies shows that does not happen in the real world. Consumers got the short end the stick though. Merchant [sic] are not giving enough of their gains back to consumers to compensate for the higher fees and reduced services that consumers are getting from banks as a result of the interchange price caps, nor, as we have shown, are merchants expected to do so.[xv]

They found that the relatively modest American fee caps resulted in a net decrease of consumer welfare of $22 to $25 billion.[xvi]

For the Australian cardholder to break even, $480 million of the merchants' $676 million cost reduction would have to be passed on – about 70%. Studies have shown that even in highly competitive markets, merchants rarely pass on more than 50 percent of savings. The evidence from around the world suggests much less after interchange fee caps, probably because the average saving per transaction is quite low.

CRA concluded on this aspect in 2008:

> Recognising that it is difficult to isolate price effects, the fact remains that no evidence has been presented that would allow one to conclude that the undeniable losses to cardholders have been offset by reductions in retail prices or improvement in the quality of retail service. In contrast, we know with confidence that merchants have been beneficiaries of the RBA's intervention. We know this from the fact that merchants were in favour of the past reductions in interchange fees and now would like even further reductions. It is extremely unlikely that merchants would be taking this position if reductions in merchant service charges resulting from the RBA's regulations were simply passed through to consumers in the form of lower prices and/or higher quality service.[xvii]

In 2015, the Australian Taxpayers' Alliance addressed this issue before the Senate economics committee. Matthew Sinclair explained three reasons that the lower merchant service fees resulting from lower interchange fees were not passed through to consumers:

> Firstly, there might be resale markets which are just not very competitive. Secondly, the amounts we are talking about here might be so small that they do not shift the pricepoints. If something is priced at $9.99, a very marginal reduction in the cost might not be enough to

> justify shifting to another pricepoint. Finally, for a large and increasing share of transactions, cards are cheaper than cash. Given that there is a regulatory—or, often, a customary—requirement to take cash, the pricing, in order to avoid a loss for retailers, may be to the cash cost rather than the card cost. Therefore, changes in the card cost do not lead to reductions in prices.[xviii]

Research from a survey of US merchants by the Federal Reserve Bank of Richmond[xix] found that many merchants did not see any appreciable cost savings after the imposition of debit card interchange fee caps. Small merchants often saw an increase in their costs. It was only a small proportion of merchants – mostly large retailers – who saw their costs noticeably diminish.

Regulatory policy should be made on robust economic evidence, not on wishful thinking. Accordingly, the Australian Taxpayers' Alliance submit that lower merchant service fees would not result in lower prices of final goods and services to consumers – and this should be taken into account when determining whether the Draft Standards are in the public interest.

Likely costs to future consumers

Further regulation of interchange fees will have several negative effects that can already be foreseen. It will likely continue the process of shifting costs from merchants to consumers, not just increasing interest rates and fees, but also reducing interest-free periods and reward programs. One option under consideration is to lower the weighted-average interchange fee – in this case it is also possible that this proposal would have a particularly heavy effect on the poorest consumers, and smaller banks will also have reduced capacity to offer low-cost cards.

- **Interest rates and fees will increase**

Community-owned banks have already warned the RBA that they will be disproportionately affected by the Bank's proposals and will almost certainly have to raise interest rates and fees on their customers:

> Given the major banks' dominance of the credit card market, through their roles as card issuers and acquirers, reducing interchange fees for issuers is likely to have disproportionately greater impact on smaller card issuers that do not compete in the acquiring market. In this scenario, customer-owned banking institutions would likely need to increase credit card interest rates and fees. Merchants would continue to receive benefits provided by issuers however the costs of these benefits will be borne by a small issuer's customers.[xx]

This mirrors evidence from the USA, where smaller financial institutions rely more on interchange fees than interest rates (and were therefore exempted from the interchange fee caps enacted in 2010):

> Credit unions and community banks had a higher portion of cardholders who did not carry a balance or incur penalty fees, according to representatives of financial institutions, so they had to rely more on interchange fee revenues than revenues from fee income and interest payments.[xxi]

Visa too has warned that financial institutions will need to respond as already outlined:

> Cap reductions will not only impact the respective position of merchants in the payments system, issuers too will need to respond. Issuing banks normally adjust their business models

> to ensure cost recovery through changes to product fees and charges and if interchange revenue is radically reduced by regulation they may need to respond in some of the following ways:
>
> increasing Credit card interest rates;
> increasing annual fees; and/or
> introducing a transaction fee; and
> diluting the loyalty program offerings and benefits.[xxii]

All the evidence from all over the world suggests that further caps on interchange fees will increase fees and costs to consumers. In summary: in Spain there has been an increase in annual fees for standard four-party payment cards following interchange fee caps; in the United States, retailers have saved $8 billion per annum while consumers are paying higher costs for goods and services, higher banking fees and lower rewards; and in Europe there is a range of early signs of increased fees following the EU implementing a fixed cap on interchange fees in 2015.[xxiii]

Some financial institutions offer longer interest-free periods than others. Again, community-owned banks are more likely to have to reduce the length of these periods if their interchange fee revenue is reduced.

We consider the effects on reward and frequent flyer programs further, under the section on competition and innovation.

- **These cost increases will harm the poorer bank customers**

One further point for this inquiry and the RBA to consider is the effect of the price increases discussed above on the poorest in society. This welfare cost is particularly badly felt among marginal groups like the "underbanked" and "unbanked" (those who cannot afford the full services of a bank account and rely on products like prepaid debit cards or payday loans). Research from America has shown that interchange fee caps on banks contributed to *one million* poorer Americans being forced out of the banking system altogether.[xxiv]

Laws requiring no-frills bank accounts notwithstanding, the worst economic effects are always felt at the margins. Further increases in costs to consumers may indeed force some people down the chain:

Credit → Debit → EFTPOS

But it might well have the effect of adding another link to the chain:

Credit → Debit → EFTPOS →Unbanked

If this is the case, and evidence from America suggests it might well be, then the effect of interchange fee regulation will not just be to increase credit card rates and fees on the wealthy, but to force thousands of people at the margins of society into greater poverty.

- **Effect on smaller banks and low-cost cards**

Lowering interchange fees will mean some, predominantly smaller, banks will have a reduced capacity to provide low-cost cards because of the need to cover the previously-eligible costs

of transaction processing and authorisation. The Community Owned Banking association warned the RBA:

> To continue to offer market-leading, low-cost credit cards, it is vital that COBA members be able to rely on the current level of interchange fees to cover the eligible costs of issuance. Transaction processing and authorisation, fraud and fraud prevention and the provision of an interest-free period are significant costs that, if not recovered through interchange fees, would reduce the capacity of customer-owned banking institutions to offer affordable, low-cost credit cards.[xxv]

The above discussion goes the Australian Taxpayers' Alliance submission that reducing the weighted-average interchange fee would be the worst course of action for the Board to take. By contrast, the best course of action to maximise consumer welfare would be to remove interchange fee regulation altogether.

Competition and innovation

Competition is a driver of innovation in the financial services sector, yet interchange fee regulation limits an important aspect of competition in the market. The Consultation Paper takes a clear position against premium credit cards. The Draft Standards clearly target premium credit cards tied to reward and frequent flyer programs. For example, the Consultation Paper states that:

> The reduction in interchange fees, especially the cap on the highest credit card rates, is likely to result in some reduction in the generosity of rewards programs on premium cards. It is likely, however, that there would be only limited changes to other elements of the credit card package (e.g. interest rates, interest-free periods). (p. 38)

It seems that the Board's view is that premium cards, with relatively higher interchange fee arrangements, are unnecessary – this substitutes a subjective value judgment for basic market function. Premium cards exist because the parties in the system—consumers, merchants and banks – find value in them. They would not exist if they did not increase net spend for merchants and provide value for consumers—this is true as well for merchant rewards programs that are not linked to credit.

In Australia there are over 100 financial products linking credit cards to frequent flyer programs and credit cards. For instance, every major bank in Australia has a co-branded Qantas credit card. Virgin's Velocity is not far behind, with co-branded arranged with NAB and American Express, and arrangements with other banks' rewards schemes. These arrangements are a point of competitive difference, promoting competition and innovation in the financial sector. Consumers value these programs, as evidenced from the recent decision by Woolworths Ltd to reverse its decision to scrap its partnership with Qantas Frequent Flyer following an intense consumer backlash.[xxvi]

Increased regulation of interchange fees – whether it is lowering the weighted-average, or putting in place a binding cap - will have the effect of banning these premium credit cards. It is feared that this will stifle competition, and harm consumers – a point which the Board appears to concede, at page 24 of the Consultation Paper, as it notes that banning premium cards "would also increase the importance of addressing the issue of competitive neutrality and companion cards". Of course, competitive neutrality would not need to be addressed if interchange fees were removed altogether.

Further, the targeting of premium cards goes well beyond the RBA's brief. The RBA should not have the power to micro-manage which cards consumers have access to. Such interference in a highly competitive market is simply unjustifiable in a liberal market-based economy.

Lastly, interchange fees contribute heavily to the funding of innovation, which is the gateway for future competition in the payment systems market. Lower interchange fees reduce incentives to innovate – slowing future competitive pressures.

We know that the payments market is a fast-moving one with continuous innovation. Not only do security procedures have to be continually updated and reformed but also new forms of more convenient payment are being introduced all the time. For example, the contactless payment system known as "Tap n Go" has been a huge success in Australia, with over 28 million payments per month using Visa PayWave as of February 2014.[xxvii] Lower revenue from interchange fees reduces incentives for financial institutions to develop innovative and convenient products that encourage more use of cards and will instead focus on products that deliver more interest rate or fee income.

The Act makes clear that competition is a factor that must be taken into account by the Board in making a decision about the Draft Standards. The Australian Taxpayers' Alliance submit that any actions to introduce hard caps on interchange fees would be against the public interest on competition grounds.

Section two: Summary Response to Reform Options

This section of the submission makes recommendations in response to specific reform proposals outlined in the Consultation Paper. This submission is confined to interchange fees, companion cards, scheme payments to issuers, and surcharging. For each issue, we indicate whether the proposed approach is appropriate, and whether it meets the public interest test enshrined in the Act.

Interchange benchmarks and ceilings

Option 1: No change to the current standards

Option 2: Retain a weighted-average framework for the benchmarks, supplemented by a ceiling on individual interchange rates

Option 3: Reduce the weighted-average interchange fee benchmarks

Option 4: Remove interchange regulation but introduce measures to increase transparency of interchange fees to merchants and strengthen the ability of merchants to respond to high interchange cards.

The Australian Taxpayers' Alliance recommends that the Board pursue Option 4 – and completely deregulate interchange fees. However we question whether it is the Board's role to introduce transparency measures as part of a deregulatory approach; the best transparency measure is a competitive market. Option 4 is the only course of action which promotes efficiency and competition, while Options 1, 2 and 3 increasingly hamper efficiency and competition.

The Board has expressed a preliminary preference for Option 2, which is reflected in the Draft Standards. The Consultation Paper, at page 23, states that that "[The Board] has decided at this time to not consider the implementation of hard caps in place of a weighted average". Nevertheless, the Board have opted for a hybrid position of a weighted average combined with hard caps.

The Australian Taxpayers' Alliance submits that Option 2 is an inappropriate approach, on both competition and efficiency grounds. The hard caps proposed in the Draft Standards will be binding on the market. The effect of this will be to ban premium credit cards – typically those linked to rewards and frequent flyer programs. This will severely limit competition in the credit card market by reducing hundreds of products. It is also likely that interest rates and fees & charges will increase for consumers. All of the available data suggests that more stringent interchange fee regulation will result in cost shifting from merchants to consumers, reflecting an inefficient allocation of costs and benefits of the payment system.

The Australian Taxpayers' Alliance is pleased that the Board has indicated it will no longer be proceeding with Option 3, which would have deleterious effects on efficiency and competition. It would also put at risk the financial safety of the payments system – as interchange fees contribute to funding card benefits such as fraud protection and payment guarantees.

Companion Cards:

Option 1: Retain the current arrangements

Option 2: Remove regulation of interchange fees for four-party schemes

Option 3: Regulate issuer fees and other payments to issuers

The Australian Taxpayers' Alliance recommends that the Board pursue Option 2. Under this approach, the four-party card schemes currently subject to interchange fee regulation would be free to set interchange fees at levels to directly compete with American Express' companion cards. This is consistent with our position on interchange benchmarks and ceilings.

The issue here is competitive neutrality. It is an unintended consequence of interchange regulation that four-party card schemes do not compete on an equal footing with three-party card schemes. Because it is a problem caused by regulation, the only way to permanently fix the problem is to remove the regulation. In other words, the only way to ensure that all card schemes are subject to the same rules is by removing interchange fees altogether.

We strongly disagree with the Board's assessment, at page 14 of the Consultation Paper, that "under Option 2 (removal of interchange regulation for four-party schemes), unconstrained interchange fees… would be likely to result in rising payment costs, distorted price signals to cardholders and an inefficient allocation of resources in the payments system." We consider that regulatory policy should be made on robust evidence. The Board has not provided any economic evidence in support of these claims. Indeed, the economic evidence points to inefficient distortions caused by interchange fee regulation, compared to reducing interchange fees over time in competitive markets.

The Board's current preference for Option 3 would be inappropriate on efficiency and competition grounds, for the same reasons discussed under interchange benchmarks and ceilings, above. Option 3 would also add a further layer of complexity to interchange fee regulation, and comes with the risk of unintended consequences.

Scheme payments to issuers

Option 1: No regulation of scheme payments to issuers

Option 2: Limits on payments by schemes to issuers

The Australian Taxpayers' Alliance recommends that the Board pursue Option 1. This approach would seek to retain the status quo. Our recommendation is based on our position, outlined above, that interchange regulation should be removed. So-called 'anti-avoidance' provisions would therefore no be required.

Even if the Board is not minded to remove interchange fee regulation, the Australian Taxpayers' Alliance view of this issue would not change. Simply put, limits on payments by schemes to card issuers would have a negative impact on competition in various product segments. This option is likely to add significant compliance costs on consumers and taxpayers.

Surcharging

Option 1: No change to the existing definition of reasonable cost of card acceptance

Option 2: Remove regulation

Option 3: Modifications to the cost of acceptance framework

The Australian Taxpayers' Alliance submits that the RBA got it wrong in 2003 – and this action was the cause of excessive surcharging by merchants. Such a position would not be inconsistent with the Government's FSI response (as asserted by the Board on page 29 of the Consultation Paper). On the contrary, it would remove the need for legislative action by the Parliament in favour of a free-market solution. The proposed legislation was to mop up previous regulatory failure.

About the Australian Taxpayers’ Alliance

The Australian Taxpayers’ Alliance is a unique grassroots advocacy & activist organisation comprised of over 25,000 members dedicated to standing up for hardworking Australian taxpayers. We oppose the high taxes, wasteful spending, and crippling red tape that are hurting Aussie families and businesses, and provide a voice for everyone who opposes the big-government agenda.

About the authors

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Appendix – *Amici Curiae* brief in *United States of Amercia v American Express Company,* in the United States Court of Appeals for the Second Circuit.

15-1672

IN THE
United States Court of Appeals
for the
SECOND CIRCUIT

UNITED STATES OF AMERICA, *et al*.,

Plaintiffs-Appellees

– v. –

AMERICAN EXPRESS COMPANY, *et al*.,

Defendants-Appellants

(Full caption on inside cover)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF NEW YORK

BRIEF FOR *AMICI CURIAE* J. GREGORY SIDAK, ROBERT D. WILLIG, DAVID J. TEECE, AND KEITH N. HYLTON SCHOLARS AND EXPERTS IN ANTITRUST ECONOMICS IN SUPPORT OF DEFENDANTS-APPELLANTS AND SUPPORTING REVERSAL

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Plaintiffs-Appellees,

STATE OF HAWAII,

Plaintiff,

v.

AMERICAN EXPRESS COMPANY, AMERICAN EXPRESS TRAVEL RELATED SERVICES COMPANY, INC.,

Defendants-Appellants,

MASTERCARD INTERNATIONAL INCORPORATED, VISA INC.,

Defendants,

CVS HEALTH, INC., MEIJER, INC., PUBLIX SUPER MARKETS, INC., RALEY'S, SUPERVALU, INC., AHOLD U.S.A., INC., ALBERTSONS LLC, THE GREAT ATLANTIC & PACIFIC TEA COMPANY, INC., H.E. BUTT GROCERY CO., HYVEE, INC., THE KROGER CO., SAFEWAY INC. WALGREEN CO., RITE-AID CORP., BI-LO LLC, HOME DEPOT USA, INC., 7-ELEVEN, INC., ACADEMY, LTD., DBA ACADEMY SPORTS + OUTDOORS, ALIMENTATION COUCHE-TARD INC., AMAZON.COM, INC., AMERICAN EAGLE OUTFITTERS, INC., ASHLEY FURNITURE INDUSTRIES INC., BARNES & NOBLE, INC., BARNES & NOBLE COLLEGE BOOKSELLERS, LLC, BEALL'S, INC., BEST BUY CO., INC., BOSCOVS, INC., BROOKSHIRE GROCERY COMPANY, BUC-EE'S LTD, THE BUCKLE, INC., THE CHILDRENS PLACE RETAIL STORES, INC., COBORNS INCORPORATED, CRACKER BARREL OLD COUNTRY STORE, INC., D'AGOSTINO SUPERMARKETS, INC., DAVIDS BRIDAL, INC., DBD, INC., DAVIDS BRIDAL CANADA INC., DILLARD'S, INC., DRURY HOTELS COMPANY, LLC, EXPRESS LLC, FLEET AND FARM OF GREEN BAY,

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IDENTITY AND INTEREST OF *AMICI CURIAE*

The *amici* are scholars and experts on the economic analysis of antitrust law whose scholarly writings have been cited approvingly on multiple occasions by the federal courts:[1]

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[1] Pursuant to Fed. R. App. P. 29(c)(5), *amici* certify that no party's counsel authored this brief in whole or in part; no party or party's counsel contributed money intended to fund the preparation or submission of the brief; and no person other than *amici* or their counsel contributed money intended to fund the preparation or submission of the brief. Pursuant to Rule 29(a), all parties have consented to the filing of this brief.

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The *amici* sign this brief in their individual capacities.

The *amici* have an interest because they believe that errors in the district court's opinion threaten to undermine proper economic analysis of antitrust questions in two-sided markets.

INTRODUCTION AND SUMMARY OF ARGUMENT

Credit card networks—like shopping malls, executive recruiting firms, dating services, social and professional networking websites, and video games—exemplify multi-sided platforms. A consumer accessing a smartphone application like AirBnB or Uber uses a two-sided platform. Similarly, Amazon and eBay connect online vendors with online shoppers, and Google Search, Android, and Facebook connect advertisers, consumers, application developers, and social media users to one another. Such two-sided markets (or two-sided platforms) have features that differ in significant ways from traditional markets, and a proper analysis should acknowledge those differences.

Since the early 2000s, economists (including Nobel laureate Jean Tirole) have produced an extensive literature on two-sided markets.[2] Economists now

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[2] *See, e.g.*, David S. Evans, *The Antitrust Economics of Multi-Sided Platform Markets*, 20 Yale J. on Reg. 325 (2003); Jean-Charles Rochet & Jean Tirole, *Two-Sided Markets: A Progress Report*, 37 RAND J. Econ. 645 (2006); Roberto Roson, *Two-Sided Markets: A Tentative Survey*, 4 Rev. Network Econ. 142 (2005); Mark Armstrong, *Competition in Two-Sided Markets*, 37 RAND J. Econ. 668 (2006); Andrei Hagiu, *Two-Sided Platforms: Product Variety and Pricing Structures*, 18 J.

widely accept the definition of Tirole and Jean-Charles Rochet that, in a multi-sided market, "one or several platforms enable interactions between end-users and try to get the two (or multiple) sides 'on board' by appropriately charging each side."[3] Antitrust scholars have applied the economic principles of two-sided markets to a range of cases and regulatory policies.[4]

Typically, platforms in two-sided markets charge a low, sometimes negative, price to attract customers on one side of the market and a higher price to the other side of the market.[5] A credit card network might charge the cardholder a negative

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Econ. & Mgmt. Strategy 1011 (2009); Sujit Chakravorti & Roberto Roson, *Platform Competition in Two-Sided Markets: The Case of Payment Networks*, 5 Rev. Network Econ. 118 (2006); Jean-Charles Rochet & Jean Tirole, *Platform Competition in Two-Sided Markets*, 1 J. Eur. Econ. Ass'n 990, 990–91 (2003); Marc Rysman, *The Economics of Two-Sided Markets*, 23 J. Econ. Persp., no. 3, 125, 125–27 (Summer 2009).

[3] Rochet & Tirole, *Two-Sided Markets: A Progress Report*, *supra* note 2, at 645. Rochet and Tirole clarify that a market is two-sided only if the volume of transactions between the end users on each side of the platform depends on the allocation of the aggregate price—the sum of the price that the platform charges each side. *Id.* at 648. In a one-sided market, the volume of transactions would depend only on the aggregate price. That is, the allocation or division of the aggregate price between the two sides will not affect the number of transactions.

[4] *See, e.g.*, Robert H. Bork & J. Gregory Sidak, *What Does the Chicago School Teach About Internet Search and the Antitrust Treatment of Google?*, 8 J. Competition L. & Econ. 663 (2012); J. Gregory Sidak, *A Consumer-Welfare Approach to Network Neutrality Regulation of the Internet*, 2 J. Competition L. & Econ. 349 (2006); Hagiu, *supra* note 2.

[5] *See, e.g.*, Rochet & Tirole, *Platform Competition in Two-Sided Markets*, *supra* note 2, at 992, 1013–14; J. Gregory Sidak & David J. Teece, *Innovation Spillovers and the "Dirt Road" Fallacy: The Intellectual Bankruptcy of Banning*

price by offering rewards or discounts to entice consumers to use the network's card. By allocating a relatively small, or even negative, portion of the aggregate price to the cardholder and allocating a relatively large portion to the merchant, a card network encourages cardholders to use credit cards belonging to that network, which in turn increases a merchant's incentive to accept that network's credit cards. If the card network instead allocated a relatively large portion of the aggregate price to the cardholder and a relatively small portion to the merchant, fewer consumers would adopt that network's credit cards, and fewer merchants would accept those credit cards, all other things being equal. Thus, network effects magnify the effect of a price change on one side of the two-sided market.[6]

In other words, a card network's allocation of the aggregate price between the cardholders and the merchants affects the total volume of transactions on that card network and therefore the success of that network. Consequently, if a court in an antitrust case considers only the discount fee that the card network charges merchants, it disregards the salient fact that the proper allocation of the aggregate price between the two sides of the market is essential to optimizing the number of

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Optional Transactions for Enhanced Delivery Over the Internet, 6 J. Competition L. & Econ. 521, 541–42 (2010).

[6] *See* Rochet & Tirole, *Two-Sided Markets: A Progress Report*, *supra* note 2, at 648. Economists have recognized the relevance of this insight to telecommunications regulation since at least the mid-1990s. *See, e.g.,* Robert W. Crandall & J. Gregory Sidak, *Competition and Regulatory Policies for Interactive Broadband Networks*, 68 S. Cal. L. Rev. 1203, 1219–20 (1995).

transactions on both sides of the platform and thereby promoting consumer welfare. Although the district court did recognize that American Express operates in a two-sided market, it did not properly apply this perspective and widely accepted two-sided market principles in its analysis.

We *amici* do not purport to be experts on the facts of this case, and we do not address every disputed economic issue. Instead, we focus on three reversible errors committed by the district court concerning (1) whether American Express possessed market power, (2) the competitive effects of the challenged conduct, and (3) market definition in this two-sided market. We first address the district court's analysis of market power, which we consider the most significant error.

ARGUMENT

I. THE DISTRICT COURT'S ANALYSIS OF MARKET POWER WAS ERRONEOUS

The district court emphasized the customer loyalty or cardholder insistence of American Express's cardholders in its finding that American Express possessed market power. The district court said that "Amex's market share alone likely would not suffice to prove market power by a preponderance of the evidence were it not

for the amplifying effect of cardholder insistence."[7] The district court said that American Express cardholders insist on using their American Express payment cards, which "effectively prevents merchants from dropping American Express."[8] This ignores the fact that, as the district court noted, some three million merchants accept Visa, MasterCard and Discover but do not accept American Express.[9] A merchant chooses whether or not to accept a card based on its assessment of the costs and benefits of doing so. Different merchants face different costs and benefits, and can (and do) reach different conclusions about whether or not to accept a particular card. There is no meaningful economic difference between "dropping American Express" – which the district court said would not happen and which it says indicates market power – and a decision not to accept American Express in the first place – which the district court recognizes that millions of merchants do. Moreover, the district court recognized that this cardholder insistence arises because of the rewards and other associated services that American Express offers,[10] which does not indicate market power but instead indicates the competitive benefits on the cardholder side of the two-sided market

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[7] *United States v. Am. Express Co.*, No. 10-CV-4496 (NGG)(RER), 2015 WL 728563, at *37 (E.D.N.Y. Feb. 19, 2015).

[8] *Id.* at *38.

[9] *Id.* at *9.

[10] *Id.* at *37.

and the concomitant resulting competitive benefits to merchants that accept American Express cards.

Moreover, the district court erroneously asserted that "American Express cannot avert a finding of market power premised on cardholder insistence merely because that loyalty and [American Express's] current market share would dissipate if the company were to stop investing in those programs that make its product valuable to cardholders."[11] That assertion reveals the district court's confusion between market power and consumer benefit resulting from successful innovation and product differentiation under competition. Cardholder insistence on using American Express's cards is a part of what makes accepting American Express's cards (and paying the merchant discount) a worthwhile business for the merchants that accept them.[12] In addition, the district court's recognition that American Express's market share would dissipate if it were to cease investing in its

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[11] *Id.* at *40. That American Express's market share would dissipate, either due to ease of entry or ease of expansion by competing firms, implies that American Express could not possess market power. *See* William J. Baumol, John C. Panzar & Robert D. Willig, *Contestable Markets and the Theory of Industry Structure* 351 (rev. ed. 1988).

[12] Customer loyalty, of which the cardholder insistence on using American Express cards is an example, can have procompetitive effects. *See* Richard A. Posner, *Vertical Restraints and Antitrust Policy*, 72 U. Chi. L. Rev. 229, 240 (2005) ("Another name for [loyalty] might be low transaction costs and customer inertia, which might be another name for economizing on transaction costs.").

cardholder rewards and services undermines—rather than supports—the court's finding of market power.

The district court's analysis of American Express's "Value Recapture" initiatives from 2005 to 2010 and the associated increases in merchant discounts is incomplete, incorrect, and does not indicate market power. Price increases alone are not evidence of market power if there are no concurrent adoptions or expansions of anticompetitive conduct. The district court recognized that American Express's costs were increasing concurrently with the Value Recapture program.[13] Raising prices when costs increase is not evidence of market power. Moreover, the district court recognized that American Express invested substantially in new co-branding programs that had marketing and promotional purposes and effects.[14] Competitive firms raise prices when expensive marketing and promotional efforts succeed in elevating demand for their products. When demand for American Express's product expands on the cardholder side, value also expands on the merchant side, which indicates that increases in merchant discounts are a concomitant of a successful investment in creating output and value.

In sum, although we certainly do not purport to have assessed all the evidence on market power, we believe that the district court's evidentiary findings

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[13] *Am. Express Co.*, 2015 WL 728563, at *42.

[14] *See, e.g.*, *id.* at *47 & n.37.

(particularly the finding that American Express's market share would dissipate without its continued investment in consumer benefits), properly interpreted, indicate the *absence* of market power. While the district court's analysis of the Value Recapture program does not indicate to us the absence of market power, it suggests that the district court's inference of the existence of market power was unwarranted.

II. THE DISTRICT COURT'S ANALYSIS OF COMPETITIVE EFFECTS WAS ERRONEOUS

For Sherman Act claims analyzed under the rule of reason, "plaintiffs bear an initial burden to demonstrate the defendants' challenged behavior had an actual adverse effect on competition as a whole in the relevant market."[15] Because the district court failed to evaluate American Express's market power correctly in a two-sided market, the court necessarily failed to determine correctly the net competitive effect of the challenged conduct by summing the conduct's competitive effect on the merchant side of the market and its competitive effect on the cardholder side of the market. The United States argued that the former reduced consumer surplus, and American Express argued that the latter increased consumer surplus. To determine the *net* effect on consumer surplus, the district court needed

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[15] *Geneva Pharm. Tech. Corp. v. Barr Labs. Inc.*, 386 F.3d 485, 506–07 (2d Cir. 2004) (emphasis and internal quotation marks omitted).

to make factual findings of the magnitude of both the former and the latter—which the court did not do.

American Express presented evidence of the competitive effects of its Non-Discrimination Provisions (NDPs) on the cardholder side of the market. For example, American Express argued that the NDPs were necessary "to preserve American Express's differentiated business model and thus the company's ability to drive competition in the network services market[.]"[16] That is, American Express could not pursue its business model if merchants could discriminate by steering the cardholder at the point of sale to a different form of payment. This "discrimination" by merchants would make the cardholder less likely to use American Express as a form of payment in subsequent transactions.[17] Consequently, a negative feedback effect in merchant steering would cause American Express to lose discount revenue from merchants. The loss of discount revenue from merchants would increase the cost to American Express of providing enhanced benefits to its cardholders, a practice which differentiates American Express from its competitors and benefits cardholders and merchants.[18]

Given a reduction in merchant revenue, American Express's optimal level of cardholder benefits would decrease, which in turn would reduce the intensity of

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[16] *Am. Express Co.*, 2015 WL 728563, at *66.
[17] *Id.*
[18] *Id.* at *67.

competition among credit card networks on the cardholder side of the market. American Express argued that, because its NDPs prevent this negative feedback effect, they help American Express "drive innovation and compete effectively with the dominant firms in the [cardholder market]"—namely, Visa and MasterCard.[19] As the NDPs increase the level of cardholder benefits that American Express will offer, they intensify competition among credit card networks on the cardholder side of the market, which benefits both cardholders and merchants.

The district court mischaracterized this argument as a proffered procompetitive benefit, which it then found not to be legally cognizable because American Express's "procompetitive benefits" on the cardholder side of the market came (in the district court's assessment) at the expense of suppressing competition on the merchant side of the market for network services.[20] The district court said that "a restraint that causes anticompetitive harm in one market may not be justified by greater competition in a *different* market."[21] However, as we explain in greater detail in Part III, the district court erroneously defined the relevant product market to exclude one side of the two-sided market (namely, the cardholder side), which the court then inaccurately called a "different" market.

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[19] *Id.*

[20] *Id.* at *69.

[21] *Id.* (emphasis added).

A correct analysis of competitive effects would have been two-sided, considering *both* the effects on network services to merchants *and* the effects on credit card services to cardholders. The correct analysis would not have enabled the district court to reason that the NDPs caused a procompetitive benefit "in one market" at the expense of an anticompetitive cost "in a different market." Only one market exists, but it has two sides. Consequently, to determine the competitive effect of the challenged conduct, the district court would have needed to balance the welfare gains on the cardholder side of the market against the possible welfare losses on the network services market, so as to determine the net competitive effect of the NDPs. It is the total price charged on both sides of the market that drives output in the general purpose credit and charge (GPCC) card industry. That the total volume of GPCC transactions increased during the period in which the NDPs were in place[22] is prima facie evidence of a net *positive* effect on competition.[23] Merchant decisions not to accept American Express do not relate to the market output and are not indicative of a net negative effect on competition. Instead, the ability of merchants to substitute away from American Express, just as cardholders

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[22] *See* PX2702.41; DX7828.10.

[23] Total output could have increased for reasons other than the existence of NDPs. However, the United States had the burden to show that other factors drove that increase and to isolate any negative effect of the NDPs.

can do as well, is plain evidence of competition facing American Express in the two-sided market.

The two-sided competitive-effects analysis that the district court failed to perform differs from asking whether efficiency justifications (such as economies of scale or prevention of free riding) offset adverse competitive effects and thus excuse them from liability. One gets to that question only after the United States has carried its burden of proving that, on balance, American Express's NDPs had an adverse competitive effect in the properly defined two-sided market. By mischaracterizing a countervailing effect of the NDPs on the cardholder side of the market as a procompetitive justification, the district court introduced a legal theory that violates economic theory and would endanger consumer welfare if applied to any two-sided market.

III. THE DISTRICT COURT'S MARKET DEFINITION WAS ERRONEOUS

The purpose of the market definition inquiry is "to identify the market participants and competitive pressures that restrain an individual firm's ability to raise prices or restrict output."[24] The overall demand for a credit card transaction is the vertical summation of the respective demand curves of the merchant and the

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[24] *Geneva Pharm. Tech. Corp. v. Barr Labs. Inc.*, 386 F.3d 485, 496 (2d Cir. 2004).

cardholder. Demand is two-sided. The consumer surplus created by a transaction conducted on the two-sided platform of the credit card network is the sum of the cardholder's surplus and the merchant's surplus. Because antitrust law aims to maximize consumer surplus, it necessarily must consider the effect that the disputed business practice has on consumer surplus on *both* sides of a two-sided market.

The district court recognized that American Express operates in a two-sided market.[25] In a multi-sided market, "[a]ny change in demand or cost on one side of the market will necessarily affect the level and relationship of prices on all sides."[26] That a firm has a high price-cost margin on one side of the market does not reliably indicate market power, because a two-sided platform needs to attract both sides to its services.[27] One must consider both sides of a two-sided platform when applying the hypothetical monopolist test (HMT) to define the relevant market. Asking whether a hypothetical profit-maximizing monopolist can profitably implement a small but significant and nontransitory increase in price (SSNIP) on one side of a

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25 *Am. Express Co.*, 2015 WL 728563, at *6.

26 David S. Evans, *The Antitrust Economics of Multi-Sided Platform Markets*, 20 Yale J. on Reg. 325, 355 (2003); *see also* Rochet & Tirole, *Two-Sided Markets: A Progress Report*, *supra* note 2, at 648, 664–65; Lapo Filistrucchi, Tobias J. Klein & Thomas O. Michielsen, *Assessing Unilateral Merger Effects in a Two-Sided Market: An Application to the Dutch Daily Newspaper Market*, 8 J. Competition L. & Econ. 297, 301–02 (2012).

27 Roson, *Two-Sided Markets: A Tentative Survey*, *supra* note 2, at 155–56.

two-sided market must account for the SSNIP's impact on the other side of the market, with its own consequences for profit and for feedback on the first side of the two-sided market. A one-sided HMT in a two-sided market ignores the hypothetical monopolist's *net* price and therefore distorts the analysis of the effect that a SSNIP would have on a hypothetical monopolist's aggregate profits, which is the relevant indicator.

The district court never made a rigorous, fact-based inquiry into the propriety of including the cardholder side of the market in its definition of the relevant product market. Its market definition is therefore unreliable, as are the district court's conclusions on market power and competitive effects.

The district court did not perform the HMT when defining a market for network services instead of a market for transactions. The court considered only (on a largely impressionistic level) the effect of a SSNIP when determining whether to include debit-card network services in the (supposedly) relevant product market consisting of network services.[28] Even then, the district court did not appear to apply the HMT correctly.

Without formally applying the HMT in any context, let alone in a manner that accounted for the two-sidedness of the market for credit or payment card transactions, the district court defined the relevant product market as the market for

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[28] *See Am. Express Co.*, 2015 WL 728563, at *24–27.

network services in a conclusory and mistaken fashion. Although the district court purported to consider both sides of the market,[29] as a proper reading of *United States* v. *Visa U.S.A., Inc. (Visa II)* requires,[30] it did not attempt to quantify the change in cardholder behavior resulting from the decreased demand of merchants to use the hypothetical monopolist's network for credit card transactions.[31] The district court considered cardholder behavior only with respect to a merchant's decision to *join* a card network. However, the relevant economic question is the extent to which cardholder behavior affects the profitability of a SSNIP by the hypothetical monopolist.

The district court analyzed whether the relevant product market should be based around transactions (a definition that would implicitly also incorporate cardholders into the relevant market) without ever considering the effects of a SSNIP on the cardholder side of the market.[32] The district court did not apply the HMT to determine whether network services constitute the relevant product market. The court *presumed* that the decrease in the quantity of network services

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[29] *Id.* at *23–24.

[30] *United States v. Visa U.S.A., Inc.*, 344 F.3d 229, 237–39 (2d Cir. 2003).

[31] *See Am. Express Co.*, 2015 WL 728563, at *21–24. Puzzlingly, the district court acknowledged "American Express is correct that the court *must account for the two-sided features* of the credit card industry *in its market definition inquiry*, as well as elsewhere in its antitrust analysis", but nevertheless concluded that the relevant market was the market for network services. *Id.* at *23–24 (emphasis added).

[32] *See id.* at *21–24.

demanded by merchants facing a SSNIP would be too small to render the price increase unprofitable, but it did not quantify or even realistically consider the change in cardholder behavior resulting from the decreased merchant demand.[33]

A proper HMT would consider the extent to which, because of feedback effects in a two-sided market, even a low level of merchant attrition would cause some cardholders to switch to alternative forms of payment. At some empirical threshold, merchant attrition would cause a SSNIP to be unprofitable for the hypothetical monopolist.[34] A proper HMT would consider the feedback effect in the assessment of a SSNIP's profitability by accounting for the reduction in cardholders' demand for cards or card transactions that would accompany any degree of merchant attrition.

To retain cardholders, a card network might need to increase the rewards to cardholders (a price cut by any other name), which would diminish the network's profitability from the SSNIP.[35] If the network chooses not to increase rewards to cardholders, then merchant attrition very likely would increase further as a result of

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[33] *See id.* at *25–27.

[34] *See id.* at *27.

[35] *See* Alexei Alexandrov, George Deltas & Daniel F. Spulber, *Antitrust and Competition in Two-Sided Markets*, 7 J. Competition L. & Econ. 775, 777 (2011) (explaining that it might be "appropriate to treat the sum of prices in a two-sided market as one would treat the price offered to buyers in a one-sided market").

the reduction in the number of cardholders, such that the reduction in transactions over time could make the SSNIP unprofitable.

In sum, the district court applied the HMT incorrectly. By ignoring the response of cardholders to the SSNIP, the district court defined a relevant product market that was improperly narrow.

IV. CONCLUSION

For the foregoing reasons, the judgment of the district court should be reversed.

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Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH F.R.A.P. 32

Pursuant to Rule 32(a)(7)(C)(i) of the Federal Rules of Appellate Procedure, the foregoing brief is in 14-Point Times New Roman proportional font and contains 4,210 words, excluding the parts of the brief exempted by Rule 32(a)(7)(B)(iii), and thus is in compliance with the 7,000 word limit for *amicus* briefs in the Federal Rules of Appellate Procedure for the Second Circuit.

Dated: August 10, 2015

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