



ANNEXURE 1

## **Reform of the EFTPOS and Visa Debit Systems in Australia: Economic Analysis**

PREPARED FOR  
VISA INTERNATIONAL

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## 1 Economic issues in the RBA Consultation Document

- 1 This annexure sets out economic comments on the RBA Consultation Document “Reform of the EFTPOS and Visa Debit Systems in Australia”, dated February 2005 (the “Consultation Document”). These comments have been prepared by the Network Economics Consulting Group (“NECG”) on behalf of Visa International (“Visa”).
- 2 Visa has provided extensive material to the RBA on the economic issues covered in the Consultation Document. While Visa does not seek to repeat that material here, Visa believes the more complete analyses and arguments presented in that material are of importance to the proper assessment of the options proposed by the RBA. Visa therefore urges the RBA to review that material as it moves ahead.
- 3 As well as responding to the matters raised directly in the Consultation Document, Visa takes this opportunity to respond to comments made by the RBA in its media release that accompanied the Consultation Document regarding the application to the so-called ‘closed’ or three-party systems of the interchange standards that apply to ‘open’ or four-party credit card systems.
- 4 The structure of this section is therefore as follows. First, Visa briefly restates issues it considers the RBA has neglected in its decisions to regulate the payments system. Visa then considers the RBA’s proposals with respect to the proper setting of interchange fees for Visa debit. Thirdly, Visa discusses the issues associated with the “Honour All Cards” (“HAC”) rule. Visa explains why it believes the RBA’s position in respect of each of these matters is incorrect and contrary to the efficiency and competitiveness objectives of the *Payment Systems (Regulation) Act 1998*. Finally, because of the crucial importance to Visa of competitive neutrality, Visa sets out its views on the RBA’s comments as to whether the interchange standards that apply to four-party systems can be applied to three-party credit card issuers.

### 1.1 Principles underpinning payments reform

- 5 Before proceeding to a consideration of the specific options advocated by the Consultation Document, Visa believes it is important to restate some general considerations about the reform process. While these are matters Visa has put to the RBA in previous submissions, Visa feels that the RBA has not adequately addressed them. Instead, the Consultation Document simply restates previous positions which, in Visa’s view, are poorly founded in economic theory. In other cases, such as the RBA’s views on the balancing theory of interchange, the RBA does not put forward an alternative analysis. Without fully restating material Visa has already put, Visa highlights the relevant issues below.

- 6 As a preliminary matter, Visa notes that underpinning the RBA's recent policies with respect to the payments system is the presumption that the system is distorted in important respects. This presumption seems to be based on a number of indicators that, in Visa's view, do not provide a proper basis for the inference the RBA seeks to draw.

### 1.1.1 Competition in two-sided markets

- 7 The use of interchange has been fundamental to the development of credit and debit card markets around the world. It has enabled the card schemes to tailor the net benefits that accrue to both cardholders and merchants in order to best promote growth in the overall market. For example, an interchange fee flowing from 'acquiring' banks to 'issuing' banks has the effect of merchants providing direct encouragement for increased card holding and use which, in turn, will benefit merchants. As elaborated below, interchange allows a 'balancing' of market conditions on both sides of the network, and in doing so fosters network externalities to the benefit of cardholders and merchants alike. Under very general conditions, social welfare will be improved.
- 8 The RBA acknowledges that the theoretical literature has demonstrated that interchange fees can promote greater social welfare,<sup>1</sup> but then ignores these insights on the grounds of practicality. In so doing, the RBA has embarked upon a course that risks introducing distortions that will limit choice, harm products with more features and deter innovation.
- 9 In particular, the RBA places great stress on its view that "in normal competitive markets, prices are driven towards costs" (Consultation Document, at 19) with the inference then being that if the interchange fee is not cost-based, that mere fact connotes a distortion to efficiency. In contrast, Visa submits that in a two-sided network, there is no presumption that the price charged to each side of the market should reflect (or under competitive conditions, would reflect) the costs attributable to that side of the market; rather, competitive forces bear on the overall level of charges, and force them towards costs, but would not necessarily move any particular charge to cost. For example, commercial realities have led Adobe (Adobe Systems Incorporated) to charge those users who wish to use its software for publication but not users who make use of the reader required to view the software's output. The charges do not reflect the direct costs incurred on each side of the network. Indeed, if they did reflect the resource costs on the respective sides of the market, it is highly likely that the market would not have developed or, if such pricing were to be imposed today, it is highly likely that the demand for Adobe Reader would be seriously impaired.

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<sup>1</sup> See, for example, the range of articles in *Review of Network Economics*, Vol.2, Issue 2, June 2003.

- 10 The RBA also implies that the mere fact that credit card use has increased relative to use of other payment instruments reflects or evidences a distortion to competitive forces. In Visa's view, no such inference can properly be drawn. Rather, Visa believes that the continued growth of credit card use is the result of the substantial benefits credit cards provide to cardholders and merchants alike.
- 11 The RBA is concerned that the increase in credit card use relative to other payment instruments may place undue burdens on merchants – hence its emphasis on reducing merchant service fees. However, a number of independent surveys do not show merchants sharing these concerns. For example, Cannex found that three-quarters of merchants surveyed in 2004 felt that accepting credit cards contributed positively to the growth in their businesses for reasons such as the convenience that cards provided customers and the reduced risks associated with payments using cards.<sup>2</sup> Similarly, UMR market research found a large majority of merchants felt that credit cards played both an important role in the business growth (73 per cent) and that the benefits of accepting cards outweighed the costs (77 per cent).<sup>3</sup>
- 12 Equally, the RBA states that the fact that interchange fees have not been changed over time reflects or evidences weakness in the competitive process. In Visa's view, however, the strong and continued growth of credit card use, in a situation where supply and demand have expanded in parallel, implies that the level of interchange fees has been broadly correct. There has, in other words, been no obvious need for adjustments to fee levels and hence no such adjustments have been made.
- 13 In short, while the RBA claims that there are important distortions that its policies must address, it continues to provide little economic basis for that assertion.

#### 1.1.2 Implications for social welfare

- 14 The RBA puts forward in the Consultation Document an analysis of its regulations implemented in connection to credit card schemes in order to justify similar measures being extended to scheme debit cards (as well as to EFTPOS). Visa finds this analysis to be seriously deficient in that it relies on reductions in merchant service fees as an implied measure of the impact on social welfare; it fails to adequately address the benefits to flow from interchange as a balancing mechanism; and, as part of this, it does not recognize the network externalities inherent in two-sided card markets.
- 15 In particular, the Consultation Document stresses the fact that reductions in interchange fees have given rise to reductions in merchant service fees (Consultation Document, at 12)

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<sup>2</sup> Cannex, *Card Reforms in Australia: Monitoring of Market Effects*, November 2004.

<sup>3</sup> UMR, *Credit Card Merchants: Australian Brand and Advertising Monitor*, December 2004.

and argues that a benefit of encouraging substitution from Visa debit to EFTPOS is the resulting falls in merchant service fees (Consultation Document, at 10). However, taken as an indicator of social gains from the reforms, this focus on merchant service fees is at best misleading: first, the RBA does not consider or seek to quantify the associated increases in charges to card holders;<sup>4,5</sup> second, the policy has resulted in significant transfers to merchants, but a transfer between economic agents clearly does not constitute an overall social gain.

- 16 Visa welcomes the RBA's explicit recognition of the justifications that exist for an interchange fee (Consultation Document at 2.1). However, the Consultation Paper's discussion of this matter is limited in scope and does not appear to inform much of the argument that ensues. Accordingly, Visa has some comments on the manner in which the Consultation Document sets out the analysis of the role of interchange.
- 17 More specifically, as in any two-sided network, the purpose of the balancing methodology is to optimize the growth of the network for the benefit of all stakeholders having regard to demand and supply conditions on each side of the network. The RBA's approach unduly simplifies the balancing methodology that underpins Visa's approach to interchange. In Visa's view (and in an increasing section of the economic literature),<sup>6</sup> the primary justification for the balancing methodology does not lie in a concern that card holders could not cover the costs associated with issuing – as the example given by the RBA (Consultation Document, at 16) suggests. Rather, Visa believes that a system in which cardholders were required to cover those costs in their entirety would be smaller than a system that maximised the overall value of the network.
- 18 Maximising overall value requires that account be taken of the benefits the card scheme provides both to cardholders and to merchants.<sup>7</sup> It is, for example, appropriate even under a narrow view of interchange (i.e. where network externalities are not considered) for merchants to contribute to the costs of those features of the scheme that provide them with substantial benefits – such as the scope to accept cards in situations where the merchant

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<sup>4</sup> In fact, research conducted for Visa indicates that the direct impact of higher cardholder fees, some modest surcharging by merchants and the possible increase in the more expensive closed card schemes' market shares appears to have more than offset the direct impact of the reduced merchant service fees.

<sup>5</sup> Or, in the case of substitution from Visa debit to EFTPOS, the foregone economic value to consumers and merchants of the broader range of features Visa debit supplies – a broader range the RBA itself recognises, see Consultation Document, at 5.

<sup>6</sup> See for example Rochet J.C, Tirole, J. (2004), "Two-Sided Markets: An Overview", Institute D'Economie Industrielle Working Paper, Toulouse University, and Evans, D. (2002), "The Antitrust Economics of Two-sided Markets", AEI-Brookings Centre, Related Publication 02-13.

<sup>7</sup> As noted above, significant majorities of both cardholders and merchants judge that they are benefiting from the use of cards.

cannot check the signature, the protection given cardholders in situations in which the merchant does not deliver the goods as promised, and the ability to accept cards issued overseas. These features benefit both cardholders and, either directly or indirectly, merchants. Absent a merchant contribution to the cost of providing these features, consumer charges for holding and using cards would be too high, as they would not reflect the benefits that card holding and use create for merchants. As a result, card holding and usage would be below efficient levels, reducing the benefits of the payments system both to the community and to the institutions involved in its supply.

- 19 The rationale for merchant contributions becomes even stronger when a broader view of the role of interchange is considered. The more customers who use cards, the greater the benefits to individual merchants that accept cards. Absent such a contribution from merchants, externalities provided to merchants by card issuance and usage would not be internalised. As a result, the potential benefits to accrue from the network externalities would not be realised. This clearly would neither be in the interests of the schemes nor in that of an efficient payments system overall.
- 20 There is obviously an issue as to, and considerable and continuing controversy about, the quantum of the network impacts, and whether the appropriate level of interchange fees could be zero. While recognising these debates, and that an interchange fee of zero is a possible market outcome, Visa believes there cannot properly be any presumption that the appropriate level is zero. Rather, so long as card issuance and usage provides some features of benefit to merchants, a contribution by merchants to funding issuance and usage is privately and socially justified. As a result, Visa views with concern the RBA's statement that looking to arrangements post-2007, it is attracted to a zero interchange (Consultation Document, at 32). This is especially so in light of the substantial ongoing investments that Visa believes will be needed to add further security and an ever greater range of functionalities to the cards its members issue.
- 21 In fact, the imposition of zero interchange fees in any card scheme where the balancing of costs and revenues on both sides of the system call for some other level of interchange would seriously risk stifling innovation, reducing choice and harming economic efficiency. For example, the discussion in the Consultation Document implicitly assumes that additional features that different products offer could be funded through higher charges to cardholders. Not only does this fail to recognise the benefits that accrue to merchants, it also neglects the economic and practical advantages that can be offered by bundling a range of attributes within one card (just like many goods and services in other parts of the economy). It is likely that such an approach would see the payments system forced towards products with minimal features, even if cardholders and merchants were willing to support other products because of the additional benefits they would enjoy.



- 22 These considerations are also of obvious relevance to the RBA's proposals with respect to Visa debit, with the specific issues involved being considered in greater detail below.

## 1.2 Interchange standard for Visa debit

- 23 Visa believes two aspects of the options set out in the Consultation Document with respect to Visa debit require particular comment, above and beyond the material Visa has already submitted to the RBA in the course of the current process. These are the RBA's view that Visa debit and EFTPOS are close substitutes; and the proposed method for the calculation of the cost base to be used in the calculation of the Visa debit interchange fee standard. In addition, Visa judges that the new regulations are likely to harm rather than foster competition, making it especially difficult for new debit card products to enter.

### **Substitution between Visa Debit and EFTPOS**

- 24 In the Consultation Document (see for example, page 5), the RBA recognises that there are substantial differences in the functionalities provided to cardholders and merchants by Visa debit and by EFTPOS, with the former providing a far broader range of features than does the latter. Despite this, the RBA's substantive analysis relies mainly on an implied close degree of substitution between Visa debit and EFTPOS. Visa contends that restricting the analysis of substitutability between the two to their attributes as payment services only is far too simplistic in these circumstances.
- 25 For example, in assessing the likely consequences of alternative regulatory options, the RBA stresses its belief that the approach it intends to take will induce substitution to EFTPOS from Visa debit and that in turn, this will reduce merchant service fees (see Consultation Document, at 10).
- 26 The RBA's analysis here is lacking because it fails to adequately examine all aspects of the likely impact on consumer prices induced by the regulations and, more importantly, as noted above, the emphasis on reducing merchant service fees is inappropriate as a basis for assessing whether particular reform options will or will not promote social welfare and the objectives set out in the relevant statutes.
- 27 Firstly, focusing narrowly on the impact on merchant services fees as implied by the discussion in the Consultation Paper, Visa is concerned that the RBA is overstating its case. In the case of the credit card regulations, the reduced interchange fees did translate into lower merchant services fees, as intended. The impact of reduced merchant service fees on final prices, however, appears to have very limited with survey evidence indicating that few merchants knowingly passed on the lower costs to consumers. Moreover, any impact on consumer prices appears to have been more than offset by a combination of

higher fees for cardholders, surcharging by an admittedly small proportion of merchants and, while the signs are tentative at this point, a shift in market share towards the more expensive closed card schemes which have been made more competitive by the RBA's regulations. In the case of debit cards, the impact on prices of reduced merchant service fees are also likely to be offset to some extent by similar responses.

- 28 More fundamentally, as noted above, the emphasis on reducing merchant service fees is inappropriate as a basis for assessing whether particular reform options will or will not promote social welfare and the objectives set out in the relevant statutes. It confuses transfers with welfare gains and, while accounting for the 'winners' from the changes, it fails to consider offsetting losses.
- 29 The problems introduced by using an estimate of resource costs as the basis for regulating prices (or, in this case, interchange fees) can be especially acute if they cause a service that provides a wide range of functionalities (Visa debit) to be replaced by one that provides fewer (EFTPOS). Regulations could encourage such an outcome were the price for the different products to be based on the resource cost of the more basic product. Unless the costs associated with providing the additional features of the more extensive product can be recovered through some other means – something that may well not be feasible – some of those features will have to be pared back in an effort to maintain its viability. Consequently, the inferior product will gain a strong competitive advantage. Consumers who were attracted to the more expensive/higher value product will no longer have the same choice and social welfare will be harmed.
- 30 In effect, this is one manifestation of the use of resource costs as the basis for welfare comparisons being plainly incorrect – as the RBA itself elsewhere notes (Consultation Document, at 10-11). Reliance on transfers rather than on welfare gains as a measure of social gain compounds the error.
- 31 Even putting this aside, Visa remains of the view that the RBA misstates the closeness of substitution between Visa debit and EFTPOS. Certainly no information is provided in the Consultation Document that confirms or even supports the RBA's emphasis on that substitution. As a result, Visa believes that the RBA cannot properly base the assessment of alternative options on the mere assumption that there is close substitution between these payments instruments.
- 32 This is all the more the case looking forward. In effect, Visa would expect continuing evolution – both in terms of its cards and of their uses – that may see further distinctions between Visa debit cards on the one hand and EFTPOS cards on the other. This has two important implications for policy going forward.

- 33 First, both networks need sufficient flexibility in how they are structured – including the setting of fees and benefits – in order to best realise possibilities that the evolution in markets and technologies will offer. In particular, Visa believes it means that there are social welfare benefits from the continued growth in holding and usage of Visa debit cards. In Visa’s view, the RBA pays too little regard to these benefits in considering alternative options.
- 34 Second, it means that reducing the attractiveness of Visa debit may simply induce substitution to credit cards by customers who find advantages in using branded cards and who, at this point, have chosen to use debit cards. This would be at odds with the RBA’s own stated objectives. (Of course, where consumers wish to shop on card-not-present channels – the Internet and mail order/telephone order transactions – if they do not have a Visa debit card, the only substitute is a credit card.)
- 35 Overall, the RBA’s assessment of options is based on an inference of close similarity between Visa debit and EFTPOS that is unsupported by any evidence.<sup>8</sup> This assumption of close similarity leads the RBA to misstate the likely effects of its policies on the composition of card holding and usage and on social welfare more generally.

#### 1.2.1 Calculation of the cost base for Visa debit interchange

- 36 The RBA proposes differing approaches for differing instruments in determining the cost base to be used in calculations of allowed interchange fees. There are differences both in terms of which costs are included and in terms of how those costs are to be measured.

#### Differences in direction of interchange and in included costs

- 37 As a general matter, Visa views with some concern the RBA’s proposal to allow the interchange fee for EFTPOS to flow in a different direction from that for credit and Visa debit without providing any economic or public benefit basis for that decision. Instead, the RBA simply stresses its desire for incremental change, rather than more wholesale reform, as providing a justification for this difference. If there is to be regulation, it should follow good regulatory practice and good regulatory practice requires consistency in the application of principle that is grounded in sound economic analysis.
- 38 In addition, proper reflection of a commitment to incrementalism as central to the RBA’s thinking would surely lead Visa to expect it to also affect the RBA’s approach to Visa debit interchange and to the Honour All Cards rule. However, the Consultation Document does not evidence any such intention. Rather, the RBA’s proposal to allow the interchange fee for EFTPOS to flow in a different direction than for credit and debit can only be

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<sup>8</sup> No such evidence has been published or disclosed by the RBA and Visa assumes this would have been done if the RBA holds it.

reasonably explicable as the result of undue weight being placed on merchant interests in the RBA's assessment of policy options. This perception is reinforced by the Consultation Document's emphasis on reductions in merchant service fees as a primary metric of welfare gains.

### **Differences in method of cost calculation**

- 39 Turning to the specific issue of how costs are calculated, the RBA proposes to use the costs specifically associated with EFTPOS as the basis for determining the EFTPOS interchange fee benchmark. If a cost-based approach is to be used for setting an interchange benchmark for a system, then it is logical to use the costs for that system as the basis for the benchmark.
- 40 However, in respect of Visa debit, a different basis is proposed, namely one that effectively uses the costs associated with large issuers of credit cards. Determining that a cost-based approach is to be used for setting an interchange benchmark for a system and then using the costs relevant to a different system – where, moreover, the participants are almost entirely different – is inappropriate and defies any sense of reasonableness in regulation.
- 41 To justify this difference, the RBA points to two considerations (Consultation Document, at 36). The first is that current Visa debit issuers are relatively small, so that should their costs be used as the reference point, then an entrant large issuer *might be* over-compensated. The second is that MasterCard may at some point launch a debit card of its own.
- 42 With respect to the first of these considerations, the proposed approach bears no relation to the commercial imperatives in this market and it is inconsistent with widely accepted results in contemporary regulatory economics. In particular, the approach rests on the RBA's views of something that “might” happen – that is, a large issuer entering the market – and what “might be” overcompensation if that were to happen. It takes no account of the costs that a large new entrant would doubtless incur in entering into issuance of a new product, including the way such a product would be developed, sold and operated in order to find and develop a market niche. For example, if the card centre channel that is used for credit cards were deemed to be inappropriate by an entrant into the debit card market, it may have to incur significant costs in developing its branch network. Equally importantly, the RBA does not have any basis, other than its view of costs, for assessing whether current issuers are or are not ‘too small’: for example, it may be that ‘small’ issuers are providing service quality that is valuable to, and valued by, the scheme and its consumers. As a result, the RBA should not be seeking to social engineer the relevant scale of supply: rather, what it should do is ensure that price signals encourage entry or expansion *if that entry or expansion is indeed efficient*.

- 43 This goal – of promoting an efficient industry configuration, including by encouraging entry if it is efficient – is best achieved by setting costs on the basis of the current scale of supply. If the current scale of supply is broadly efficient, then current suppliers will be able to cover their costs and continuity of supply will not be threatened. However, if there are unexploited scale economies, then lower cost entry (or expansion by existing suppliers) will be encouraged by the scope to gain from the difference between the resulting allowed level of the interchange fee and the lower attainable level of costs. The level of the fee can then be adjusted (and indeed, if the costs of suppliers in the market are used as the basis for fee determination, will automatically adjust, albeit with a lag) as market forces reveal the efficient scale of supply. This is the essence of modern price cap regulation.<sup>9</sup>
- 44 In contrast, the RBA’s approach would likely ensure that current suppliers would not be able to cover their costs, while eliminating the margin that could attract larger scale entry.
- 45 Visa is unaware of any regulatory precedent for the RBA’s proposed approach. While regulators in some jurisdictions do seek to “optimise” the costs used in calculating allowed charges for regulated assets, this is almost invariably in the context of natural monopolies or of assets for which by-pass, though possible, is highly unlikely. Even then, that optimisation takes the scale of the activity as given, rather than seeking to make it an element of the optimisation process itself. Moreover, even those regulators that rely on optimisation have sought to ensure that the level of charges will incent efficient entry, if that is a feasible objective, rather than prejudging its extent and outcomes. The scope for periodic adjustments to allowed price levels is then used to prevent indefinite over-recovery, should entry or expansion reveal that costs can be lower than the initial cost base. Last but not least, any optimisation is invariably done on the basis of detailed cost studies, rather than by arbitrarily replacing the existing and observed cost basis by the costs incurred in supplying some different set of services.
- 46 Visa also does not accept the RBA’s contention that its proposed approach is desirable in the light of possible entry by MasterCard into the provision of a debit card. While the basis for this contention is unclear, it appears to rely on the view that the same fee should apply to both schemes (Consultation Document, at 36). However, that goal – with which Visa agrees – can be achieved by using the costs of current supply as the basis for setting the allowed fee for both schemes. Should MasterCard’s costs be higher than current costs (and not be offset by a quality of service differential), then doing so will discourage what would be inefficient entry; if they are lower, then efficient entry would be encouraged.

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<sup>9</sup> To reiterate, notwithstanding this discussion, price cap regulation is *not* appropriate in two-sided markets and, specifically, for card payment systems.

- 47 In short, Visa has serious reservations about the RBA's proposed approach to the definition of allowed cost base for the debit interchange fee standard. That approach risks making current supply uneconomic, without any clear evidence that that supply is inefficient. Additionally, far from encouraging efficient entry, it is more likely to compromise it, as it will remove some of the margin that an efficient entrant could hope to obtain. As a way of setting regulated prices, it is unprecedented in Australian experience.
- 48 Visa therefore believes that the eligible costs should be based on those of current Visa debit issuers and then adjusted at the subsequent review, should the base of supply have changed.

### 1.3 The Honour All Cards rule

- 49 Visa along with other card schemes in Australia and overseas has employed its Honour All Cards ("HAC") rule as a crucial element of developing a robust system that is open to a wide range of participants. Under the rule, all merchants who accept the Visa 'flag' must accept all Visa branded cards regardless of its issuer or the precise product.
- 50 The HAC rule has been pivotal in providing secure products, minimising search costs for consumers, reducing transactions costs associated in running the system and facilitating innovation. As such, it is fundamental to improving efficiency and to the competitiveness of the Visa system. It facilitates the entry and expansion of new issuers and new products, both of which would face start-up hurdles if the HAC rule did not operate. In turn, the rule has helped to underpin the growth of the card networks to the benefit of both cardholders and merchants.
- 51 The Consultation Paper focuses solely on the HAC rule as it pertains to different products, namely debit versus credit cards. The RBA's approach to the HAC rule appears based on three elements: the contention that rules such as the HAC are inconsistent with "normal competitive forces" and prevent "competition on the merits" (Consultation Document, at 41 and 43); the assertion that the recent Wal-Mart litigation in the US bears out that contention (Consultation Document, at 42); and finally, the presumption that the HAC rule could be removed with little cost to consumers, competition or efficiency.
- 52 In Visa's view, each of these premises is incorrect. Instead, the HAC rule has promoted competition and innovation; the Wal-Mart settlement is of no direct relevance to the situation in Australia given differences in circumstances and law; and the removal of the HAC rule would add significantly to the transactions costs associated with operating the system and, potentially, to consumers' search costs.

### 1.3.1 Consistency with normal competitive practice

- 53 The RBA never defines what it means by “normal competitive forces” or by “competition on the merits.” However, what is apparent is that the RBA believes that what it refers to as ‘tying’ is for some reason undesirable and undermines competition.
- 54 There is, in Visa’s view, no basis whatsoever for the RBA’s presumption. Even the joint *amicus* brief filed by US Department of Justice and the US Federal Trade Commission in the 3M/LePage litigation begins by noting that various forms of bundling and tying, and associated rebates or discounts, are pervasive in modern competitive markets. While they can be anti-competitive, there can be no presumption that they are so in most, much less all, instances, and any assessment of whether they are requires a detailed analysis of actual competitive effects. In the vast majority of cases, competition will be between alternative suppliers of more or less bundled or tied offerings, and that competition will not be distorted by the mere fact of the bundling or the tying.
- 55 Instead of hindering competition, the HAC rule in fact promotes competition and efficiency. By facilitating innovation, it enhances what all economists agree is the most potent form of competition – that is, dynamic competition, which centres on the development of new products and processes. Additionally and importantly, in the Australian context, the HAC rule has made it feasible for financial institutions that were precluded by legislation from providing credit facilities to enter the payment card market, through the supply of Visa debit, thus expanding consumer choice and the range of competing issuers of cards. The goal of competition has been advanced rather than obstructed by the HAC rule.
- 56 The RBA does not provide a comprehensive assessment of the effect that the HAC rule may have on competition. Rather, it relies on a series of partial or “practical” benchmarks (at p.9). The second of these benchmarks asserts that merchants should be “free to set prices for customers that promote the competitiveness of their business”. While superficially appealing, such a benchmark fails to recognise the economic and commercial benefits that bundling or tying of products will often create and thereby improve welfare. In fact, contemporary economic analysis suggests that tying and bundling are more likely to be beneficial than harmful.<sup>10</sup>
- 57 To the extent to which there could be any concerns with respect to the HAC rule, it would be if the rule allowed the imposing of too high charges on merchants by reducing their ability to not accept a particular type of Visa card. While Visa does not believe this claim has merit (and even if it did, any proper assessment of the consequences for competition would need to take account of the pro-competitive impacts noted above), any concerns it

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<sup>10</sup> See for example Cabral, L (2000), *Introduction to Industrial Organization*, MIT Press, Cambridge MA.

might give rise to higher merchant charges have in any event been rendered moot by the imposing of regulatory controls on the level of the relevant interchange fees and the fact that merchants are able to surcharge. Merchants are free to adjust the terms that they accept cards if they feel that the HAC rule may not suit their commercial objectives.

- 58 Finally, the reality that bundling and tying can improve social welfare is recognised in the implementation of competition policy in Australia in the context of the broader economy. In particular, under s. 47 of the Trade Practices Act, a tie such as that at issue here would only be a contravention if it had the purpose, effect or likely effect of substantially lessening competition. The RBA fails to analyse this fundamental issue and, as outlined above, Visa contends that there is no reason to believe that Visa's HAC rule has either the proscribed purpose, the proscribed effect or likely effect.

### 1.3.2 Implications of US litigation

- 59 Visa has already provided extensive material to the RBA which shows that it would be erroneous to infer, as the RBA does, that the Wal-Mart litigation demonstrates that the HAC rule is in any sense anti-competitive. While Visa USA decided to settle the case rather than risk damages at a level that would have endangered the viability of Visa's ongoing operations, it is important to stress that the case proceeded on anti-trust grounds that were significantly different from the regulatory and competition laws applicable in Australia.
- 60 Specifically, Visa has noted that US anti-trust law about product tying differs in important respects both from contemporary economic analysis and from competition law in Australia. While US tying law is in evolution, reflected for example in the Microsoft decision (United States v. Microsoft Corp. 253 F.3D 34 (D.C. CIR. 2001)), it remains the case that there is a *per se* rule against tying, with its illegality not depending on a finding of likely or actual competitive effects (International Salt Co. v. United States 332 U.S. 392 (1947)). As US Supreme Court Justice O'Connor, joined by Chief Justice Burger, Justice Powell and Justice Rehnquist, noted in an opinion in Jefferson Parish Hospital District No. 2 v. Hyde (466 U.S. 2 (1984)), the US tying doctrine "may be interpreted to prohibit arrangements that economic analysis would show to be beneficial".
- 61 This obvious contrast with contemporary economic analysis – which largely suggests that tying and bundling are more likely to be beneficial than harmful – also distinguishes US antitrust law from its Australian counterpart, which does not involve any presumption that tying, even when engaged in by a firm with a substantial market position, is anti-competitive. Accordingly, Visa believes that the RBA's reliance on the US litigation to draw inferences as to the economic consequences of the HAC rule is at best misleading.



### 1.3.3 Costs of removing the HAC rule

- 62 Finally, Visa does not accept the RBA's view that removal of the HAC rule would cause little harm to consumers or competition.
- 63 To the extent to which removal of the rule has any practical effects, those effects are likely to involve a substantial increase in transactions costs. Separate branding would be required and, depending on how merchants intend to use the ability to recognize debit cards electronically, support systems such as retailer electronic terminals and PIN pads may need modification. Acquirers and merchants would face an increase in the time and expense required to reach agreements, as negotiations come to deal not merely with a single set of cards but with credit and debit cards separately. The costs this entail will of course be passed on, resulting in higher prices for consumers. As far as consumers are concerned, if the removal of the rule does lead to merchants refusing to honour particular cards, this will inevitably cause higher search costs, as well as damage to the Visa brand. Again, Visa finds it difficult to see how the RBA can ignore or dismiss these costs without any careful attempt to quantify their amount.
- 64 Additionally, Visa repeats its view that the HAC rule provides important protection to smaller issuers, as these issuers disproportionately rely on issuing Visa debit cards. If removal of the HAC rule does have any effects, those effects are likely to weaken the smaller issuers, which seems more likely to harm than to promote competition.
- 65 It is incorrect to believe that these costs would be small, as merchants would only have incentives to refuse to accept a particular card if it was efficient for them to do so. Each merchant has an incentive to seek to free-ride on the services Visa, its issuers and acquirers provide. If a merchant can avoid making any contribution to the common costs of the supply of those services, it will do so. In a system in which there are some very powerful merchants, the likelihood is that attempts will be made to use monopsony power to drive payments to issuers below average costs, including by threatening to – and in some cases proceeding to – refuse to accept particular cards. The resulting bargaining costs are inefficient (as they merely involve attempts at securing transfers) and cannot contribute to any of the goals the RBA seeks to promote.

### 1.3.4 Conclusions on the HAC rule

- 66 Although the RBA says that it has a preference for evolutionary, rather than drastic, changes to existing arrangements, it proposes to remove the HAC rule without a careful analysis of the rule's effects. In Visa's view, these effects are to promote innovation, reduce transactions costs for consumers and suppliers, and encourage competition. Particularly given the imposing of controls on debit interchange, there is no clear way in which the rule's overall impacts could be harmful.

#### 1.4 Application of Rules to Three-Party Systems

- 67 In its Media Release of 24 February 2005 on Payments System Reform, the RBA argues that it is not appropriate to regulate the payments made to issuers by closed schemes (most notably American Express and Diners Club) as these payments, in its view, do not significantly affect merchant service fees.
- 68 The overriding principle should be one of competitive neutrality. In particular, Visa (and other open payment systems) should not be placed at a competitive disadvantage by regulatory intervention. Visa makes three comments in this respect.
- 69 To begin with, the RBA cannot properly limit its consideration of the desirability or otherwise of regulating open and closed systems on a competitively neutral basis to an assessment of the implications for merchant service fees. The Payment Systems (Regulation) Act calls for the RBA to consider the efficiency and competitive aspects of the payments system which, as outlined above, cannot be measured solely in terms of merchant service fees. The result of the RBA choosing to regulate only open card schemes is that the closed schemes are being advantaged by the RBA's intervention. The closed card schemes are making consequential commercial gains.
- 70 Visa cannot reconcile the inconsistency in approach inherent in the RBA stressing a concern about ensuring competition "on the merits" when it comes to Visa (see, for example, Consultation Document, at 43 – 44), but ignoring distortions to that competition caused by asymmetric application of its regulations. Such an approach is at odds with the goals of an efficient and competitive payments system set out in the relevant statutes and ignores Visa's legitimate commercial interests.
- 71 Second, in both open and closed payment schemes there is necessarily a transfer from the acquiring side of the business to the issuing side of a proportion of the merchant service fees collected from merchants. The RBA's argument that there is a difference between open and closed schemes in the relation of the interchange fee to the merchant service charge only holds true as a matter of terminology regarding this payment. In particular, Visa sees little merit in the claim that while interchange fees affect the level of the merchant service fee in open systems, that they do not do so in closed schemes.
- 72 Rather, there is, in both open and closed schemes, the same equilibrium relationship between the acquiring and issuing sides of the business calling for a transfer payment. Simply put, a higher interchange fee (in an open scheme) or a higher issuing fee (in a closed system) increases the number of card holders; in turn, that greater number of card holders makes it more attractive for merchants to accept cards at any given level of the merchant service fee. As a result, within a certain range, higher interchange fees/issuing

fees are associated with higher merchant service charges. This relationship holds in the same way for open and closed schemes alike.

- 73 That the relationship between interchange/issuing fees and merchant service fees is no different in closed schemes from that which prevails in open schemes can be seen by considering the impact on closed schemes of limiting the payments they could make to issuing institutions. Clearly, such a limitation would – on the RBA’s own logic (see Consultative Document, section 2.3.2 stressing the effect of payments to issuers on demand for cards) – affect the ability of closed schemes to induce affiliated issuers to more aggressively promote their cards. As a result, there would, over time, be fewer consumers holding cards issued by the closed schemes than would otherwise be the case. Given this, the closed schemes, to attract merchants, would have to reduce merchant service fees below the levels they could otherwise charge.
- 74 Visa therefore submits that the RBA’s assertion that restricting the payments closed schemes could make to issuers would not affect the level of merchant service fees is incorrect.
- 75 Third, Visa accepts that regulating the payments closed schemes could make to affiliated issuers would be an extensive and intrusive form of regulation. However, that merely reflects the fact that the RBA has chosen to apply a highly extensive and intrusive form of regulation to open schemes. Given that decision, competitive neutrality – which is essential to the goals of competitiveness and efficiency – requires that the closed schemes not be artificially favoured by the regulator.
- 76 In short, Visa believes that its legitimate commercial interests, and the competitiveness and efficiency of the payments system, are being harmed by continued asymmetric regulation. Visa does not believe that the arguments advanced by the RBA to justify perpetuating that harm have merit and urges the RBA to reconsider its position.



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