AUSTRALIAN RETAILERS ASSOCIATION

Working for Retail

Response to the VISA Card Submission

By

The Australian Retailers Association

September 2001

CONFIDENTIAL

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Introduction

As with most material that has been written on the subject to date, Visa's focus is understandably on the protection of its member's interests. Very little attention has been paid to the role of the retailer in the transaction process, and the costs that merchants incur in participating. In fact Visa claim that the retailer benefits significantly by accepting credit cards, and that it is economically responsible for the retailer to contribute significantly to the cost of the provision of credit cards.

The underlying argument presented by Visa in their report is that merchants benefit significantly from network effects, however in their report Visa are unable to provide statistical data to evidence their claims. Instead Visa relies on economic theory. The Australian Retailers Association (ARA) on the other hand has been able to access data that challenges Visa's claims of higher sales to merchants resulting from the acceptance of credit cards.

The following paper represents the ARA's response to the Visa submission to the Reserve Bank of Australia dated January 2001.

Australian Retailers Association

The Australian Retailers Association, and its component state associations, represents some 12,000 members across the nation operating 40,000 stores and employing around 640,000 Australians (or about 70% of employees in the retail work force).

The retail industry is the nation's largest employing industry with -

- one in every eight of the nation's work force,
- one in every five female employees and,
- one in every two employees aged between 15 and 20 years.

ARA members, which range from the smallest independent retail shop and the variety of specialty retailers - both chain and independent - to the major national supermarket and department store groups, transact around 70% of the nation's retail sales.

Approximately 95% of the Association's members are small businesses (i.e. employing less than 20 staff) operating in only one State.

The Association's mission is:

"To be the pre-eminent, cohesive, nationwide organisation which is recognised as representing the diverse interests of all retailers and is the most effective provider of quality information and services to members which fosters an environment conducive to their business success."

The competitive nature of the retail industry is highlighted in the Productivity Commission Staff Research Paper "Productivity in Australia's Wholesale and Retail Trade", October 2000, which found that the wholesale and retail sector "appears to be, on the basis of industry profit margins, highly competitive" and that the percentage of operating income available as operating profit was 3.4% in the retail industry. The retail industry has generally embraced technological change such as scanning and computerisation, and changed management systems all of which has lead to enhanced retail productivity. The Productivity Commission noted that the retail industry has pursued productivity improvements, "with competition as the catalyst and technology the enabler".

1. Open Competition

In its report Visa claims that the card payments market is open to free competition. The ARA believes that the competitiveness of the card payment industry can be questioned on a number of levels.

By the very existence of card association rules that establish the composition of the credit card industry and its operations, barriers to entry are created that prohibit a truly competitive market. Common stakeholders that exist within the card associations prevent the sharing of the current structure with responsible non-financial institutions, as well as ensuring the associations act with only the interests of members in mind. These factors highlight the failure of the existing market to be truly competitive.

In the current Anti-Trust case in the United States involving Visa and MasterCard the issue of common stakeholders and its consequences has been well documented. In terms of the domestic market it is unlikely that common Board membership between major retail companies in the Australian retail industry would be considered acceptable due to the potential negative competition implications for consumers and other retailers. Whilst this analogy is obviously quite hypothetical, this scenario is not that different to what the card associations have been able to operate under.

The distribution network (based on the comprehensive merchant network) is a substantial barrier for new entrants. The comprehensive extent of the network, coupled with the lack of transparency of costs to consumers of the credit card programs, means that consumers have no desire to seek alternatives. Therefore this establishes a very substantial barrier to entry.

Another example of limited competition is illustrated by retailers having effectively little ability to negotiate the fees if they want to accept credit cards due to the fees being effectively supported by a floor (interchange fees). Transactional volumes have continued to grow over the years and electronic processing has delivered efficiencies. Despite this the interchange fee structure has changed little, illustrating retailers' lack of negotiating power.

2. Value vs Price

Visa's statement that no agent can face a price that exceeds the value it receives from the service is also based on erroneous assumptions.

The assumption made by Visa is that merchants receive additional benefits in the form of more sales and sales of higher value by accepting credit cards. At this point it is helpful to distinguish between a positive benefit and a defensive action. A positive benefit is one that builds or increases business. A defensive action maintains or protects the business or the current customer base.

Retailers are driven by the needs of customers, and therefore when growing businesses, or maintaining a current customer base, the needs and requirements of the customer must be met by the retailer. If this is not the case, then that customer will be lost to the competitor that offers the desired service. The acceptance of credit cards by merchants in fact becomes a defensive action because the absence of credit cards would seriously erode the current customer base. Widespread acceptance of credit cards by retailers means that growth in sales will largely be derived from the merchandise offer, quality of service and price of merchandise.

In this way the retailer is captive to the card associations. It is easier for the retailer to accept the price charged for credit cards due to the relatively similar cost of credit cards for all retailers. This is regardless of whether there is a positive sales benefit or whether it is a defensive action, in preference to the risk of losing that customer to a competitor.

The issue regarding the captivity of retailers, and the general meaning of competition for markets as a whole was addressed by Mr Schwarz, chief litigator for the Justice Department in the Anti Trust case in the United States. In that case Mr Schwarz explained "Sometimes you're forced to do things you don't want to because your competitor is doing it.'[1] This same reasoning can be applied to retailers accepting credit cards even though they carry a high cost. Competitors accept credit cards, so to remain competitive, other retailers must also accept credit cards regardless of the high cost of doing so.

From the consumer's perspective, they are oblivious to the true cost of the transaction and so are misled to use the product. An open and transparent pricing mechanism would discourage use by consumers, or would make consumers more aware of the consequences of their payment decision.

The ARA would contend that consumers perceive credit cards as being of high value with little cost, when in fact credit cards carry high "hidden" costs.

3. The Credit Card Transaction

The Visa report fails to provide a definition of the credit card, and fails to identify the functionality of the credit card. Instead the report focuses on an attack of the RBA Joint Study, and in doing so ignores fundamental differences in the way a credit card may be used by consumers. The identification of the differences in the way a credit card may be used is crucial when examining the impact of interchange fees on both retailers and consumers, and in fact when examining the validity of an interchange regime.

[1] "Visa / MC Suit: Still Waiting and Guessing", Lee, W.W., American banker.com, 30 April 2001.

The credit card, when originally offered to consumers, was intended to represent a convenient source of short-term finance. Enhancement of this original functionality through the introduction of loyalty programs, and the evolution of various consumer financial packages (for example home equity loans with an attached credit card) has seen the credit card evolve into a payment card with functionality not dissimilar to a debit card. However despite the similarity in functionality, the pricing of transactions to both cardholders and merchants is significantly different.

The Visa report does not attempt to distinguish between the two types of credit card users - transactors and revolvers. This is an important omission from the report since there are significant-differences between the two types of credit card users, and there are significant implications for the operations and pricing of the card system dependent upon how the credit card is used. Perhaps a major flaw of the current payments system is that it fails to distinguish between the two types of credit card users, and to adjust the pricing mechanism accordingly.

The importance of this distinction was highlighted in a report prepared by Merrill Lynch. According to that report, in December 1999 just less than half total system outstanding debt was interest bearing.[2] This statistic highlights the growing use of the credit card as a payment instrument rather than as a source of short-term finance, and the growth of transactors as credit card users. This reduction in the use of the credit card as a revolving source of credit means that financial institutions are now more reliant on the merchant service fee/interchange fee income to compensate for the falling income.

The transactor ensures that their credit card balance is repaid prior to the required date, and so does not make use of the available line of credit. The aim of the transactor is to use the credit card as a payment card, and to thereby earn loyalty points, as well as making use of the interest free period. Therefore it does not follow that the transactor will contribute to incremental sales to retailers as stated by Visa in numerous sections of their report. Rather it illustrates the ability of marketing to influence the payment decision of consumers by offering rewards.

The second type of credit card user is the revolver. In this case the consumer takes advantage of the line of credit attached to their credit card, and uses the credit card as a source of short-term finance. Again while the ARA does acknowledge that some additional sales may be achieved by the offer of the acceptance of credit cards, this does not mean that all sales are incremental sales. Some of the purchases by the consumer may be brought forward, and may not in fact be incremental to the retailer.

[2] "Credit Cards - An Ace Up The Sleeve", Merrill Lynch, 14 April 2000

As revolvers revolve, a greater part of their disposable income contributes towards the payment of interest. Therefore over time, their retail spend using cards must in fact decrease as their credit limit is reached, or they establish a self imposed credit limit, and their disposable income is used to repay interest, and eventually principal. In this event, future purchases are arguably delayed, as interest on outstanding debt must be met. This would then have the effect of eroding benefits for cardholders and introducing negative consequences for merchants. Cardholders must spend less in the future to facilitate the repayment of debt obligations whilst retail sales to merchants will fall as consumers decrease spending as they instead repay debt.

The revolving consumer, at some stage, is required to repay their credit card debt. This further challenges the claim by Visa that credit cards result in incremental spend, and incremental sales to retailers, and further challenges the reasoning behind the requirement for retailers to fund this form of lending.

4. Incremental Sales vs Behavioural Benefits

The basic premise behind the Visa report is that credit cards provide retailers with incremental sales. As discussed above, distinction between the two types of credit card users helps to determine between whether or not incremental sales follow from the use of credit cards. Again as previously stated, the ARA acknowledges that there are some benefits to accepting credit cards, however the ARA would challenge the reasoning of Visa when categorically saying credit cards produce incremental sales.

The real benefit to retailers and a substantial benefit also for banks, from credit cards is the value of the communications channel, more so than the assumption that the credit card provides retailers with incremental sales. At the retail level, the credit card can have a powerful influence on the customer's behavioural pattern in terms of deciding between payment methods. From the bank's perspective, the credit card provides a valuable database from which other banking products can be cross-marketed.

This is the prime motivation behind retailers offering store cards. Store cards can provide strong and effective communication channels that can stimulate sales, but passive acceptance of third party cards do not. If a retailer promotes in conjunction with 3rd party issuers, then this can drive sales, but this is fundamentally as a result of using a credit card as a marketing tool, not purely because of the available credit itself. Therefore the costs of the provision of credit should be met by the provider and beneficiary of the credit and should not be a cost of those accepting the credit card as payment.

Who are the beneficiaries and who bears the costs is addressed in Appendix I.

5. Network Effects

Visa, in their report, argue that the more consumers accept and use credit cards, the greater the benefits to merchants from more sales, and from sales of higher value. This is the benefit that arises to merchants as a result of 'network effects'. According to Visa these benefits arise from:

- the activities of card issuers in promoting cards through the use of loyalty programs to encourage more cardholders to accept and use credit cards
- as the number of cardholders increase, so to will the incremental sales to merchants
- the characteristics of credit cards such as the interest free period and loyalty programs encourage more sales, and sales of higher value

Visa claims that by accepting credit cards, merchants are able to make more sales that they otherwise would not make. Confidential statistics made available to the RBA indicate however, that a shift in payment type has occurred, and that credit card sales have merely replaced other payment types.

6. Mature Network

Visa, contrary to the beliefs of the RBA and ACCC as documented in their report, claim that the credit card network in Australia is not mature, and that in fact is still experiencing strong growth.[3] It can be demonstrated however, that this growth is basically a switch in payment types and an increase in the use of credit cards. The Joint Study on the other hand refers to the payments network as being a mature network, and that an interchange fee regime is only relevant to encourage a developing network to reach its optimal participation. The ARA agrees with this analysis.

Visa claims that the Joint Study's analysis does not comprehensively establish that credit card networks are mature. Visa refers to market maturity in terms of 'product life cycle' and 'market saturation'.

The penetration or acceptance of an item in a market is an indicator of the maturity of that market. By way of example in the Australian retail market, the penetration of credit card acceptance in the grocery market is considered. According to AC Nielsen, the following table illustrates the allocation of market share in the Australian grocery market.

[3] "Credit Card Schemes in Australia", Network Economics Consulting Group Pty Limited, January 2001, pg 12

Table 1. Australian Grocery Market	
	Year end 2000
Woolworths	37.2
Coles	33.3
Franklins	11.9
AAW	15.6
Others	2.0
Source: AC Nielsen	

The market share of the Australian grocery market was, until recently characterised by 4 main supermarket chains - Woolworths, Coles Supermarkets (including BiLo, Newmart and Pick n Pay), Franklins and AAW. Together these four grocery retailers accounted for 98 percent of the grocery market share in 2000.

Each one of these retailers accepts credit cards as payment for merchandise, and it could also be assumed that a proportion of retailers in the 'Other' category would also accept credit cards (convenience stores, petrol stations etc). Therefore at least 98% of the grocery market in Australia accepts credit cards as payment, and probably more. However according to Visa's arguments unless 100 percent of retailers accept credit cards then the market cannot be classified as mature.

In this case Visa's argument is misleading. The 'Other' category represents a minimal percentage of the total grocery market. In terms of 'network effects, if merchants in the 'Other category that did not already accept credit cards began to accept credit cards, the benefits derived by all merchants and cardholders would be minimal at best, since those merchants represent such a small percentage of the market. For the overwhelming majority of consumers, their perception would be that all supermarkets accept credit cards.

Visa also refers to 'product life cycle' as a measure of the maturity of a product. As stated by Visa in their analysis, the credit card is experiencing a strong growth phase. This is primarily due to the new applications for the use of credit cards as a payment type such as for the payment of utility bills over the phone, Internet transactions, telephone transactions and so forth, replacing the traditional payment methods (cash and cheques). However these new applications are created by users chasing loyalty points, and in many instances the credit card is the only payment option made available for some of those new applications or the only payment method available to pay these accounts by phone or over the internet. For example, the ARA's survey (ARA Member Survey November 2000) revealed that many online computer software and hardware retailers only accept credit cards.

Growth statistics may be distorted because of the inability of consumers to use alternative payment types, and also as a result of changing tender patterns. Therefore to refute the claim that the industry is mature based on the growth in the use of the credit card is incorrect. A lack of desirable customer payment alternatives guarantees credit card growth.

7. Average Transaction Values

Visa's analysis concludes that credit cards deliver incremental sales to retailers and that credit card transactions are of a higher value than other transaction types. Such claims seem to be based on broad industry data, which ignores customer behavioural factors, and structural factors that apply to different tender types. Confidential information gathered from ARA members and provided to the RBA indicates a different conclusion.

More transactions of lower value are paid for using debit cards than credit cards. This would be at least partly due to the 'cash-out' facility offered with debit cards, whereby customers often make a small purchase when getting cash-outs. This behaviour tends to lower the average value of debit card transactions.

In contrast to low value transactions, transactions of higher value are dominated by credit cards as the preferred tender method. This behaviour can be partially explained by the limits placed on debit card withdrawals as consumers are constrained from using debit cards for higher value purchases because of daily withdrawal limits imposed by the banks. Therefore there is a distortion in the average transaction value where credit cards are used for these higher value transactions.

Summary

The Visa report, understandably given the revenue flows at stake, staunchly defends the interchange regime using economic theory and subjective argument. However without empirical data to defend their claims of purported benefits to merchants of increased sales and sales values from the acceptance of credit cards, their arguments have little basis in the current market place.

The ARA has been able to source real statistical data and has been able to identify from this data behavioural factors in spending patterns and restrictions on consumer choices that influence overall average transaction values which fundamentally refutes Visa's claims of higher transaction values.

The ARA would also point out the lack of economic rationale available to Visa to defend other anomalies in the credit card payments system. Anomalies such as the higher interchange rates on card not present transactions, Visa debit transactions, which attract merchant service fees and the occurrence of "double dipping" in terms of cost recovery from cardholders and merchants.

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Appendix I

Credit Cards – who benefits and who bears the cost

Introduction

The Australian Retailers Association ("ARA") has sought to identify the costs and benefits that accrue to both consumers and retailers from the use of credit cards. It is important to understand who the main beneficiaries are from the use of credit cards, and to compare this against those parties bearing the costs.

Who the beneficiaries are and who bears the costs

a) Consumer Benefits

Consumers benefit from the convenience offered by credit cards. Because credit cards are accepted virtually universally by all merchants, and can be used for nearly all forms of payment, from paying utility bills to purchases on the Internet, the need to obtain cash or to use cheques to facilitate payments is reduced.

Financial institutions also promote credit cards as a means of avoiding transaction fees, allowing consumers to minimise their cost of banking.

Most credit cards feature loyalty programs enabling some users to gain significant benefits.

The consumer further benefits from the use of credit cards by receiving all purchases itemised on a monthly statement. This provides the consumer with a consolidated record of transactions, requiring only one monthly payment.

The credit facility also allows customers to better manage their cash flows without necessarily having to draw down on a loan facility.

Credit cards therefore offer many and substantial benefits to consumers.

b) Consumer Costs

Consumers pay very little directly in the way of fees and charges for credit cards. Some consumers are required to pay an annual fee. Where consumers choose to borrow funds, interest will be payable on the outstanding amount. Where the card holder is able to redeem loyalty points, and where the value of those loyalty points is greater than any fees payable by the cardholder, there may in fact be a negative cost to the cardholder. That is, the cardholder is in fact financially rewarded to use their credit card in preference to other payment methods.

However all consumers pay indirectly for the use of credit cards through higher prices that are charged by retailers to recover the MSFs levied by financial institutions. This leads to inequity for consumers as credit card users are being subsidised by non-credit card users through the averaging effect of higher prices, irrespective of the method of tender used.

c) Retailer Benefits

In the early stages of the development of the credit card network, acceptance of credit cards offered merchants a competitive advantage. By offering an additional payment alternative to consumers, merchants were potentially able to attract new customers and hence the potential for additional sales. Therefore it could be said that initially credit cards encouraged consumers to increase their spend, initially providing retailers with incremental sales.

However the market has changed dramatically and the credit card has evolved into a different product (payment card) from the one originally offered to consumers. Retailers can no longer gain a competitive advantage by offering the acceptance of credit cards as a payment type. In fact it is a disadvantage for retailers not to accept credit cards due to the potential loss of sales to other retailers.

It is often argued that credit card acceptance has benefited retailers who did not provide credit to their customers by enabling them to do so. Similarly it is argued that for those merchants that did provide credit, credit card acceptance has allowed them to substitute credit funded by financial institutions for credit they were previously funding themselves. However the continued presence of store cards indicates that the benefits of maintaining a card base, including the opportunity to maintain direct marketing relationships with cardholders, outweighs any additional costs. This point illustrates the value of credit card customer databases.

The principle benefit of credit cards to retailers is that of a payment tender option for customers. Similar to cash, cheque and debit cards, acceptance of credit cards is necessary to facilitate the retailing of goods and services.

d) Retailer Costs

Retailers are not significant beneficiaries of credit cards to the extent that consumers and financial institutions are. However, retailers play a significant role in the operation of the electronic payments network, and in particular in the processing and collecting of data associated with credit card transactions.

Retailers incur costs in the capturing and processing of transactions (either by providing infrastructure or renting it from a financial institution), yet the retailer must also pay fees to financial institutions in the form of the merchant service fee.

Some larger retailers have invested significantly in the development of streamlined and efficient point of sale processing systems. Those retailers recognised that they could capture data and process that data at point of sale in a more efficient manner than financial institutions, and so developed their own systems. This includes providing the facility to authorise each transaction with the card issuer, enabling them to manage their credit risk. In all discussions and debates to date there has been very little recognition of this investment by retailers.

In addition to infrastructure and network costs, retailers incur point of sale processing costs that are not recognised in the interchange fee regime. These costs include the time associated with the capture and processing of transaction data by the point of sale operator. Whilst institution's staff costs are usually included in the credit card cost analysis, retailer's staff costs are not.

The retailer is also in effect the facilitator for the lending institution in the offering of a loan product to the cardholder at the point of sale, and facilitates the draw down of the facility. Again these services are not acknowledged in the current credit card arrangements, unlike other loan products where referrals usually earn a commission.

Summary

The above discussion highlights the significant costs incurred by retailers in the acceptance of credit cards, and the marginal benefits that they derive from doing so. On the other hand, consumers are significant beneficiaries, yet pay very little directly for the use of credit cards.

Discussion thus far has not recognised the significant costs incurred by retailers in the capture and processing of credit card transactions on behalf of consumers and financial institutions. Reform of the credit card payments system should recognise these contributions made by retailers.

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Motor Trades Association of Australia

Dr John Veale
Head of Payments Policy
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

Dear Dr Veale

I write to you to support the submission of the Australian Retailers Association (ARA) to the inquiry into Credit Card Schemes in Australia.

The Motor Trades Association of Australia (MTAA) is the peak body for the retail motor trades in Australia. Retail motor traders (vehicle dealers, service station operators, automotive body repairers, engine reconditioners and so on) are among those retail businesses affected adversely by the current system of interchange fees and merchant service fees. MTAA believes with the ARA that these fee arrangements are exploitative of retailers and significantly weaken profit margins. The level of fees is not established according to the actual costs of transactions but simply as a profit making venture by the credit card issuers.

MTAA supports the ARA's proposals to reform the credit card system to make fees reflect actual costs and to remove the burden of unfair fee arrangements from retailers.

Yours sincerely

Michael Delaney
Executive Director
12 October 2001

WOOLWORTHS LIMITED
A.C.N. 000 014 675

12 October 2001

Mr John Veale
Head of Payments Policy Department
Reserve Bank of Australia
GPO Box 3947
SYDNEY NSW 2001

Dear John

Re: Australian Retailers Association – Submission to the RBA, Credit Card Schemes in Australia.

This letter is to confirm Woolworths full support of the A.R.A's submission to the R.B.A., titled 'Credit Card Schemes in Australia'.

Woolworths was an active and financial contributor towards the submission. Our strong belief is that the issues raised and the recommendation put forward in the submission be aired for public debate.

Yours sincerely

Mark Kelly
National Banking Manager
Woolworths Limited

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