EFTPOS REFORM

Submission to the EFTPOS Industry Working Group

September 2002

Coles Myer Limited

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Introduction

The Australian EFTPOS network is an efficient and secure payments network that has developed in part because of the involvement, participation and acceptance of retailers in developing and maintaining the system, and has been described by the Reserve Bank of Australia ("RBA") in their consultation document as a 'world class' payments system. [1]

The current network offers a low cost payments system when compared to other payment systems, particularly the current credit card payments system. Abolishing interchange fees, or reversing them so that card issuers are paid a fee (as possible options for reform proposed in the options paper as presented by the EFTPOS Industry Working Group ("EIWG")), will only increase the cost of the system from the perspective of all merchants, and ultimately increase prices of goods and services for all consumers.

We are also concerned that the changes proposed by the EIWG are likely to reduce incentives for new acquirers to enter the market and for current market participants to continue to develop and upgrade the network, thereby threatening the sustainability and advantages of the current system.

The fee structure of the debit card network recognises the contributions of those who have invested and developed the network which has lead to the development of a nation wide highly secure, efficient payments system.

This submission critiques the options paper and will highlight a number of issues that the options paper fails to discuss. The submission will also outline the rationale of the current EFTPOS model, in particular the directional flow of fees in that model, and show it to be the most appropriate model to benefit all stakeholders.

[1] "Reform of Credit Card Schemes in Australia – A Consultation Document", Reserve Bank of Australia, December 2001, pg 1.

The proposed reforms outlined in the options paper also do not adequately address the issues of access to the EFTPOS network. Open access to the network, for both new card issuers and new card acquirers, is about more than just interchange pricing.

Part One - Background

1.1 History of EFTPOS / Debit Cards

Technological advances facilitated the offering of financial services outside of normal banking hours through the introduction of the Automatic Teller Machine ("ATM"). The debit card was the means by which financial institutions enabled their customers to access and to utilise the service.

The ATM network was developed based on the payment of fees to the network owners. This fee, which is still charged today, is based on the economic principle of 'user-pays'. Whilst some may argue that current ATM charges may not be accurately reflective of the costs involved in the provision of the service, the directional flow of fees rewards the contributions of owners of the network. The current ATM model and the associated directional flow of fees have proven worldwide to be a most efficient model to establish and maintain these types of networks. To some degree all participants in the network contribute to the costs of operating and maintaining the system.

Reform of the ATM network, as suggested by the RBA in the joint study, would see the directional flow of fees remain, so that the ATM owner is paid a fee by those accessing the network. This is consistent with the directional flow of fees for EFTPOS transactions, where those parties accessing the network pay the network owner a fee.

As a further development of electronic services, the EFTPOS network emerged, facilitating access to customers' bank accounts to enable payment for the purchase of goods and services, and the offering of cash-out facilities at the point-of-sale by retailers. The EFTPOS system in Australia is based on the ATM model where the owner of the network is paid a fee.

In this process the banks recognised the similarities between ATMs and EFTPOS services, where the network owner should be rewarded for their investment and participation in the network by receiving a fee from those parties accessing their network. The banks recognised that to encourage acquirer and retailer participation in the system, the fee structure that best encouraged this was the ATM model where the costs of operating and maintaining the network are shared amongst the participants.

The willingness of acquirers and some retailers to develop the EFTPOS system to meet the needs of customers, and the subsequent acceptance of debit cards by consumers as a payment instrument, led to the rapid growth in the use of debit cards (although credit cards have emerged as the favoured payment type due to the growth of loyalty programs). A majority of retailers now accept debit cards as a payment method, and virtually all financial institutions offer their customers access to their funds via the EFTPOS and ATM networks across Australia.

Sharing in the benefits of the debit card network has been critical to the success of the network. The debit card network is a good example of where the benefits of the system can be shared amongst all participants and not just the banks, and where this ensures the continued development and acceptance of the network. The banks also recognised that the development of a debit card network was a cost-effective way for them to reduce their channel costs. As retailers began to offer EFTPOS facilities, and began to offer the option of 'cash-out', banks were able to reduce their costly branch networks, and hence reduce their operating costs.

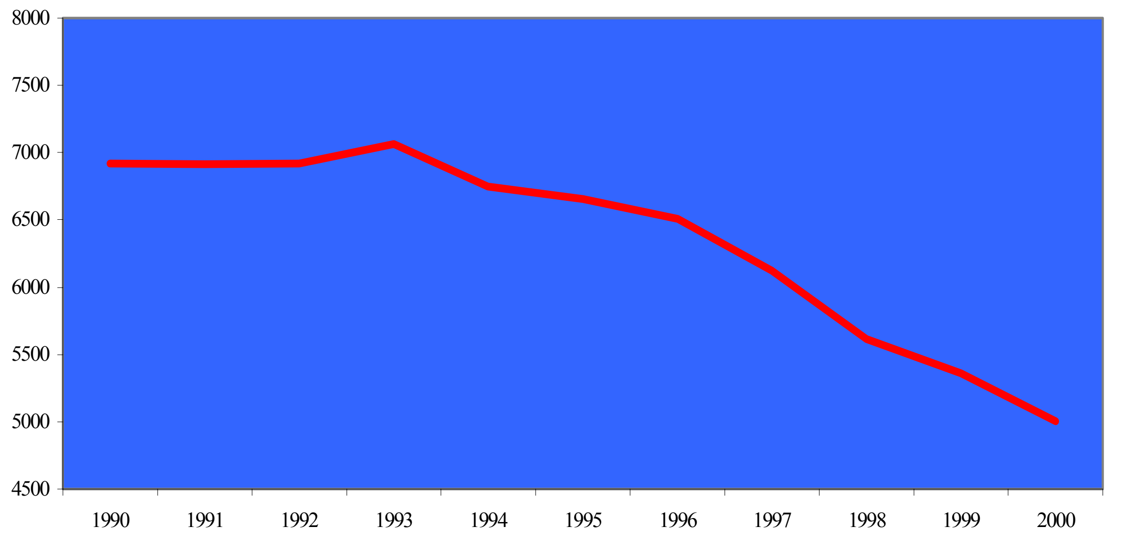
However the introduction of loyalty programs associated with credit card use in the mid 1990s, coupled with the fact that consumers do not incur transaction fees for credit card transactions, has seen the use of debit cards peak. Credit cards have now become the consumers' preferred payment method over and above debit cards, although to some extent the rapid expansion of the electronic credit card transaction processing was only made possible because of the development of the debit card network.

1.2 Access to Financial Services

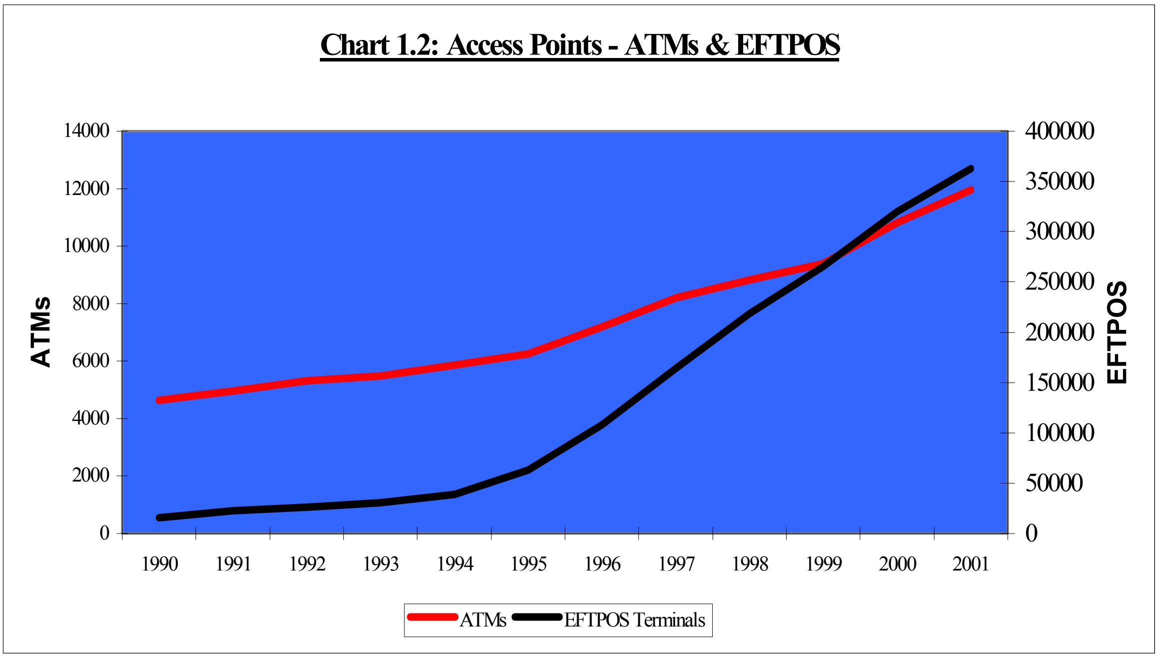
Technological advances have also led to a significant decrease in the size of bank branch networks, and an increase in the use of electronic banking services such as ATMs, EFTPOS and the Internet, which may involve parties other than financial institutions.

It is important to recognise these other points of access to the payments system. A key argument of retailers is that their increased involvement in the payments process, which has gone largely unrecognised to date, must be acknowledged by the banks. Chart 1.1 illustrates that the banks have been able to significantly reduce the number of physical branches they operate, and hence they have been able to reduce significantly their costs of operation. In contrast to these statistics the number of

Chart 1.1: Access Points - Bank Branches



ATM and EFTPOS facilities available to consumers have grown significantly. Chart 1.2 shows the growth in these alternative electronic networks and alternative points of access to cash at the same time that the banks have been reducing their number of branches. This growth would not have been possible if retailers and acquirers did not invest, support and participate in the EFTPOS network.



This investment has been encouraged by a fee structure that recognises that card issuers should contribute to the costs of network owners via an access fee or an interchange fee. Coles Myer would also point out that this is also a key element of encouraging new card acquirers to the network, as these fees would also recognise their investment in the network.

It is most doubtful that if the current fee structure were changed, retailers and card acquirers would provide the same level of support for the system, in terms of security, maintenance and development. It is also doubtful whether any new debit card acquirer would enter the market.

The growth in the number of EFTPOS terminals available to consumers over the past decade as illustrated in chart 1.2, also highlights the changing role of the retailer. The retailer is now an important provider of financial services on behalf of financial institutions. Retailing has become an important distribution channel through which financial institutions are significant beneficiaries. The provision of this service should therefore be recognised in the fee structure of the network, as the current fee regime does to some extent.

The topic of access to financial services by consumers is a key argument of retailers in the context of a review of EFTPOS interchange fees. The nation wide EFTPOS & ATM networks have enabled many financial institutions, particularly smaller institutions, to offer services well beyond the geographic reach of their branch network, which has in turn enabled them to better compete with major banks. It is the card acquirer, and in some cases the retailer, that provides the infrastructure that enables the card issuer's customer to access their funds. For the provision of these services that facilitates access to consumers' funds, a fee payable by the card issuer represents a valid and logical contribution by issuers to the continual development of the EFTPOS and ATM environment.

1.3 Credit Card / Debit Card Cost Comparison

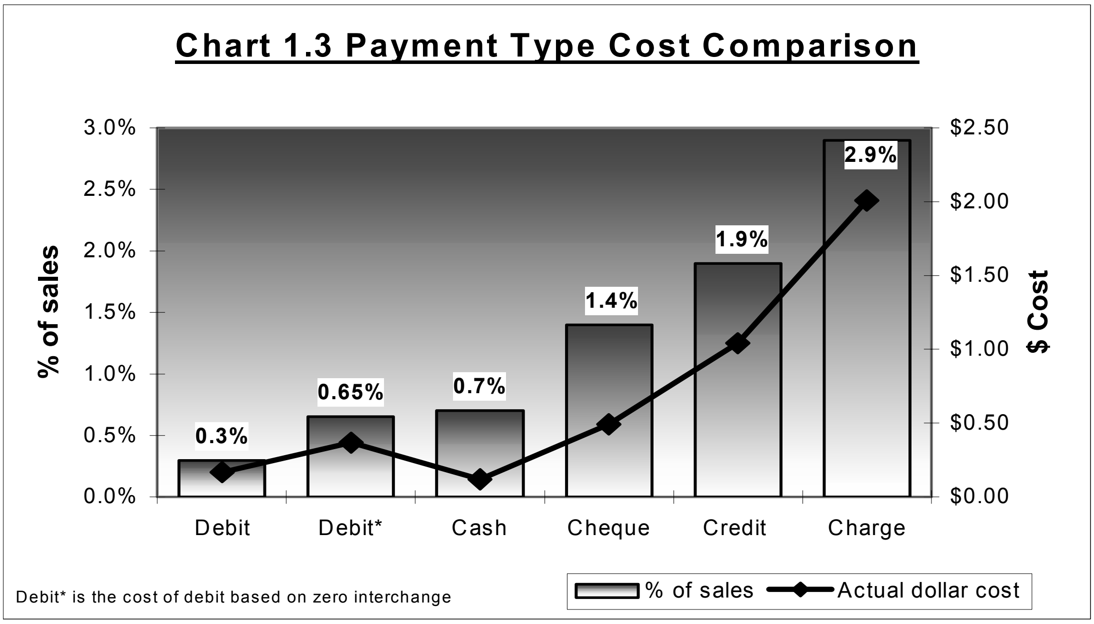
A comparison of costs between credit cards and debit cards indicates that on average, a credit card transaction costs a merchant $1.04 to process compared to a debit card transaction which costs a merchant on average $0.17[2], illustrating the low cost of the debit card network. As a percentage of sales, a debit card transaction costs a merchant 0.3% compared with 1.9% for credit cards. The fees that are payable for EFTPOS transactions are also more representative of the cost of the transactions. Chart 1.3 illustrates the cost comparison, as well as illustrating the impact proposed reforms will have on the cost of transaction types for merchants.

Significantly, the cost of debit card transactions will increase substantially to be more in line with the cost of cash.

Proposed reform of the debit card network and the fees that flow within that network, will result in an increase in costs to merchants, which will ultimately result in an increase in the prices paid for goods and services by all consumers.

The debit card system is already a lower cost payments system than all other major payment types, and reform will only increase merchant costs.

[2] "Submission to the Reserve Bank of Australia, Credit Card Schemes in Australia", The Australian Retailers Association



Source: Australian Retailers Association, Submission to the Reserve Bank of Australia, Credit Card Schemes in Australia.

The current structure of the EFTPOS system provides a low cost, transparent payments system compared with cash and credit cards. To illustrate, Table 1 below shows the cost incurred by the three parties involved in transactions for the three forms of payment – cash, debit and credit card.

Table 1. Transaction cost comparison.

	Acquiring Bank	Issuing Bank	Retailer	Customer
Cash			$0.12[a]	$0.50 - $2.75 for access (see below)
Debit	($0.06)[b]	$0.16[c]	$0.17[d]	$0.20[e]
Credit	($0.29)[f]	($0.76)[g]	$1.78[h]	Revolvers $1.64[1] Transactors $0.10[i]

a. Australian Retailers Association

b. RBA joint study page 65, represents the margin between costs and revenue

c. RBA joint study page 65, represents the interchange fees paid to card acquirers less fees received from account holders.

d. Australian Retailers Association

e. RBA joint study, page 65

f. RBA joint study page 46, $0.29 represents the margin between costs and revenues

g. RBA joint study page 44, $0.76 represents the margin between costs and revenues

h. RBA joint study page 45, represents the weighted average MSF charged to merchants

i. Macquarie Research Equities, "Credit cards – it's déjà vu", June 2002

* Note CML is not in a position to comment on the cost of cash to financial institutions.

From a consumer point of view, the cost of using credit cards varies depending on whether they are transactors (pay their credit card bills at the end of each month) or revolvers (incur interest charges).

On average the cost of using debit is only $0.20.

Arguably the cost of cash to consumers needs to be assessed by reference to the various bank fees that are charged according to the methods by which they choose to access their cash. The following is a list of those charges:

Over the counter withdrawals	$2.75
Own bank's ATM	$0.65
Other bank's ATM	$1.40
EFTPOS	$0.50

(These fees may apply to one or multiple transactions)

From a consumer point of view EFTPOS is a cost efficient alternative to revolving credit card debt and cash.

Clearly if the payment of fees to acquirers for debit card transactions were removed, the retailer would be required to pay higher fees for EFTPOS transactions, which would ultimately be passed on to the consumer in the form of higher prices.

1.4 Economic Principles and EFTPOS

The following economic principles, upon which the current EFTPOS network is based, are consistent with the economic principles outlined by the RBA in relation to credit card reform. In relation to credit cards, the RBA has stated that reform should provide for an objective, transparent and cost based fee structure. The objective of the RBA's credit card reforms is to "…promote efficiency in the Australian payments system and enhance community welfare…"[3] These objectives should also be applied to the debit card network in Australia. Proposed reform will create a structure that is in fact inconsistent with the RBA's stated reform objectives.

Acquirers are not only providing services to merchants, they are also providing services to card issuers. For a network service to be economically sound, that system must have a balanced fee structure.

1.4.1 User Pays

The current EFTPOS system is representative of the economic principle of 'user pays'. As previously noted, it follows the same principle as ATM networks where the operators of the networks are paid a fee by those institutions whose customers are using the network.

Therefore, in the case of EFTPOS transactions, large retailers such as Coles Myer that own and operate their own networks, and perform the functions of an acquirer, are paid a fee by those institutions accessing and utilising that network.

Smaller retailers on the other hand, rent equipment from card acquirers, and therefore pay for the services that they utilise by way of rental fees, and flat, low EFTPOS merchant fees.

The Australian debit card system is also analogous to other network arrangements such as the Australian telephone network. Telstra owns the network, and if Optus or

[3] "Reform of Credit Card Schemes in Australia IV, Final Reforms and Regulation Impact Statement, August 2002, Reserve Bank of Australia, page 9

any other party wants to gain access to that network, they must pay an access fee to Telstra.

It is difficult to see how any network owner could operate a network without charging fees to access it, unless you are both an issuer and an acquirer and derive benefit from both sides of the transaction.

1.4.2 Equitable

The Australian debit card system is an equitable system, whereby the contributions of all parties to the transaction are recognised. Retailers, along with acquirers, have been key participants in the ongoing operation, development and maintenance of the network, and the payment of fees to these parties is incentive to continue the maintenance of a secure and efficient system. Whilst smaller retailers typically do not receive a fee for EFTPOS transactions, their merchant fees are lower to the extent that issuers contribute part of the cost through the interchange paid to the smaller retailer's acquirer.

1.4.3 Reflective of Cost

The fees charged to consumers for EFTPOS transactions are more closely reflective of cost than credit card transactions. In the RBA's Impact Statement, it was stated that consumers using a debit card pay a fee of around $0.50, compared with an average cost incurred in providing those services of about $0.41[4].

[4] "Reform of Credit Card Schemes in Australia IV, Final Reforms and Regulation Impact Statement, August 2002, Reserve Bank of Australia, page 3

Part Two - Critique of the Options Paper

2.1 Perceived Problems with EFTPOS Interchange Arrangements

The options paper suggests there are a number of perceived problems with the current EFTPOS interchange arrangements. The following section looks at each of these perceived problems and offers CML's comments:

"Fees set through bilateral contracts have been rigid and appear to lack flexibility to change."

CML would argue that the bilateral negotiation of EFTPOS interchange fees means that fees are set in a competitive market environment, unlike credit card interchange fees that are set collectively by scheme members.

CML would also point out that as a relatively recent new entrant, our own bilateral network access fees have varied in recent years both up and down. The criticisms made of bilateral fee setting arrangements are more applicable to the alternative of multilateral fee setting, which have been observed in the context of credit cards to be less flexible and less competitive.

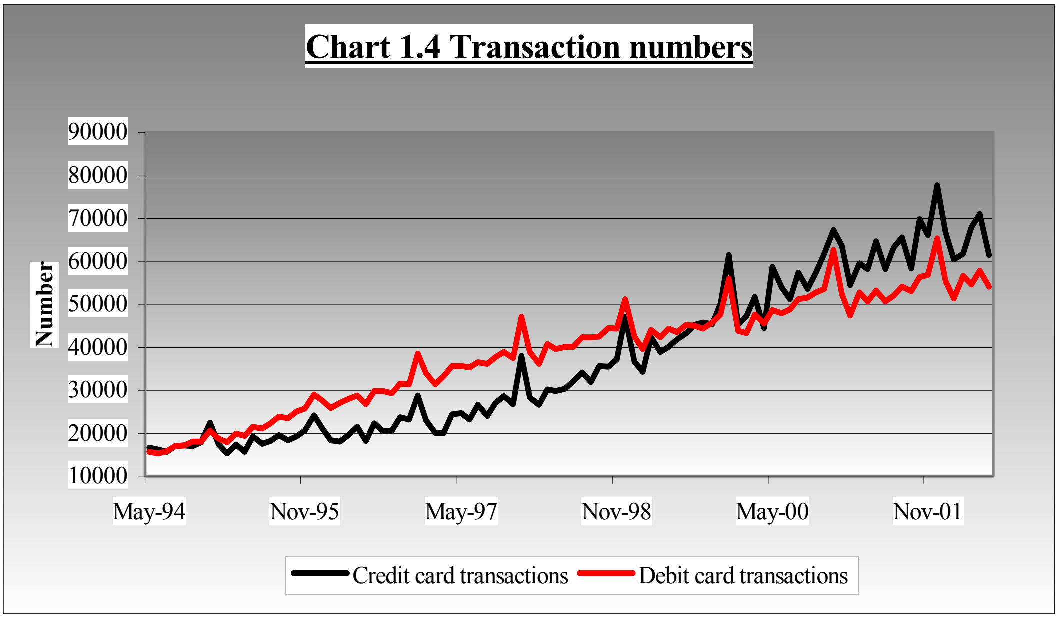
"Direct network access is linked to successful negotiation of an interchange arrangement, which includes an interchange fee, with each counterparty issuer or acquirer."
And
"This structure leads to difficulties and inefficiencies in negotiating bilateral interchange arrangements due to market and network structures."

The issues that arise concerning access to the EFTPOS payments system are not adequately addressed by debating the pros and cons of bilateral and multilateral fee structures. The issues concerning access to the EFTPOS payments system are driven by the obligations of participants to connect to other parties wanting access to the system, and providing incentives for new card acquirers to enter the market. The setting of a standard fee or no fees does not provide an existing participant incentive to allow new card issuers connection to the system, nor does it provide incentive for new card acquirers to enter the market.

"There is potential for shifting of issuer and consumer incentives away from promotion and use of EFTPOS, particularly relative to credit cards."

The incentives for issuers and consumers to shift away from EFTPOS have more to do with the structure of the credit card payments system than they do with the interchange arrangements currently in place for EFTPOS transactions. Indeed up until the introduction of loyalty programs EFTPOS debit was more widely used than credit, as illustrated in chart 1.4 below.

Credit cards have been recognised as having a significant pricing distortion effect on the payment system in Australia. Whilst these pricing incentives have led to a significant increase in the use of credit cards, it is important to note that debit cards still maintain strong customer acceptance and use. Once these pricing distortions are removed, it is expected that there will be a shift away from credit cards to other tender types including debit cards.



Source: Reserve Bank of Australia, Bulletin June 2002.

"There is an apparent lack of consistency between EFTPOS payment interchange fees and those for other retail payment types."

The existence of inconsistencies does not mean that the interchange fees for EFTPOS transactions are inappropriate. CML believes that the providers of payment system infrastructure ought to be recognised by way of payment of a fee by those parties accessing and utilising the network.

There are in fact some parallels with the current credit card interchange arrangements. Under the current credit card arrangements issuers have lowered their fees by 40 basis point which represents a 33% reduction on the standard interchange rate where transactions are processed electronically via a terminal or pinpad. This equates to a $0.40 fee reduction on an average credit card transaction of around $100, nearly twice the current debit card interchange fees.

The inherent nature of EFTPOS requires a robust, secure, online network to facilitate access to customers' cheque and savings accounts. As previously stated, current EFTPOS fee arrangements are consistent with other network arrangements such as those in place for ATMs.

The RBA, in its consultation document for the reform of credit card schemes in Australia, has stated that "The Reserve Bank acknowledges that interchange fees can have a role in credit card schemes, as a means of enabling issuers to recover the costs of providing specific credit card payment services that are of benefit to merchants."[5] CML would argue that fees payable for debit card transactions to the acquirer and to some merchants are justified on the basis that acquirers and retailers should be able to recover costs in the provision of debit card services from which card issuers derive significant benefit. We believe that the payment of fees to the network owners is a justifiable contribution to the operation, maintenance and development of the network.

[5] "Reform of Credit Card Schemes in Australia – A Consultation Document", Reserve Bank of Australia, December 2001.

2.2 Options Paper Objectives

The options paper proposes a number of objectives that should be considered when evaluating alternative interchange arrangements. The following is a discussion of the impact that proposed reform of EFTPOS interchange fees will have on those objectives.

Flexibility

It is agreed that interchange fees should be more representative of the costs involved in providing EFTPOS services, and should be flexible to change as the environment changes. The current range of EFTPOS interchange fees ($0.18 - $0.25) indicates a degree of flexibility in the fee structure. Low flat transactions fees are also more reflective of the costs incurred in processing debit transactions.

Customer acceptance

CML agrees with this objective. The current system has and continues to enjoy strong consumer acceptance. Coles Myer would point out that the EWIG proposals for EFTPOS would increase the costs incurred by merchants which would ultimately be passed on to all consumers in the form of higher prices. If the proposed changes and subsequent reductions in the fees payable by card issuers are not passed onto cardholders, then potentially the acceptance of EFTPOS as a form of payment will be reduced. Merchants may also resist offering EFTPOS facilities if their costs increase as a result of proposed reform.

Efficiency

Proposed changes will not be consistent with the objective of efficiency. Reforms will create a higher cost payment system, and will not provide incentives for further investment in improvements to the system. For example it has been proposed that the EFTPOS network could be used to provide deposit-taking facilities, in part to address concern with respect to branch closures, particularly in rural Australia. Changes to the directional flow of interchange fees would not provide an incentive for network owners to participate in such developments.

Competition

The objective of competition is tied to the accessibility of the network to market participants. The options paper does not give due consideration to the issues surrounding access to the EFTPOS payments system for either new card issuers or new card acquirers. Coles Myer would argue that any change to the current EFTPOS system that reduced the incentives for network owners to invest in the network would also reduce the incentive for potential new acquirers to enter the market.

Access

The fee setting arrangements of bilateral negotiation, multilateral setting of fees, or no interchange fees, discussed in the options paper, do not address the underlying issues of access to the network, and therefore should not be assumed to be solutions to the problem of access. Access is a function of the connectivity between market participants, not just about fee setting arrangements, and is discussed in more detail in Section 3 of this submission.

Sustainability

Proposed changes do not provide for sustainability of the EFTPOS network. As mentioned earlier, the proposed changes provide little incentive for some participants to invest in technological improvements or to invest in systems to maintain and improve efficiencies and security.

Practicality of implementation

CML agrees with the options paper in that any change must be easy to implement and should require a minimum amount of administrative requirements for it to operate effectively. However this objective should not form the basis of the review, nor should it form the sole basis upon which recommendations are selected.

2.3 Options Paper EFTPOS Reform Alternatives

The following section looks at the options for reform of the EFTPOS network put forward by the EIWG in its discussion paper.

2.3.1 Option 1: Bilateral interchange agreements

Bilateral interchange agreements currently exist in today's EFTPOS market, and contribute to promoting a degree of competition between participants in the setting of interchange fees. The RBA report showed that a range between $0.18 and $0.25 exists for interchange fees payable on EFTPOS transactions. This range in fees indicates the existence of a competitive market process for setting these fees.

The options paper states that a perceived problem with current bilateral arrangements is that bilaterally negotiated contracts lack flexibility and are rigid. It could be argued that in fact bilateral arrangements offer greater flexibility and less rigidity. The degree of negotiation, the timing and frequency of those negotiations are up to the parties concerned.

2.3.2 Option 2: Multilateral interchange fees

Multilateral fees, where an independent party sets the level of interchange fees, may in fact promote pricing inefficiencies. An arbitrary fee stifles competition, and discourages incentives for participants to set fees lower than the arbitrary fee.

Determination of a standard fee will also be difficult due to the varying costs of network participants. Those parties may also nominally increase their input costs to ensure that a standard fee does not disadvantage them, and is set at the higher end of suggested costs.

A multilateral fee structure also raises questions on how fee setting would be administered and managed.

2.4 Multilateral pricing methodologies

Option A: Issuer costs only

This option ignores the significant costs that acquirers and many retailers incur in facilitating and completing financial transactions for customers on behalf of the banks. Not unlike card issuers, retailers too incur their own costs. It should not then be expected that retailers should have to meet the costs incurred by card issuers, as well as their own costs.

Coles Myer has a high degree of involvement in the capture and processing of EFTPOS transactions, however all retailers are involved in at least some aspects of the transaction process. In doing so, retailers incur costs, that in today's EFTPOS model, are recognised to some extent, and are reflected in the fees paid and received by retailers for EFTPOS transactions.

Recognition of only issuer costs ignores the important and significant contribution of acquirers and retailers to the EFTPOS system. Recognition of issuer costs only would threaten future security upgrades required as part of the ongoing maintenance and development of the network.

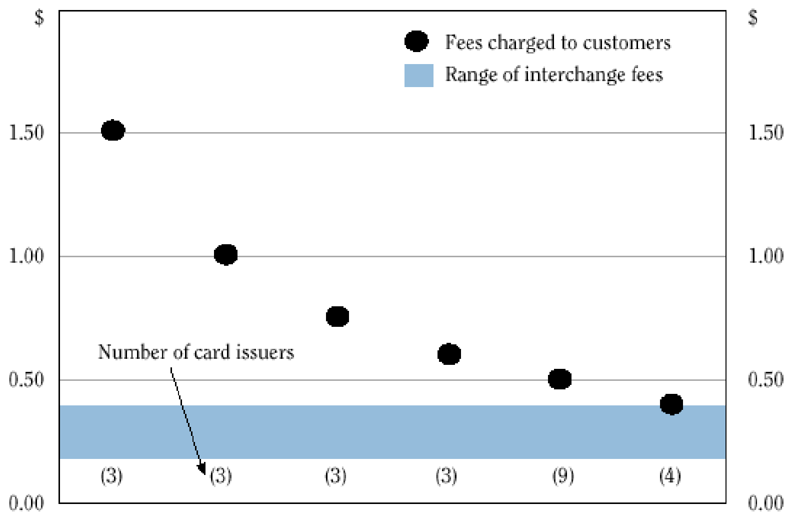
Option B: Acquirer costs

The options paper refers to fees payable to acquirers as leading to lower acceptance costs to merchants that may encourage merchant acceptance of EFTPOS transactions and greater investment in the EFTPOS network.

It must be remembered, that this structure was established by the banks, and that the banks have benefited significantly by being able to utilise the existing electronic EFTPOS network to also process their credit card transactions electronically, and to rationalise their branch network. Savings that retailers may have made in terms of reduced cash handling costs are negligible when compared with the savings from branch closures the banks would have made.

The options paper also states that cardholder fees may be higher than they would otherwise be due to the payment of a fee to acquirers. Figure 6.3 reproduced from the RBA Study, suggests that there are a number of factors that determine card fees paid by customers and that there is a wide range of fees paid by customers, with some issuers charging significantly more than the current range of interchange fees would otherwise indicate.

Figure 6.3: Customer fees for debit card transactions (after fee-free transactions)



Source: CANNEX Australia and information provided to the study

CML would also argue that it is unlikely issuers would charge lower fees to cardholders if they were not required to pay interchange fees to card acquirers. The current fee structure in fact results in lower costs to consumers as retailers are not required to recover higher bank costs through the prices charged for goods and services.

The card issuing market, as recognised by the RBA, is not a highly competitive market, and it is therefore most doubtful that these savings would be passed on to account holders in the form of lower account fees, transaction fees, or higher interest rates payable on account balances.

In many cases cardholders receive 8 free transactions before they incur transaction fees or in fact they pay no transaction fees for EFTPOS transactions. Banking services are typically bundled or packaged together so that the customer does not pay EFTPOS fees directly, rather these costs are built into the margins paid on other financial products. In these cases it is difficult to see how a 20 cent reduction in fees payable by issuers will be passed on to cardholders, and how in fact it would be possible to monitor the market to ensure that any fee savings were in fact passed on to cardholders.

Therefore it is likely that cardholders will continue to pay fees to the card issuer, and will pay higher prices for goods and services as retailers recover the higher costs imposed by the card acquirer.

2.5 Comments on the review process

The Voting Process

The options paper does not address the issues concerning how the decision making process will proceed, and how final recommendations will be determined. It is not known how resolutions will be passed, if a voting process will be put in place, and how in fact such a voting process will operate.

Review of Submissions

It is not known how the submissions lodged with the working group in response to the options paper will be reviewed, and the process for incorporating those views in a final document of recommendations for review by all stakeholders. Without representation on the working group, there is a danger that the views of consumers and retailers will not be considered in the review process.

Submissions from Working Group Members

CML believes that it is also necessary for members of the working group to lodge submissions providing details of their stance on the matter of the EFTPOS review. It is also necessary for these submissions to be reviewed by all stakeholders. It is not sufficient for members of the working group to pass judgement on the submissions of other stakeholders without making their own position on the matter known.

Scheme Based Debit Cards

International debit cards

As has been common in other parts of the world, proprietary debit card systems have gradually been replaced by scheme based debit cards which generate substantially more income for issuers. This in fact has recently been announced in the UK. In the UK, the Switch Card Scheme Board has agreed in principle with Mastercard Europe to convert all Switch debit cards to Maestro debit cards. CML understands that issuers of scheme based debit cards are paid a percentage based interchange fee, and retailers that currently accept Mastercard credit cards will be required to also accept those scheme based debit cards.

The payment of a percentage based interchange fee for what is essentially a transaction where the cardholder accesses their own funds, bears no relevance to the costs incurred in providing the transaction facilities.

Therefore the Australian EFTPOS review should be broadened to include the broad range of debit cards, as scheme based debit cards will be shown to be a less than ideal alternative to the current debit card arrangements. This inclusion should prevent any undesirable consequences of this payment card being introduced into the Australian market.

Visa Debit Cards

The RBA in their study into credit card arrangements have also highlighted the anomaly of what are ostensibly Visa branded debit cards. These cards operate from a customer's point of view as a debit card, but because of their Visa branding attract credit card interchange fees. Once again in order to fairly assess the proprietary debit card system in Australia, it is important that these alternative arrangements are considered by this review.

Part Three - Access to the System

3.1 The need for better access

The debit card issuing and acquiring market in Australia is dominated by the four major Australian banks as stated by the RBA. Restrictive access to the network both from a card issuing and card acquiring point of view is not conducive to creating a competitive and efficient market.

The RBA has stated that "Conditions of access are critical in determining the degree of potential competition in a market" and "High barriers to entry are likely to entrench the market power of incumbents".[6]

3.2 Impact of access restrictions

The options paper states that "Interchange reform options that move toward a more uniform and transparent interchange fee regime could help to address access concerns." CML considers that this would not be the case as connectivity, not interchange fees, has a greater influence on the accessibility of a system.

Setting a standard interchange fee does not address the issues of access to the EFTPOS payments system. The issue of access is concerned with the willingness of existing participants to provide access to new card issuers and acquirers. This is often a question of the competitive market positioning and IT development priorities of existing participants. If there are no financial incentives for an existing participant ie an ability to negotiate on interchange fees, then from our own experience, it is difficult to see how new entrants would gain direct access to these networks.

As with the reform of the credit card network, a key platform of reform is the opening up of the credit card system to allow new card issuers and new card acquirers to compete in the market with the existing players. It is doubtful that a new player would enter the credit card acquiring market without also participating in the debit card acquiring market. It is an objective of the RBA to increase competition in credit card

[6] "Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access", Reserve Bank of Australia, Australian Competition and Consumer Commission, October 2000.

issuing and acquiring, but this may not be possible if there is little incentive for new parties to enter the debit card issuing and card acquiring market as well. If acquirers are not paid a fee as compensation for their involvement and investment in the network, then there will be little incentive for new acquirers to enter the debit card acquiring market and consequently the credit card acquiring market.

Shifting the full cost burden of debit card processing to merchants will make EFTPOS less attractive for merchants, and less attractive for potential new entrants.

3.3 Access and the EIWG paper

The options paper put forward by the EIWG does not adequately address the issue of access to the EFTPOS network. It is incorrect for the working group to assume that "…a more transparent interchange fee regime could help to address access concerns". As previously stated deciding between a bilateral and multilateral fee structure will not solve access issues.

CML therefore recommends that a more detailed investigation of the issues surrounding access to the debit card network be undertaken. Rather than looking to debate the pros and cons of bilateral and multilateral fees, a solution to the issue of access would address many of the concerns held by the Reserve Bank.

Part Four – Impact of Reform

4.1 The impact of changing the current directional flow of interchange Fees

A number of issues would arise if the current reform proposals were implemented. These issues are discussed below.

Fees payable to card issuers

Card issuers currently charge account holders transaction fees, account fees, and earn revenue from the interest rate margins. Cross-subsidisation exists between account holders. Some account holders do not pay transaction fees, whereas other account holders pay fees when they exceed a given number of free transactions. Therefore, if the current interchange arrangements are eliminated or reversed, it will be difficult to evidence financial institutions passing on benefits to cardholders.

The current levels of customer fees are already in some cases significantly higher than the current range of interchange fees. This suggests that there are a number of factors other than the level of interchange that determine the level of fees paid by customers for EFTPOS transactions.

Increased costs to merchants

Card acquirers currently receive fee revenue from card issuers. Under proposed reforms this fee revenue will cease. Therefore card acquirers will only be able to recover their costs from merchants, resulting in increased costs to merchants.

To recover these increased costs, merchants will be forced to either reduce their margins (the average margin for retailers is currently only about 3%), or recover the additional costs from all consumers in the form of higher prices for goods and services.

As the RBA pointed out in its Impact Statement for the reform of the credit card payments system, " …because merchants have no alternative but to pass merchant service fees into the general level of prices, the costs are borne by all consumers…".[7] The same will occur if the directional flow of EFTPOS interchange fees is changed – consumers will pay higher prices for goods and services.

No Transparency

The current EFTPOS system is a transparent system, where fees are visible to consumers on their bank statements. Unlike the credit card payments system, fees are not hidden in the prices paid for goods and services. If reform proposals are implemented, increased costs to merchants will be passed on to all consumers in the prices paid for goods and services.

Contrary outcome to credit card reform

Contrary to the reforms being worked through for the credit card payments system, proposed changes to EFTPOS will result in additional costs for all retailers, service providers, higher prices for consumers, and a lack of transparency.

[7] "Reform of Credit Card Schemes in Australia IV, Final Reforms and Regulation Impact Statement, August 2002, Reserve Bank of Australia.

Part 5 – Conclusion

The payment of fees by issuers to acquirers, and in some cases larger merchants that perform the functions of an acquirer and own and operate their own network, is an appropriate contribution by those parties accessing and utilising proprietary networks.

In the case of the ATM network, those parties accessing the network pay the network owner a fee. The same principles should also be applied to the EFTPOS network.

The Australian EFTPOS system is a 'world class' payment system and we do not believe that the EIWG options paper has presented any compelling arguments for change.

The current system is:

- low cost
- secure and has very low levels of fraud
- based on sound 'user pay' economic principles
- has transparent fees to cardholders
- enjoys strong customer and retailer acceptance
- provides bank customers with low cost access to <u>their money</u> compared to other channels such as bank branches
- allows banks to provide access to their customers accounts whilst reducing their own branch numbers and costs.

Changing the current EFTPOS fee structure is likely to have significant number of negative impacts on the EFTPOS system as follows:

- acquirers will seek to recover lost revenue from all merchants
- higher fees payable by merchants will be passed on to all consumers in the form of higher prices for goods and services.
- it is unlikely that cardholders will receive lower fees from their banks
- there will be little incentive for new acquirers to enter the market.
- there will be little incentive for current market participants to upgrade and develop the network therefore threatening the viability and advantages of the current system.