



Submission to the RBA

Live Group, 20 July 2011



Executive Summary

The provision of EFTPOS terminals into the market has predominantly been the domain of the first and second tier banks and some building societies. This has meant that many SME's in Australia have either tried in vain to secure EFTPOS capabilities but been declined for a vast range of reasons or simply walked away from the provision of EFTPOS completely. We need to only look to the number of SME's in Australia, estimated to be some 1.426 million active SME's¹, versus 700,000 EFTPOS terminals deployed into 325,000 merchants². With a total of over 2 million registered businesses at best this means that less than 23% of businesses have EFTPOS capability. As a result limiting the current EFTPOS market to the realm of the major retail chains and the SME's that are able to pass the banks skewed criteria.

Assuming that an SME is able to secure an EFTPOS facility through a financial institution then the merchant is forced to endure significant cost for the privilege. Costs that include annual fees, monthly terminal rental, minimum transaction volumes in the form of a minimum MSF, transaction fees, supply fees, chargeback and query fees and a range of general account fees that result in the merchant paying in the vicinity of \$1,000 per year for EFTPOS capability.

The ability for these costs to be recovered is a critical element to many small businesses and the question is how to manage small business or low turnover environments in regards to the surcharging in an industry.

The taxi industry is one such industry where the definition of a micro merchant is applicable and the need to therefore have a service fee that reflects the cost of EFTPOS provision a critical part of maintaining EFTPOS capabilities in taxis. This submission explores the need to consider micro merchant and the companies that service this market further rather than to simply tar this group with the same service fee brush that might be currently considered.

It is easy to seek to make a decision on the recovery of costs based on some macro level view of what appears to be a fair and reasonable surcharge however consideration must be given to the merchant's size and therefore the real, not MSF, cost of EFTPOS provision. With 51% of all SME's turning over less than \$50,000 per annum the MSF quickly becomes the smallest part of the cost structure. A decision that removes that ability for full costs recovery (rental, fees, MSF, fraud, chargebacks and all other elements) will see EFTPOS provision move backwards 10 years and the ability for SME's to accept credit cards and maintain competition against the big box retailer paradigm diminish completely.

Any decision on surcharging by the RBA may have the potential to singlehandedly erase EFTPOS provision from SME's forever.

¹ Telstra business report

² <http://www.sefiani.com.au/news/eftpos-launches-first-advertising-campaign-in-23-year-history/>

Introduction

The RBA decision to investigate the current surcharging and service fee practices in the Australian market has wide reaching implications for the RBA, banks, large organisations, SME's and payment processors (aggregators, third party processors and ISO). While a number of questions have been posed by the RBA in relation to consultation on this issue it appears that there are some critical questions that have been omitted from the consultation.

As it stands the RBA has sought consultation on the following key questions:

1. Is there a case for modifying the Standards to allow schemes to limit surcharges?
2. Is a surcharge cap best implemented by the Board setting a transparent and specific permissible cap or should the Standards allow scheme rules to limit surcharges?
3. Should there be some level of tolerance allowed around any surcharge cap?
4. Is the merchant service fee an appropriate measure of the cost of card acceptance?
5. Should the no-surcharge clarify that, notwithstanding any surcharging cap, scheme rules cannot prohibit merchant from applying a surcharge?
6. Should the no-surcharge Standard require acquirers to pass on information about the merchant's costs of acceptance for each different car type?
7. Is there a case for disclosure of the cost of card acceptance by merchants?

While many of these questions provide scope for the ability for related parties to provide opinions and consultation there are several glaring omissions that need to be addressed as part of the consultation process. Specifically these include:

8. What is the definition of merchant versus transaction processing facilitator and what impact does this have on the price of merchant (or sub-merchant) processing?
9. Is it better to increase the penetration and breadth of EFTPOS capabilities or to limit the surcharging practices and potentially stifle or decrease EFTPOS penetration?
10. If banks have been able to apply margins to the interchange rate at what point is merchant surcharging considered excessive?

The answer to the omitted questions reveal more about what should be considered acceptable practice in the EFTPOS merchant landscape than the consultations questions alone. While answering the consultation questions will provide some context for the RBA Board to consider the surcharging debate it fails to factor in the broader issues faced by businesses. Already only 22.8% of all businesses accept EFTPOS and costs, difficulty in dealing with banks and the complexity of the process are all reasons for not providing a cashless solution. Anything less than full cost recovery and allowing the consumer then to exercise buyers choice will see even less businesses provide this valuable service to consumers.

The following document explores the consultation and omitted questions by first exploring the EFTPOS market through a holistic lens focused on the true market dynamics and characteristics. This is achieved by examining:



- The merchant landscape
- The true provision cost cloud
- Natural forces driving the schemes and banks
- Consumer behaviour

Each of these 4 elements combine to provide a holistic picture of what would appear to be a simple, manageable and appropriate model for the RBA to consider regarding the surcharging practices in the Australian EFTPOS environment.

The merchant landscape

Understanding the merchant landscape is the most important element to consider before any surcharging position can be reached. The current merchant landscape looks something like:

- Approximately \$360 billion in credit and debit card transactions per year;
- Approximately 750,000 EFTPOS terminals in the market;
- Approximately 325,000 merchants.

Based on the above numbers it is fair to assume the profile of the Australian market can be defined with an average turnover per terminal of \$480,000 per year and an average merchant turnover of \$1.1 million per year. This is consistent with the categories defined by East & Partners (2010) report of a large merchant being one with a turnover of \$530 million per annum and a small merchant is between \$1 million and \$20 million. Basing decisions regarding the cost structure of all merchants on the current paradigms significantly skews the emphasis on major retailers and further increases the cost pressures on SME's and new merchants.

There is a significant gap between the categories of East & Partners and the reality of the market. Consideration must be given to defining merchants and terminals where turnover does not compare with the current averages. In fact, with only 22.8% of businesses covered with an EFTPOS solution there are companies that fall well short of the current market paradigms and need a different lens when considering the cost of EFTPOS processing.

It is recommended that any consideration by the RBA relating to appropriate surcharging broaden the definition of businesses to include organisations that fall at the smaller end of the criteria where the cost of EFTPOS provision is a significantly higher percentage of the sales price. This granularity and appreciation of the subtlety of the true costs of SME's will ensure that the penetration of EFTPOS provisioning continues to grow and the primary consideration of the RBA, prevalence of EFTPOS without surcharging profiteering, continues.

Below is a model for the categorisation of merchants and appropriate surcharging principles that can then be applied to each category. This ensures that merchants are not disadvantaged when the cost consideration of EFTPOS provision is higher due to the lack of economies of scale, buying power or the lower than typical transaction volume.

Category	Description
Micro merchant	Generally non-employing business, low turnover (less than \$100,000 per year) with a single terminal (therefore less than \$100,000 per terminal) only used occasionally and provided more as convenience to customers. Unlikely that this segment can deal with a bank directly and therefore will need a third party processor and/or aggregator for assistance
Meso merchant	An employer of one or a few staff with low turnover (less than \$200,000 per year) but may have more than one terminal (therefore less than \$100,000 per terminal) used consistently and provided due to the demands of customers. Unlikely that this segment can deal with a bank directly and therefore will need a third party processor and/or aggregator for assistance
Macro merchant	An employer of several staff with reasonable turnover (less than \$500,000 per year) with multiple terminals (still likely to be less than \$100,000 per year per terminal) used regularly and provided due to customer demand. Unlikely that this segment can deal with a bank directly and therefore will need a third party processor and/or aggregator for assistance
Small merchant	May or may not be an employer of staff but has a reasonable turnover (less than \$1,000,000 per year) with one or a few terminals (therefore likely to be in the order of \$250,000 per terminal) used regularly and provided as a requirement of a business this size. While could have a direct relationship with a bank still likely to consider working with a third party processor and/or aggregator for assistance
Medium merchant	Will be an employer of staff and has a reasonable turnover (over \$1,000,000 but less than \$20,000,000 per year) with multiple terminals (however still likely to be in the order of a minimum of \$1,000,000 per terminal) used regularly and provided as a requirement of a business this size. Most likely has a direct relationship with the bank but still not of a size where terminals would be purchased and managed internally
Large merchant	A relatively large employer of staff with significant turnover (between \$20,000,000 and \$300,000,000 per year) with multiple sites, multiple terminals and integration into POS and other in house ERP systems (which also means per terminal turnover of \$2,000,000 per annum as a minimum) with terminals as a necessity of doing business and expected by customers. In fact, not providing EFTPOS would not be acceptable to the target customers. Will either have a direct relationship with a bank for terminal provision or will take a leap and seek to in house this as part of a broader strategy.
Mega merchant	As a segment this counts for by far the largest slice of the current annual turnover of credit and debit cards. These are very large employers within the economy and turnover in excess of \$300,000,000 per annum. There are multiple sites with multiple terminals but the sheer size of the business means that annual turnover per terminal is very significant. Most likely these businesses will run their own terminal fleet and potentially even their own switch which means the cost and control rest entirely with the merchant.

The true provision cost cloud

Understanding the true cost of EFTPOS provision is a critical element in determining a reasonable and sustainable surcharging policy. While much of the discussion appears to focus on the MSF charged on each transaction this is solely a self-fulfilling prophecy of the schemes and banks to portray a reasonable and acceptable position to the RBA regarding the cost of processing a transaction. Interestingly the schemes and banks never seem to answer the very simple question of how do merchants actually process transactions and the costs associated with this activity.

Could a merchant process a transaction with some form of hardware? Without power for the EFTPOS terminal to charge or run? With no communication to send and receive the messages required to authorise a transaction? Can the terminal provide customer and merchant receipts without paper rolls? Will chargebacks and query costs be covered by the customers?

All of these questions have been conveniently ignored in much of the communication that has played out in the public arena since the RBA announced the current consultation process and have left the general public under the perception that the MSF is the single largest and all encompassing cost for EFTPOS transaction processing. If we are to follow this train of thought then it appears that the schemes and banks are entering into the free provision of all hardware, software, communications, support and supplies. However this scenario is as unrealistic as a scenario that factors in only the MSF cost as the basis for surcharging.

So what are the other real costs and what impact does this have on a merchant?

The costs include, but are not limited to, the following:

- Terminal rental - \$360 to \$500 per annum
- Minimum transaction revenue - \$240 to \$360 per annum
- Annual merchant facility fees - \$400 per annum
- Terminal supplies (paper rolls and other supporting requirements) - \$60 to 400 per annum depending on transaction volume
- Chargeback and query fees - \$210 to \$420 per annum assuming half to one per month
- Support costs such as staff training time, electricity, troubleshooting and any other costs associated with having EFTPOS functionality

Total costs of EFTPOS provision for one terminal alone can be estimated to be \$1270 for the average business. This cost is per merchant for the first terminal and while additional terminals will only result in an increase of an additional \$870 (as the annual merchant fees are a fixed) even the amortisation of the fixed costs keeps the per terminal cost at \$1,000.

What does this mean for each of the categories that have been defined above when considering the cost per transaction?

At the mega and large merchant levels the answer is very little. The ability to process significant volumes of transactions ensures that the business can absorb or amortise the EFTPOS provision cost



over a very large based of transactions. Effectively, at turnover greater than \$20 million per annum the business can claim that the cost of transaction processing is close to equal the cost of the MSF including all other elements described above. This is consistent with the views expressed in the RBA Consultation request and appears to be supported by the essence of the East & Partners findings. The real question is how does the cost of provision impact at the micro, meso, macro, small and even medium merchant levels. The table below highlights the cost of EFTPOS provision as a percentage of the businesses turnover. The costs include terminal rental, annual fees, chargebacks, fraud, R&M and any other appropriate charges for the provision of a terminal. Transaction mix has also been based on 50% being Visa and MasterCard, 30% American Express and Diners, and 20% debit.

Annual turnover	5,000	25,000	50,000	100,000	200,000	500,000	1,000,000	5,000,000	20,000,000	100,000,000	300,000,000
Monthly turnover	417	2,083	4,167	8,333	16,667	41,667	83,333	416,667	1,666,667	8,333,333	25,000,000
Annual cost per terminal	788	820	861	941	1,103	1,586	2,393	8,845	32,258	161,290	483,871
Merchant Service Fee	126	628	1,256	2,511	5,023	12,556	25,113	125,565	251,129	888,387	2,665,161
Merchant Partner costs	538	970	1,511	2,591	4,753	11,236	22,043	108,495	16,159	80,675	241,965
True cost as a % of turnover	29.03%	9.67%	7.25%	6.04%	5.44%	5.08%	4.95%	4.86%	1.50%	1.13%	1.13%

The above table demonstrates that micro, meso and macro merchants have a total transaction cost that is significantly more than the MSF alone. It has been assumed that the costs include the need for a third party processor, merchant partner or aggregator to facilitate the capability of processing. This is driven by the fact that the banks are reluctant to service customers that represent smaller volume to the business due to the inherent costs of servicing and managing a merchant. This has been recognised by the schemes with the development of the Merchant Partner or Aggregator models where businesses, such as Live TaxiEpay, exist to bring together the needs of the many into a single relationship. While this delivers cost efficiencies to the smaller merchants it does add to the total cost of service for customers. However, without this role there would be little to no chance of the smaller merchants electing to have EFTPOS capability in their business.

The question regarding profiteering from the surcharging of customers therefore must look at the holistic costs of the merchant and clearly merchants, or sub-merchants, that transact in the lower end of volume will find it difficult to recover the full costs of the transaction under any scenario as customers have a surcharge tolerance. However, this should be determined by market forces and the decisions of the merchant rather than through an artificially imposed surcharge cap for low volume merchants and sub-merchants. A cap that restricts the cost recovered will further inhibit what is a very low level of penetration into the market.

Natural forces driving the schemes and banks

It is often difficult to gain a real position of the market requirements when looking through the lens of the schemes and banks. This is through no fault of the organisations and in fact often schemes and banks are actively trying to encourage the broader acceptance of EFTPOS in Australia and to the smaller SME's. However, it is also difficult to manage the requirements of the smaller merchants that have specialised needs and often a higher service level requirement. The role of ISO's (Independent Sales Organisations) has played a part in closing this gap but has inevitably been relegated to be resellers and leaving the relationship with the bank.

As banks and schemes look to accurately price the cost of service we see MSF that are often in the high 1% range and even at the 2% mark with all of the additional costs to effectively price out the risk of smaller merchants that do not transact often. This has driven the price of EFTPOS provision higher and is really a natural progression of managing and maintaining the large institutions that are required to service the Australian banking requirements. To some extent the second tier of banking in Australia sees the more agile and entrepreneurial banks and building societies fill a market void with more flexible pricing, higher service and lower lock in requirements but this still falls short of the market needs.

Therefore, like many natural eco-systems, there is a role for the larger and more revenue risk averse organisations (big 4 banks), smaller more agile regionally based banks and building societies (second tier) and the agile and flexible Aggregators and Merchant Partners.

Aligning with the categories outlined above this means that the following relationships can be expected to be formed between providers of EFTPOS capability and business size:

- Big 4 banks – Mega, large and medium merchants with selective other merchants based on a broader bank relationship;
- Second tier banks and building societies – Medium and small merchants generally based on regional or location based drivers with selective other merchants based on broader bank relationship;
- Aggregators and Merchant Partners –focused on the micro, meso and macro level merchants with selective relationships with small and medium merchants, likely based on the growth of a customer over time.

Aligning appropriate relationships with appropriate providers ensures market efficiencies that maximise the reach of EFTPOS within the Australian market while optimising the cost position of each supplier to the market. Large merchants are unlikely to accept the higher cost of provision from an Aggregator or Merchant Partner and SME's are unlikely to want to deal with the complexity and lack of personal relationship offered by the bank level of infrastructure.



Consumer behaviour

There must be some credit given to the consumer and their likely behaviour where a surcharge is considered to be excessive. If a surcharge is seen as too high and the customer has alternative forms of payment then it must be fair to assume that consumer will elect to use an alternative method of payment that does not attract the surcharge costs. Often this will mean that the customer will select cash or bank transfer based method of payment however we should not discount the fact that the consumer may elect to not transact with the merchant at all. This very behaviour is the true market equilibrium provider of surcharge capping as business simply cannot encourage customers to walk away and therefore not capture the sale.

Consumers also calibrate their expectation of surcharging. This is based on the businesses size, the payment method and the industry that they are in. Micro, meso and macro merchants will be able to recover most if not all of the total EFTPOS provisioning costs as consumers accept the SME's have a very low propensity to be able to absorb the significant costs of provisioning. However, the concept that a mega merchant has to pass on any surcharge becomes more difficult to accept as consumers expect that this is a cost of doing business for major retailers and service providers.

Are there any areas where an exception or alternative view needs to be considered?

It is hard to imagine a scenario where consumers have not been informed of the fees associated with the transaction in advance and where they elect not to incur the costs cannot pay with an alternative method of payment. Provided the merchant has informed the customer and an alternative (generally cash or direct transfer alternative) exists the choice becomes the consumers to manage.

Conclusion

The above analysis of the industry and the true cost of terminal provision go a long way to answering the 7 questions for consultation proposed by the RBA review. Clearly, any surcharging that is limited by the schemes effectively represents only a very small part of the total cost of the provision of service. Allowing schemes to determine the level of surcharging will drive down the penetration of EFTPOS terminals and will result in many SME's continuing to elect to turn their back on credit and debit card processing and effectively further reduce the reach, support and potential for innovation in EFTPOS processing. Further, the Board setting a surcharge cap would represent some of the same dangers as schemes setting the level. While the Board can take a broader view of the industry the distance between the Board and the day-to-day industry management and costs makes setting of surcharge levels difficult and impractical.

Establishing the MSF as an appropriate cost of card acceptance would only lead to additional cost pressures on many SME's that transact at the lower end of the scale. As proven in the true cost analysis the higher the merchant's volume of transaction the closer the true cost comes to the MSF. However, for any merchant in the small and below categories this would represent a bottom line erosion that would further impact already tight margins. Either every consumer pays through inflated costs to offset the inability to recover transaction costs or a true cost model needs to be considered. Micro and meso merchants are unlikely to be able to recover the full cost and ultimately consumer behaviour, provided they have alternatives like cash, will drive the businesses decisions.

Increasing the power of the schemes or banks would further see a concentration of the breadth of service and support in the industry. Therefore, scheme rules should not be allowed to prohibit the applying of a surcharge or even set the level of the surcharge. While profiteering may from time to time appear this is best managed through the market forces that exist in this space as consumers seek alternatives.

Creating transparency in the channel either through schemes providing information or merchants sharing their costs may have a counterproductive effect on the MSF. Now merchants that might have otherwise secured better deals through negotiation or purchasing power could be forced to endure a highest common denominator approach as schemes and banks look to protect margins. Already this behaviour exists with certain schemes where the MSF is held higher than others with industry pricing used as the barrier to improving the MSF. Ultimately this hurts both the consumer and the merchant however the idea of sharing the MSF of others would likely further exacerbate this issue.

In the case of SME's the provision of EFTPOS becomes more of a service to customers allowing customers to have alternative to cash only solutions. It must be accepted that in such circumstances the surcharging may actually appear to be higher than what is a headline MSF often quoted. Rarely is it profiteering on behalf of the merchants and rather more of a reflection of the true cost of service to the consumer. Any decision by the RBA to cap surcharging in industries with micro, meso and macro levels of turnover (and even small and medium merchants) per terminal will effectively wipe out entire EFTPOS processing capabilities, reducing consumers to head back towards cash and see



schemes and banks alike lose hundreds of millions of dollars of transactions. While the role of the smaller merchant will rarely dictate the market trends they play a critical role in the holistic acceptance and value proposition of credit and debit card providers.

What does this mean for taxis?

One area where surcharge capping has been indicated is in the provision of EFTPOS to the taxi industry. While this has been a hot topic of discussion for some time the commentary has been based more on the perception of the service fee than on the facts of service provision. Deploying APCA approved terminals into mobile EFTPOS environments where there is a higher level of fraud, chargeback and damage risks comes at a significant cost. Some entrants have looked at the introduction of non-APCA approved devices to reduce costs but this only further increases the card not present transactions in the industry and the risk of fraud to the cardholder, schemes and banks.

The transient nature of the taxi industry coupled with the mobility and 24 hour requirements means that there are additional service, support and provisioning costs that are not incurred in many other applications. Add to this the lack of willingness by banks to deal directly with the taxi industry due to the nuances of the landscape and the cost to service quickly adds up.

Then there is the market dynamics regarding turnover and the category of merchant size the taxi industry falls into. The industry has an estimated turnover of \$1.1 billion dollars per annum with 75,000 registered taxi drivers in the industry, of which approximately 60,000 are considered active. Since the introduction of competition into the taxi market each driver is now effectively an SME with their own ABN who literally rents (bails) or drives on shared rewards (share of the night's revenue) and runs a small business for a 12 hour period of time each day. This means that each sub-merchant (driver) on average will process approximately \$20,000 per terminal per year, or is a micro merchant.

Using the cost structure identified for the true (or full) cost structure of EFTPOS provisioning this places the true cost at over 9.67% of the total transacted through the terminal. A removal or capping of the current service fee would see the cost pushed back to the drivers who are already struggling with the current level of turnover and the cost for operating a taxi. Any change to the service fee would immediately see the EFTPOS provision in taxis change dramatically and the consumers' ability to use credit and debit cards all but disappear.

The alternative is not a decision to cap or not cap, but do we want to continue providing EFTPOS solutions into the taxi industry. Already an estimated \$2.2 billion in cash is used in taxis each year, customers electing not to incur the service fee of 10%, therefore indicating that the decision is already being made by many consumers each day.

Over time, competition and efficiencies in the market may ultimately be the best way to reduce the surcharge of any single industry however with such significant variation in turnover levels and ability to absorb (or not as the case may be) the costs of provisioning it cannot be the RBA's, schemes or banks decision to limit cost recovery of a business.